

Responses to the exposure draft

An analysis of responses to the FASB/IASB proposals to change lease accounting



by Andy Thompson, Legal and Regulatory Editor, *Asset Finance International*



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Foreword from William G Sutton, CAE, President, ELFA



The Equipment Leasing and Finance Association (ELFA) is the trade association representing over 500 financial services companies and manufacturers in the \$521 billion U.S. equipment finance sector. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation in the U.S. and abroad. Overall, business investment in equipment and software accounts for 8.0 percent of the GDP; the commercial equipment finance sector contributes about 4.5 percent to the GDP.

Equipment leases finance all types of equipment to all types of companies but most importantly to small and medium-sized enterprises (SME). The SME sector is cited as the largest potential source of job growth needed to reinvigorate the economy worldwide. Access to capital and efficient use of equipment are the primary drivers for lease financing and not financially engineering off balance sheet transactions. The proposed Leases standard was intended to capitalize lessee operating lease obligations to improve transparency but the Exposure Draft goes much further than the stated objective. The proposal capitalizes payments that are estimates (not true liabilities), accelerates costs for lessees, creates a huge compliance burden for lessees and lessors, and changes lessor accounting in ways that will increase lease rates to maintain shareholder return targets. These factors result from choices made by the IASB and FASB beyond what is required to meet the stated objective.

Most comment letter respondents thus far do not agree with the proposed decisions made by the Boards. These far-reaching changes create a permanent charge to earnings and capital and will alter behavior of lessees and lenders/investors to such an extent that they may well have an extraordinary negative impact on the economy.

Accounting is not an exact science and we hope the Boards seriously examine the views and alternatives suggested by the comment letters. Many alternatives are based on sound reasoning and do not conflict with the objective of capitalizing true liabilities created by operating leases.

Your readers are stakeholders in this new accounting standard as lessors, lessees and/or users of financial statements – many ELFA members fall into all three categories. The negative aspects of the proposed rules can be changed as the FASB/IASB are requesting comment letters as part of their normal due diligence process. This process is not over--but time is running short! The views of stakeholders matter. We urge you to exercise your influence by writing a comment letter on the issues contained in the Exposure Draft.

For more information or to learn more about this project, contact Ralph Petta rpetta@elfaonline.org, who is coordinating the ELFA's activities in this matter. Also visit the Lease Accounting Project page on the ELFA website at www.elfaonline.org/ind/topics/Acctg/.

William G. Sutton, CAE
President, ELFA

Industry comments up to November 6, 2010

The exposure draft(ED) was released in August 2010 with a response deadline of December 15. As of November 3 a total of 26 responses had been posted. These early responses are likely to be a small proportion of those eventually returned, and their pattern may not be fully representative of the final position. Larger organizations tend to take advantage of most of the permitted response deadline.

The ED will apply to both real estate and equipment leasing. In this *Asset Finance International* update the analysis is concentrated on the issues most pertinent to equipment leasing. Some of the comments quoted below are in themselves focused on the real estate sector. However, they have been included, since the

accounting issues to which these relate will also be important for equipment leasing.

Most of the early comment comes from US-based respondents.

The check list below summarizes the pattern of early response, broken down by type of respondent and by the major emerging issues within the ED.

Some respondents have commented in a personal capacity and have not disclosed their occupations. These are included within “market analysts and others” in the check list. Those listed under “lessor interests” include lease brokers and advisers; and those capital equipment suppliers who appear to be focusing their comments on leases of their products, rather than commenting principally as lessees of other asset types.

The pattern of responses to November 6, 2010

		Lessor interests	Lessees	Auditing accountants	Analysts & others	Public bodies
Lessee Capitalization	Support	3	0	3	1	0
	Conditional support	3	2	1	1	0
	Opposition	2	1	4	0	0
Preferred lessor accounting model	Hybrid (as per ED)	0	0	0	0	0
	Performance obligation (PO)	1	0	3	0	0
	De-recognition (DR)	0	0	0	1	0
	Current rules	1	0	0	0	0
Preferred option for continuation rentals	Support as per ED	0	0	0	1	0
	Support on different basis	0	0	0	1	0
	Opposition	6	2	2	1	0

Lessee capitalization

The ED proposes that all lease agreements should be capitalized on lessees' balance sheet as "right of use" (ROU) assets with corresponding financial liabilities. This would replace the present rules where only finance leases (where the lessee assumes substantially all the "risks and rewards of ownership") are capitalized; and operating leases (i.e. all other leases) are off-balance-sheet.

Supporters

US capital equipment supplier Lubrizol supports the proposal, commenting: "We believe that the [proposed] new accounting model improves the reporting of lease agreements and reduces the ability of entities to structure economically similar agreements to gain different accounting treatment."

Private respondent Linus Low is another supporter: "I think the recognition of a ROU asset and a liability in the books of the lessee provides a more faithful representation of the economic substance of a lease arrangement than the existing finance/ operating lease accounting model...."

"The abolition of the distinction between finance and operating leases will significantly eliminate the problem of 'off-balance-sheet financing', and thus improve the financial reporting of lease arrangements, making it more transparent for investors and other financial statement users."

Auditor Rajnish Ramchurun suggests that lessee capitalization "will make leases ... consistently treated in financial statements and allow comparability for end users."

Opponents

US accountancy firm Cover & Rossiter comments: "The ED draws no distinction between small office copier, vehicle and postal machine leases that exist at nearly all entities and a very small number of massively complex leasing structures that have come into existence with a specific accounting treatment in mind."

"In attempting to cure the perceived inconsistency of treatment with a very small percentage of actual leases, the Boards will impose substantial conversion and ongoing costs on all entities."

The firm suggests that account users can glean the necessary information on major leasing

commitments from the disclosures already required in lessees' accounts: "...The current lease accounting rules ... are not perfect but they do ... provide a framework around a difficult topic...."

"In the overall small percentage of entities where there are large and complex leasing strategies being employed, financial statements are rarely taken at face value by those relying on them. Where those financial statements are being analysed, ... generally the wherewithal exists to employ individuals with the relevant expertise ... [to cut] through the accounting treatment to the substance of significant leasing transactions."

US accountant Alicia Boyd is another outright opponent. She comments: "In many instances, operating leases are utilized for vehicles, copiers, and other equipment. Reporting these leases on the balance sheet as an asset provides little, if any, added information to the reader of the financial statements. Further, the exclusion of these equipment leases would not sway the reader of the financial statements [in investment or lending decisions]."

"In fact, including operating leases on the balance sheet would seem to be deceptive to the investor or lender, as it gives the appearance that the lessee is utilizing an asset for most of the asset's useful life, when in fact, this is untrue."

Steve Harding, chief financial officer of US real estate lessor Transwestern Commercial Services, comments: "Current treatment and disclosure rules are adequate. Fundamentally I understand what the Boards are trying to achieve, but I am concerned about the complexity and subjectivity of the new proposed rules...."

"The impact that this will have on loan covenants will be profound and costly for the tenant to put in place....The costs are simply too great and the benefits too little to force tenants ... to apply this new accounting ... In the current state of our global economy, tenants cannot afford that additional burden. Now simply is not the time for this change."

Among lessee respondents, opposition is expressed by the Devereux Foundation, a US not-for-profit provider of special needs health and education services. "The recording of an asset and liability on the lessee's books unnecessarily grosses up the balance sheet and provides no greater

assistance to the financial statement reader than comparable disclosures in the footnotes would do. In fact ... it will draw unnecessary attention to the lease-related captions in the balance sheet and ... potentially divert the reader's attention from other important items."

Loftness, a US capital equipment manufacturer, comments that "Operating leases provide a means to acquire needed new equipment, machinery or vehicles ... where a company's balance sheet is not strong enough to add debt to the liabilities side." ...Banks and other financing institutions will inevitably include the ... operating lease liability in their calculations of ... loan repayment capacity while not [giving credit for the value of] the operating lease asset due to it not being available to them as collateral or equity.....For growth mode ... or start-up businesses, this is potentially a growth or survival killer."

Conditional supporters

Greg Klein, chief financial officer of US industrial company Inland Truck Rentals, commenting in a personal capacity, suggests an exemption for relatively small equipment leases. He comments: "...If a company leases its copiers for three years, there has to be an exclusion that allows leasing obligations that fall under some materiality threshold to be treated as operating leases [i.e. off-balance-sheet].

"Requiring these immaterial assets to be handled as an asset and liability would be overly cumbersome and not meaningful to the reader."

David Mirsky, co-founder of US equipment lessor Pacific Rim Capital Inc, comments on the same lines: "My average lessee is a Fortune 200 company who lease \$5m of equipment from us annually. Many of these lessees sign hundreds of schedules with us. [In the USA] there are millions of separate transactions done by thousands of companies."

"The burden of [compliance] ... will be very large and expensive, in many cases without adding transparency to the financial statements of such giant companies. Therefore, I believe that there should be some size or materiality consideration for such new rules."

Also responding on these lines is US real estate lessor Jackson Cross: "[We recommend] some materiality standard, either for individual leases or for the cumulative value. While compliance considerations may not be grounds for altering standards, common sense cost/ benefit analysis

suggests that tracking, adjusting and reporting on every piece of leased equipment, property or machinery would warrant a materiality threshold."

"In particular large, multi-location [lessee] operations, that currently delegate contracting responsibilities throughout the organization, will incur huge expenses to create the necessary tracking processes."

All accounting standards are in fact subject to an overriding materiality qualification, and this would apply to the proposed new leasing rules. However, this is generally interpreted as a very low threshold, and would not meet the concerns of some critics of the leasing ED.

US accountant Jeffrey B Kraut suggests that the Boards should consider applying capitalization to public company lessees only – which would represent a small minority of all lessee businesses.

Violation of covenants

Like some outright opponents of capitalization (see above), some of the conditional supporters point out that it will put some lessees in technical violation of loan covenants restricting overall leverage. For example, US accountant David L Wagner comments: "I partly agree with the Boards' assessment of costs and benefit ... I believe, however, that there is one potential cost that has been left out.

"What of the effect of recording significant amounts of debt on entities' balance sheets? Many of these entities will have debt covenants that include leverage and debt-to-equity provisions. The proposed statement will put hundreds (or more) of these entities in violation of their covenants ..."

"It is far from sure that a violation will be forgiven in today's climate, particularly if the debtor was already only marginally meeting the covenants and the bank is more interested in protecting its recovery options than in making allowances for the effects of new accounting standards that have overnight turned the entity into a violator."

"Thus the Boards put at risk an unknown number of jobs at a time when the global economy is struggling ... Is it worth the risk?"

Kraut makes a similar point: "Mathematically a company may now be in violation of debt agreements due to a change in accounting principles, but with no change in ... true financial conditions. Renegotiating covenants to exclude [this] effect may be difficult..."

Mirsky is also concerned about this aspect: "Loan

covenants will be violated, and unless they are changed, which will not happen rapidly for [SMEs] during these tight credit conditions, corporations will not be able to borrow as much money.”

US accountancy firm Milbern Ray suggests an exemption for SME lessees. It points out that for many such firms, the accounting adjustments required for presently off-balance-sheet operating leases could add significantly to their external audit costs.

Largely because of its concerns over the lease continuation proposals (see below), Swiss-based construction materials producer Holcim calls for more cost/ benefit analysis of the main lessee accounting proposals. It says: “We do not believe that the proposals are effective in addressing the concerns about the complexity of lease accounting and comparability of information. Furthermore, we are not convinced that the proposals result in information that is relevant to users of financial statements.”

“Since leases are so widespread, we believe that the IASB should further develop and field-test its thinking, and subsequently:

- better define what information users need;
- clearly distinguish between what should be recognized in the financial statements and what should be disclosed ...; and
- make a thorough assessment of the costs.

“We acknowledge that our recommendations may not be compatible with the June 2011 deadline that the Board has set for itself in this project. However, we believe that supplementary time required to make the final standard robust and worthwhile is a matter of months and not years.”

Other lessee accounting issues

- Amortization and expense profile

The Boards propose front-loading of lease expense recognition by lessees over the lease term, by combining straight line amortization (i.e. depreciation) with a front-loaded schedule of interest expense.

Dacourt Group, a US real estate lease broker and property manager, while supporting the principle of lessee capitalization, opposes the expense recognition proposal. It suggests instead a “mortgage annuity” type of approach where the front-loaded interest would be balanced by a back-

ended amortization schedule to produce a level profile of overall expense.

Dacourt comments: “With the ... proposed amortization method, when renewal options are initially predicted and the prediction is not accurate, lessees will then have to recognize a large gain when the [contract] is abandoned. It seems illogical to adopt a standard that has the potential to produce such distorted outcomes.”

“The Boards concluded that straight-line amortization is appropriate because it is consistent with similar financial reporting for other assets. We recognize the importance of consistency in financial reporting, but the newly created ROU lease asset is different [from] many other assets. We believe it is appropriate to use an amortization method that ... accurately reflects the transaction's economics even if the ... method differs from ones used for other assets.”

- Leases under water

Bill Bosco of US lease advisory group Leasing 101 sums up the problem with the Boards' proposal and suggests a solution within the framework of the ROU approach.: “Using straight line amortization of the ROU asset makes the lease contract appear to be 'under water' immediately, since the book value of the asset amortizes more quickly than the liability.”

As the alternative, Bosco suggests: “Amortize the ROU asset at the same rate as the debt amortization. Accrue rent payable at the average of cash paid for rent. Link the lease costs on the profit and loss statement (P&L), and label the cost as rent expense. This approach more faithfully presents the periodic costs for the use of the asset.”

“In my opinion readers of financials expect to see rent expense in the P&L of lessees as an operating expense and expect the reported cost pattern to be straight-line. The reported cost of using a leased asset should not be different in the first month of a lease versus the last month of a lease as long as the asset is able to produce the same benefits.”

Mirsky comments on the same lines: “The [amortization] proposals will result in the largest charge to earnings in the first year of the lease with the charge decreasing over time. This does not reflect the parties' intent, nor does it match the cash flows of the lease, where the payments are level throughout the term ... We believe that it will sow confusion and simply not tell the story of the transaction that is occurring.”

US private respondent Mike Brown in effect expresses the same concern, but focuses on the tax timing differences that could open up under US tax rules as a result of front-loading expense for reporting purposes. He says: “The new lease accounting needs to be less complicated and must sync up with rent expense as required by the tax returns.”

The global accounting standard setters cannot address tax accounting rules. These are of course variable in individual countries. Depending on the reactions of tax authorities, in some jurisdictions the front loading of lessees' expense for accounting purposes could result in bringing forward the tax expense for rentals. However, in the US this seems unlikely.

Lubrizol, however, supports the Boards' proposals. It comments: “While the proposed expense pattern is a departure from the historical requirements of straight line expense recognition, we believe that this is the only approach that would fit with the new accounting framework.”

US leasing consultancy Mindthegaap is concerned that the proposed lessee amortization rules will distort the use of the “earnings before interest, tax and amortization” (EBITDA) measure of corporate performance.. Since it generally supports the ROU model, it proposes additional disclosure rules beyond those proposed in the ED to address this.

It comments: “As compared with [existing standards] a number of lessees will report increased EBITDA, because the rental expenses previously associated with operating leases will instead be reported as amortization and interest expenses. As EBITDA is an important performance measure for financial statement users, we ask the Board[s] to ensure that investors and creditors are appropriately informed – and approving of – the impact of the ED on reported EBITDA.”

“If the [amortization/ interest expense split] is ultimately adopted, we strongly recommend that lessees should also be required to present in the footnotes a sum total of amortization and interest expenses arising from leases. Such disclosure will provide useful information to investors about the total costs of [leases].”

- Impact on voluntary organizations

Devereux Foundation is critical of the Boards' expense profile proposals. It fears that for an organization of its type the pattern of its governmental funding reimbursements could be affected.

Other US respondents make the same point. Bosco comments: “Replacing rent expense with amortization and imputed interest expense will create issues with cost reimbursement in existing contracts and with existing government regulations. As an example, in the US Medicare will reimburse hospitals for non-medical equipment rent expense but there is no reimbursement for amortization and imputed interest expense.”

Alicia Boyd, who is based in Indiana, suggests that in that State there could be significant effects on Medicaid reimbursements to not-for-profit healthcare providers.

- Discount rate

Consistently with existing standards for finance leases, the Boards propose that the lessee's incremental borrowing rate be used for deriving the ROU asset valuation from the lease rentals and the interest expense profile.

Dacourt opposes this, suggesting a standard commercial discount rate for all lessees rather than variable rates reflecting the individual lessee's credit standing.

- Lease continuation periods

In contrast with existing accounting rules, the ED proposes (for both lessee and lessor accounting) that some lease continuation options should be accounted for as part of lease valuations. Entities would have to estimate the longest period for which an asset was more likely than not to be retained by the lessee, and treat this as the lease period. The expected outcome would have to be reviewed, and the accounting adjusted where necessary, at each reporting date within the lease period.

The bulk of responses to date are opposed to this proposal. Wagner comments: “Only the base period should be accounted for as an asset with a liability. The method suggested by the ED ... involves estimating the probability for each possible term for each lease.

“The cost of implementing and maintaining this method will far outweigh the benefits, particularly for large entities with hundreds (or possibly thousands) of leases. Whole new systems of internal control, data collection processes and software development will be required.

“Estimating a probability will introduce much subjectivity into the process, thereby reducing the comparability and usefulness of the information and ... there would be added cost ... to audit.”

Harding makes the same point. "Assuming we do have to apply the ROU model the term should only be for the stated/ fixed portion of the lease term and it should not include 'judgemental/ non-contract' assumptions related to whether a tenant is going to exercise a renewal option. The Boards today are concerned about similar leases being accounted for differently; and that will clearly be the case [on renewals]."

"I am concerned that tenants would have to disclose their renewal intentions, and [about] what that does to the whole landlord/ tenant lease negotiation Tenants could manipulate their balance sheets and earnings."

Holcim comments that "Rentals payable during an extension period under an option which has not yet been exercised do not meet the definition of a liability based on the Conceptual Framework [for convergence standards] as the lessee does not have an unconditional obligation to pay it."

Kraut opposes the ED proposal in respect of equipment leasing: "For other than rentals of real estate, taking renewal options into account for lease term is ill conceived..... As long as the footnotes disclose [extension option data], ballooning the balance sheet is inappropriate."

- Impossible to determine

As an equipment lessor, Mirsky argues that extension outcomes "are impossible to determine at the beginning of a lease. Any decision to capitalize renewals in advance will be purely arbitrary and not depictive of reality."

Dacourt opposes this proposal for all leases. It comments: "Unless the renewal option rents are at such bargain levels that the [lease] is certain to be renewed, then the [recognized] lease term should be the primary ... term."

Referring to longer term real estate leases, Dacourt adds: "...Assigning renewal probabilities is a highly uncertain endeavour.... It is highly unlikely in our opinion that longer term predictions could ever achieve even a 50 per cent accuracy rate."

Security Finance, a US commercial lender commenting as a lessee, makes the same point – and considers it relevant to both property and equipment leases. "A lot of circumstances can change during a 5-10 year real property lease that has an automatic ... renewal option clause. The confidence level of predicting the probability of [subsequent renewal] on a new operation or piece of equipment at inception is extremely low."

Bosco makes a similar point: "One company I worked with said that virtually all its [continuation option] estimates in its 13,000 real estate leases will be wrong one month after inception ...

"Estimated [non-bargain] renewal options ... are not liabilities of the lessee at lease inception. They should not be capitalized, because they do not meet the definition of a liability since the lessee controls the obligating event - that is the exercise of the option."

Jackson Cross is equally critical on this point. It comments: "Many major leases may have three or more options to renew. Under the proposed standard, a business may need to determine whether [it] might exercise an option 10, 15 or 20 years from [inception]. Those options may not ever become obligations, and to value them as a future liability and/ or an asset is to misrepresent the true financial position of the company to users of financial statements."

"The resulting restatement or adjustments for guessing wrong will impact future earnings on a quarterly basis. For companies with hundreds or thousands of leased locations, the constant adjustment would make every quarterly report an exercise in manipulation."

- Add to the complexity

US retail property lessor West Acres comments: "The proposed rules would add greatly to the complexity of [financial reports], while decreasing their usefulness and eroding trust in the statements." Although this comment is formulated in general terms, it seems to be focused on the proposals for continuation periods, as well as other proposals from the Boards affecting contingent rentals."

Private respondent Mike Kurker comments: "I question whether management would have a propensity to cite cost/ benefit factors as a rationale for not diligently applying the requirement [for reappraisal of continuation options at each reporting date], something that would completely defeat the intent and purpose of the measurement component of the required standard."

Klein, however, broadly supports the ED proposal. In doing so he focuses on real estate leasing, commenting: "The current rules ... are misleading and do not report accurately the true nature of many real property lease transactions...."

"Most [lessees] are going to end up paying significant lease payments relative to fair market

value (FMV) of the property over the period of the lease ... At the end of the lease term the lessee could decide not to renew but only at that time would I conclude that the lease is not going to be [continued].”

- Purchase options

The ED proposals in respect of non-bargain purchase options (NBPOs) – i.e. lessees' options to purchase assets at the end of a lease period, for a more than nominal exercise fee - are regarded by some as inconsistent with the continuation period proposals. It is proposed that purchases under NBPOs be accounted for only as and when the options may be exercised.

Due to VAT factors – and, in some countries, the fiscal depreciation rules in business income taxation – NBPOs are not common in European equipment

leases. They are, however, common in asset finance in some other jurisdictions. They can also be used everywhere in consumer finance (e.g. personal contract purchase in the car market), though lessee accounting will not be relevant in that case.

Lease broker Rick Hall is critical of the ED proposal on NBPOs. He comments: “My issue relates mostly to equipment financing using a traditional FMV type lease. These lease are used today most specifically to move off balance sheet the true economics of the financing arrangement.”

“The most common end of term [outcome] is an eventual buyout of the lease ..To ignore this 'more likely than not' payment in the valuation of the lease obligation is to perpetuate the current failure to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions.

Lessor accounting

The choice of model

The ED proposes a “hybrid” model for lessor accounting. Where lessors retain “significant risks and benefits” on the asset, they would have to account under the performance obligation (PO) model. This would involve recognizing both the underlying asset and the lease receivables on the assets side of the balance sheet – and a liability representing the obligation to make the asset available to the lessee. A netting presentation would prevent inflation of the overall balance sheet number resulting from the duplicated recognition of part of the asset value.

In other cases lessors would use the de-recognition (DR) method. The asset would be divided into the lease receivables and a “residual asset” (RA) corresponding with the conventional concept of residual value (RV). There would be no liability specific to the lease.

Bosco strongly supports the DR alternative for virtually all leases: “The PO method does not comply with the basic premise that an ROU has been transferred and the lessee is obligated to pay rent for the estimated term of the lease.”

“If there is a lessor performance obligation that remains unfulfilled and its risk of performance is so high that it precludes the lessor from de-recognizing the value of the asset transferred, then no receivable should be recorded by the lessor. Likewise the lessee should not capitalize the lease....”

“The lessor PO versus DR lease classification criteria as proposed are not the [true] indicators of when a lessor has a performance obligation ... The DR or a

modified DR method is appropriate for all leases. This is based on the basic premise that a lease transfers the value of the right to use an asset from the lessor to the lessee.”

UK accountant Gary Pickard argues that DR is the only approach to the lessor side consistent with the ROU model for lessees: “The PO approach requires that the underlying asset is recognized as an asset twice in balance sheets [of lessor and lessee] ... This would be counter-intuitive to users of financial statements if a ROU approach is to be consistent.”

“On the other hand, the DR approach would mean that the underlying asset is removed from the lessor's balance sheet .. The 'right to receive lease payments' debit in the lessor's balance sheet would correspond with the 'liability to make lease payments' credit in the lessee's balance sheet. These aspects would be consistent and would be simple to understand [for] users of financial statements.”

Mindthegaap takes the same position. It argues: “The PO approach is inconsistent with the proposed approach to lessee accounting ... The lessee will record a ROU asset representing the right to use an underlying asset over the lease term. It logically follows that the lessor must have given up some of the economic benefits associated with the underlying asset (or exchanged those benefits for [the lease] receivables). This exchange is faithfully reflected in the DR approach....”

“The PO model overstates the sum total of the lessor's and lessee's assets because the carrying value

of the lessor's underlying asset overlaps to a large extent with the economic benefits that are represented by the lessee's ROU asset."

The hybrid approach

Linus Low suggests that the hybrid approach, through retaining some of the "risks and rewards" approach of the existing standards, is fundamentally at odds with the Boards' concurrent approach to another convergence project addressed to Revenue Recognition; and calls for a rethink. While he argues that the DR alternative is more inconsistent in this respect than PO, he takes issue with the approach.

Low says that the lessor accounting approach "seems to be conceptually inconsistent with the paradigm shift from a 'risks and rewards' model to a 'control' model that the Boards have recently proposed [in the draft Revenue Recognition standard] .. For conceptual consistency, lessor accounting should be based on the same model as revenue accounting. It perturbs me that the Boards are retaining the 'risks and rewards' approach for lessor accounting while transitioning to the 'control' model for revenue accounting...."

On the proposed DR model, Low comments: "I question the relevance and usefulness of retaining a 'residual asset' in the statement of the financial position when the lessor determines that it no longer retains significant risks or benefits in the underlying asset."

Ramchurun supports the DR alternative – but also strongly agrees that the lessor side proposals seem inconsistent with the conceptual basis of the project. He says: "Alternative treatments [based on] 'significant exposures to risks and benefits' ... remind us of the old phrase 'significant risks or rewards' used to distinguish finance and operating leases, [so] we are not going towards a consistent framework...."

"In my opinion only the DR approach should be adopted ... How can we create two assets in two financial statements – of the lessor and lessee – with only one physical asset?"

Low concludes: "I strongly urge the Boards to 'put the horse before the cart' and initiate a conceptual debate on the merits of the 'risks and rewards' model vis-a-vis the 'control' model ... This should be done in the context of the joint Conceptual Framework project.

"I am aware that the Boards are under tremendous time pressure to complete the projects under the Memorandum of Understanding (MoU) by June 2011. Notwithstanding this, it would be strategically myopic to sidestep difficult conceptual issues just for the sake of meeting aggressive project time lines.

"Conceptual inconsistency would not only defeat the purpose of current reforms to enhance the financial reporting standards, but would undermine the investors' confidence in financial reporting and the accountancy profession at large. ...I fervently hope that the Boards will not compromise sound principles for short term expediency in their ongoing work to revamp and converge the accounting standards."

Harding suggests retaining the existing accounting rules for lessors, on much the same grounds as he argues in the case of lessee accounting – i.e. that existing rules are adequate and change would bring unnecessary compliance costs.

Impact on the captives

In general, captive lessors will prefer to use the DR model. Under the Boards' proposals only this method will allow some sales profit - proportional to the value of lease receivables in relation to total asset value - to be recognized at inception by the manufacturer (or dealer) where products are sold on lease through a captive arm.

Bosco comments: "Much depends on the interpretation and implementation, but I see a risk that there will be many leases offered with lease terms shorter than the economic life of the underlying asset and with large residuals that will be classified as PO leases ... This means no sales-type profit recognition."

"Sales-type lease accounting allowed for a better pattern of revenue and tax deferrals on profits in the United States. This meant that lower lease rates could be charged by captives and dealers than third-party lessors. Lessees benefited but that will not be the case under the proposed rules as there will be fewer sales-type lease profit opportunities."

"Captives will be motivated to sell PO leases to third party lessors who will charge higher rates."

Amortizing the residual

Under the DR approach where lessors recognize a residual asset (RA), the Boards propose freezing the RA valuation throughout the accounting periods while the lease is running.

This has been criticized in that it does not allow for the "time value of money", which is inherent in the initial measurement in the discount to present value (PV) of the anticipated RV at the end of the lease term.

Bosco suggests a different approach: "Use [the] implicit rate in the lease to PV the expected RV and accrete the RA over the lease term.