A Better Approach to Lease Accounting

Fixing the Shortcomings of the Proposed Rules

By Kevin M. Lightner, Bill Bosco, David G. DeBoskey, and Sharon M. Lightner

Lease accounting based on a leased asset's "right-of-use" (the ROU approach) capitalizes the intangible ROU and its associated obligation at the present value of expected payments under the lease contract. This new ROU approach adopted by the FASB/IASB Leases Project had its origins in G4+1 papers written in 1986 and 2000. The project rose to an active level following the financial crisis of 2001/2002 (featuring Enron and WorldCom) and the passage of the Sarbanes-Oxley Act of 2002 (SOX). SOX mandated the SEC to identify off–balance sheet arrangements that could hide or obscure financial risk. In the SEC's 2005 report on off–balance sheet arrangements, operating lease obligations were identified as one of the largest off–balance sheet items (http://www.sec.gov/news/press/2005-91.htm). This prompted FASB to add the Leases Project to its agenda of convergence projects. Work began in 2006 and, thus far, has resulted in a 2008 exposure draft and a second exposure draft (ED2) issued on May 16, 2013, with a comment period ending September 13, 2013.

The joint FASB/IASB lease project has been controversial, largely because the boards' approach completely changes lease classification tests, expense recognition patterns, and balance sheet and cash flow presentation. These changes mean that preparers and key users (lenders, credit analysts, and equity analysts) will no longer have important information on operating leases (executory contracts) that is now available under current GAAP. In addition, ED2 proposes major changes for lessor accounting, but lessor accounting was not cited as having accounting and reporting deficiencies.

The proposed rules are complex; when compared to current rules, their application in practice might not adequately reflect the economic impact of a company's leasing policy. Because leasing is pervasive—for many businesses, it is the only practical means to acquire the use of necessary assets, including a retail location or office space—it is important to establish uniform and uncomplicated rules that improve the reliability and comparability of financial reporting. In the authors' opinion, although the boards made a concerted effort through outreach programs and consultations with experts and advisors, they did not accept feedback that could have allowed the project to be completed without going through a second draft. Feedback was limited because many lessees lack the resources to write comment letters, and there are far fewer lessors than lessees.

Because many controversial issues remain in ED2, the boards should expect to receive numerous comment letters raising valid issues that will require further work. If ED2 is adopted as is, the new rules will provide less useful decision making information than the current rules for both lessee and lessor accounting; however, a few key changes would make the proposed rules both workable and an improvement over current GAAP.

The ROU Approach to Lease Accounting

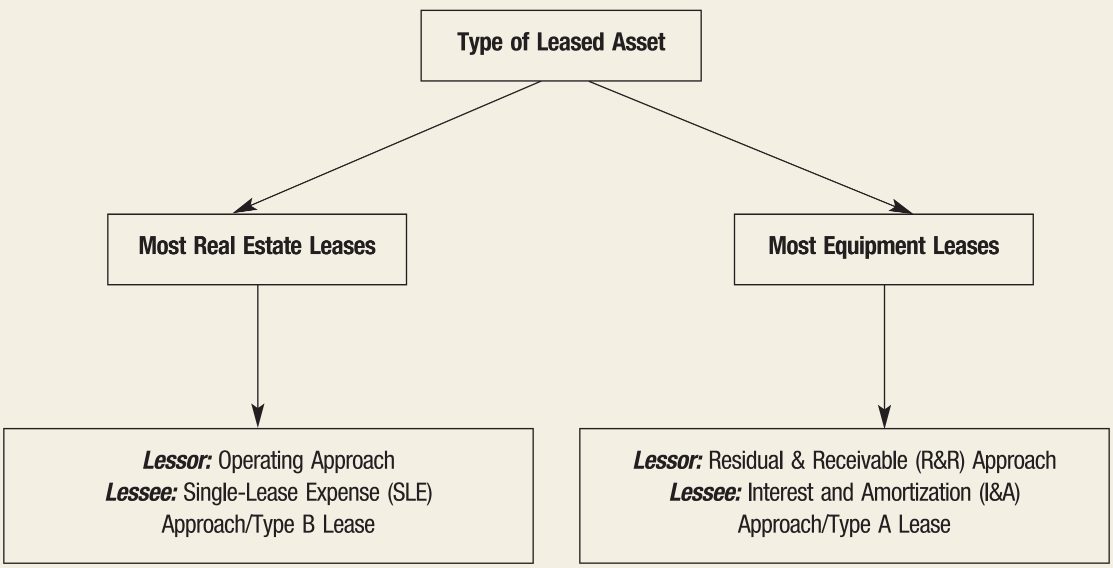
The ROU approach involves assuming that *all* leases transfer ROUs. Specifically, the intention is to account for rights and obligations arising from the lease contract. Initially, the rights and obligations are measured at the present value of the contracted lease payments. The boards described this as the best proxy for the value of the lease assets and liabilities.

Subsequent accounting involves independently accounting for the asset and liability, breaking apart the unified nature of the contract. For "Type A" leases (mostly equipment leases, whether capital or executory, and some real estate leases that have capital lease attributes), the asset is amortized on a straight-line basis and the liability is accounted for using effective interest amortization, which imputes interest expense. For "Type B" leases (mostly executory contract real estate leases and a few short-term executory contract equipment leases), the liability is accounted for using effective interest amortization, which imputes interest expense, while the amortization of the asset is a "plugged" amount that ensures a level total lease expense over the lease term.

The boards initially aimed to simplify lease accounting based upon the idea that all leases transfer ROUs. In the authors' opinion, this approach has some shortcomings. It is oversimplified; there are leases that transfer ownership rights that should be accounted for and reported differently in order to reflect their significantly different economic effects. All leases do not merely transfer ROUs; there is no step in the ROU approach to analyze the contractual rights and obligations and to separate leases by their legal nature—that is, either capital leases (rights of ownership [ROO] leases) or executory contracts (ROU leases).

The classification of leases by asset type—real estate versus equipment—does

EXHIBIT 1
Types of Leases under the Second Exposure Draft



not result in separating lease assets and liabilities by their legal nature. Capital leases create a tangible asset and debt that survive bankruptcy; on the other hand, executory contract leases (formerly operating leases) create unique intangible assets and liabilities (nondebt in bankruptcy) that only exist to a going concern. Capital lease accounting should separate the asset and liability (as it does in ED2) and treat them as any other asset or liability of that type. On the other hand, as opposed to the treatment in ED2, the executory contract lease accounting should allocate cost on a level basis as rent expense, whereas the asset and liability should be shown on the balance sheet at the best proxy for their value (i.e., the present value of the remaining payments). The asset and liability are inextricably linked, and the value of the liability and asset arising from the executory lease contract should be the same over the lease term, except for impairment, lessor concessions, and initial direct costs.

Details on Types of Leases

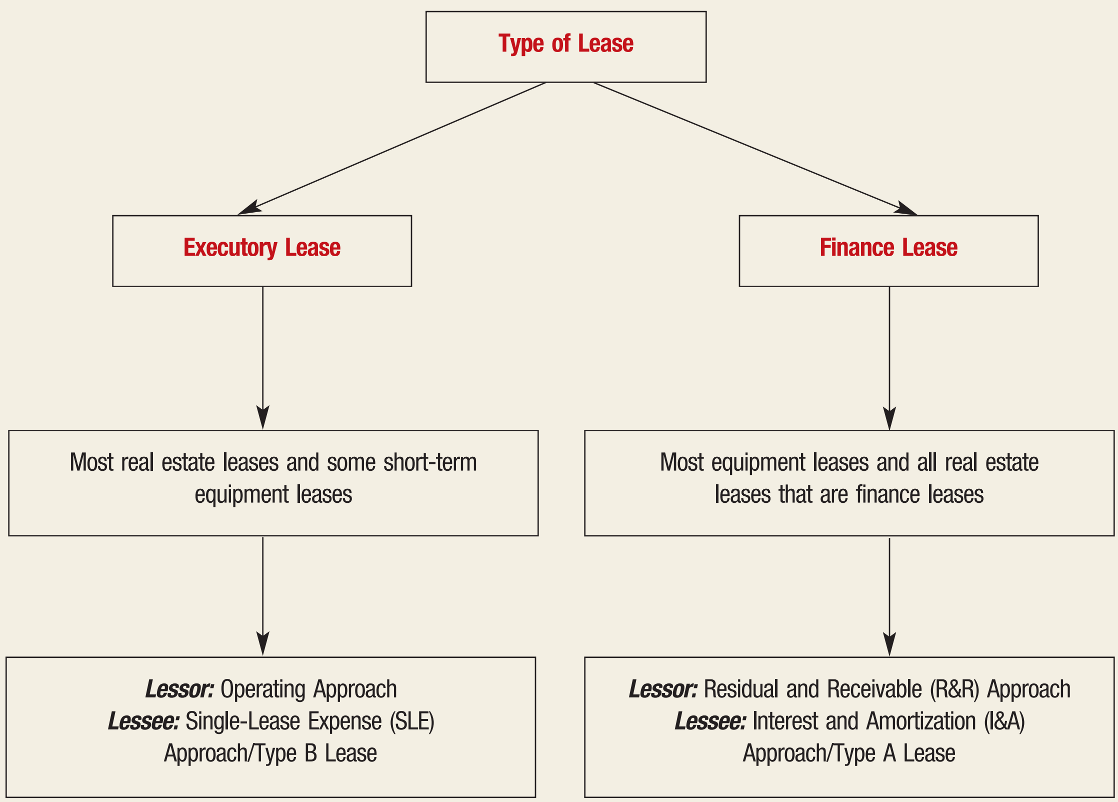
If only an ROU is transferred, it should be accounted for as a capitalized executory contract. Leases that transfer ROOs should be treated as either capital leases under the scope of the standard or specifically excluded from the scope and accounted for as a financed purchase. ED2 concluded that lease classification should be based primarily on the underlying lease asset type, and as such, ED2 categorizes leases as either a "Real Estate Lease" or an "Equipment Lease." As depicted in *Exhibit 1*—

> For real estate leases, the lessor will most likely use an operating lease approach, whereas the lessee will most likely follow a single-lease expense (SLE) approach. For equipment leases, the lessor will most likely follow a residual and receivable (R&R) approach, whereas the lessee will most likely follow an interest and amortization (I&A) approach. (Kevin M. Lightner, Bill Bosco, David G. DeBoskey, and Sharon M. Lightner, "Accounting for Leases under the Forthcoming Exposure Draft: Will Businesses Welcome the Guidance?," *The CPA Journal*, January 2013, p. 18).

This treatment requires the lessee to record an ROU asset but subsequently calculate the income effect as a front-loaded expense (I&A approach, or "Type A" approach) for an equipment lease, but as a uniform expense (SLE approach, or "Type B" approach) for a real estate lease. This approach does not consider the legal nature of the lease contract:

> In most cases, an ROU lease is legally an executory contract. The lessee acquires a temporary right to control the use of the underlying asset; it does not

EXHIBIT 2
Types of Leases by Substance of Lease Contract



purchase or control the ownership interest in the property. This temporary acquisition is designated as the ROU asset. The liability for making lease payments is not a financing arrangement, and as a consequence, is not equivalent to debt because the lessor has no claim on the assets of the lessee in bankruptcy. … The lessee must make its rent payments to obtain future use of the underlying leased asset's utility. Contracting the right to use an asset that requires ongoing performance (i.e., paying rent) is not the same as purchasing the underlying leased asset, because the ROU asset typically cannot be pledged or sold separately from the corresponding liability. (Lightner et al. 2013, p. 21)

ED2's requirement to use a front-loaded, Type A approach for equipment leases that are executory contracts gives the appearance of a financed purchase, where in subsequent accounting, the asset is separated from the its accompanying liability. This approach is contrary to the legal and economic substance of the lease.

The decision in ED2 to have two types of leased assets, each with different classification tests, lacks a common principle. The authors believe that there should be one principle for all leases, by lease type (executory versus finance/capital leases), regardless of the type of leased asset. This was included in the AAA Financial Accounting Standards Committee's commentary on the G4+1's "New Approach" paper: "The Committee believes that the nature of the asset under lease should not affect the accounting for a lease. In particular, leases of intangible assets and land should be treated in the same way as other leases" (*Accounting Horizons*, vol. 15, no. 3, September 2001, pp. 289–298). The AAA Financial Accounting Standards Committee's mission includes advising FASB on proposed rules.

The one principle for all leases should be to follow the legal view, so that the leases are accounted for according to their economic effects. A failure to differentiate executory contracts from capital leases means muddled information for lenders and analysts who need to understand the financial risks in a potential bankruptcy. Bankruptcy should matter in accounting for leases, as it does in accounting for other transactions, such as the transfer of financial assets.

In the author's view, the problem with ED2 is the advocacy of an accounting approach based primarily upon the type of leased asset, rather than the type of lease. *Exhibit 2* depicts an alternate approach with two types of leases based on an examination of the rights and obligations in the lease contract.

The current legal (Uniform Commercial Code [UCC]) tax (U.S. federal local property, and sales and use taxes), and accounting regimes in the United States are fairly well aligned in the view that some leases are executory contracts (operating leases) and some leases are financed purchases (capital/finance leases). Why should GAAP follow a completely different approach? Under current GAAP, a preparer can keep one set of books for all leases (for the most part) to satisfy all compliance and information needs. ED2's proposed standard will break the alignment and force preparers to keep two sets of records for accounting purposes and tax compliance, and provide information to help lenders and credit/equity analysts determine which leased assets are intangible or tangible, and which liabilities are executory contract liabilities versus true "debt" in bankruptcy.

The AAA's Financial Accounting Standards Committee recommended that the boards develop a conceptual framework

EXHIBIT 3
Right-of-Use (ROU) Leased Asset versus Capitalized Leased Asset

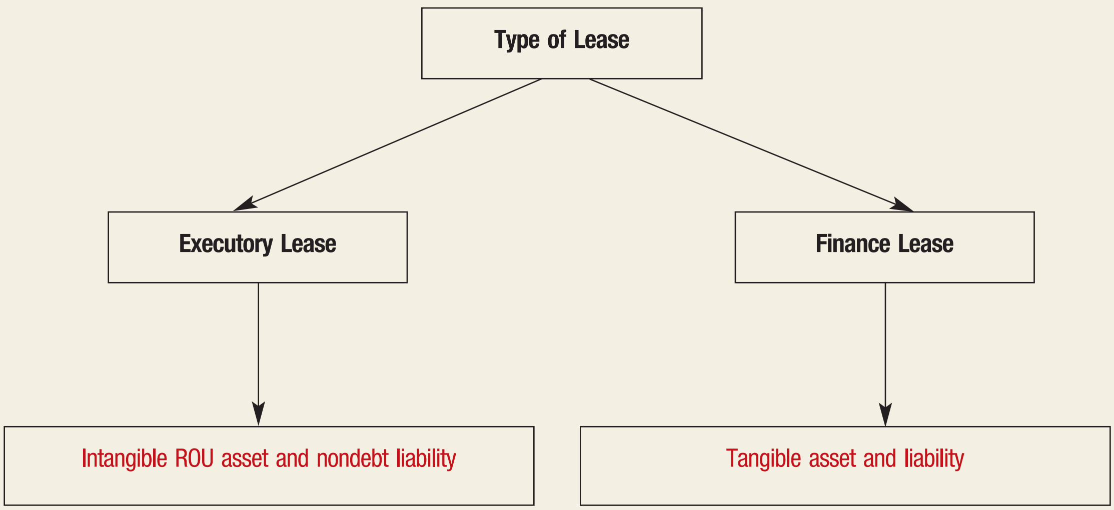
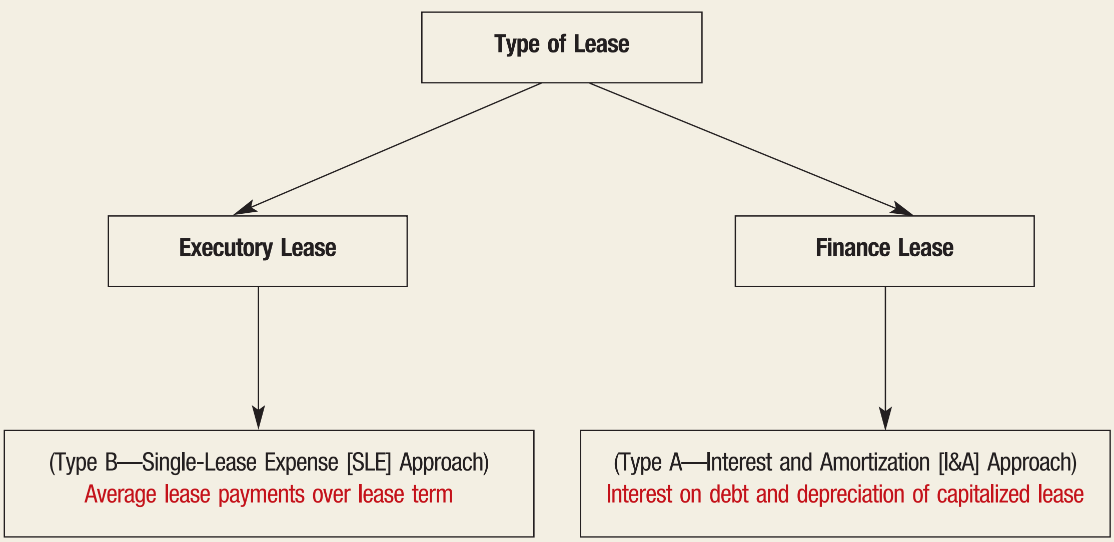


EXHIBIT 4
Lessee Cost Recognition over Lease Contract



for the capitalization of contracts (AAA 2001). In addition, the boards should reexamine the legal issues and economic substance issues that distinguish intangible assets from tangible assets and executory contracts from debt. In summary, the authors believe that the boards should amend their classification of leases by type of asset (i.e., Exhibit 1) to a classification based on rights and obligations created by the lease contract (i.e., Exhibit 2).

Lessee Balance Sheet Presentation

Under the new rules, operating leases will be the first executory contract to be capitalized. The nature of an ROU asset is that it is an intangible contract right. It is an asset to a going concern, provided the lessee continues to make payments to enjoy continued ROU, but it is not an asset in most bankruptcy scenarios.

Presentation and labeling should allow a user of financial statements to differentiate between assets and liabilities that may exist on a going concern basis but do not exist in bankruptcy. There is a growing concern about the lack of guidance on going concern, bankruptcy, and risk of bankruptcy, as evidenced by FASB's issuance of an exposure draft on June 26, 2013, *Disclosure of Uncertainties about an Entity's Going Concern Presumption*. Improving presentation and disclosures regarding the bankruptcy and going concern nature of lease assets and liabilities would be in line with the boards' stated objective of improving the usefulness of financial information.

A prospective lender to an entity does a bankruptcy risk analysis to determine the outcome of a possible bankruptcy. This involves identifying "true" assets and "true" debt of the entity that would compete with the new loan for claims on assets. As a result, debt analysts and lenders need more specific definitions of assets and debt, especially in reference to their standing in a bankruptcy.

In bankruptcy, the court rejects the lease if it is an executory contract and not essential to any planned operation of the bankrupt entity, or if the bankrupt entity is to be liquidated. This means the leased equipment is returned to the lessor, who is the legal owner of the equipment, and the lease is terminated so that no asset remains in the bankrupt estate (bankruptcy law views the ROU asset as undelivered future services) and no further liability exists to make lease payments. In other words, the contract rights and obligations disappear.

Because capital leases are legally purchases of the asset financed by debt, their treatment in bankruptcy is completely different than an operating lease/executory contract. This is the reason why lenders and analysts need lease assets and liabilities to be broken down by their legal nature, reported separately, and clearly labeled on the balance sheet. The solution in ED2, where the classification tests are different for equipment and real estate (see Exhibit 1) and where the classification tests are not aligned with legal classification tests, means that financial information regarding lease activities is not as useful as the information available from the reported operating lease obligations under current GAAP. The ED2 approach does not provide users with enough detailed information to adjust the reported numbers to get the information they need regarding the legal nature of leases.

The authors are not arguing that operating lease obligations should continue to be limited to the notes. Instead, the authors argue that, due to their unique nature, the capitalized operating lease (executory contract), which are ROU assets and liabilities, should be presented separately on the balance sheet. In other words, as depicted in *Exhibit 3*, if the boards would differentiate leases based on the substance of the contract, the intangible ROU asset and liability created from an executory lease and the tangible asset and debt created from a finance lease could be shown separately on the lessee's balance sheet. Failure to correctly label capitalized operating lease obligations as "nondebt" liabilities will also cause debt limit covenants to be broken. Those existing debt limit covenants were set by lenders with full knowledge of existing operating lease obligations; but lenders knew those obligations would not compete with their claim in a bankruptcy.

Lessee Cost Recognition

As shown in *Exhibit 4*, the cost recognition pattern will be different for leases that are capital leases and for those that are capitalized executory contracts (formerly operating leases). Capital leases are a debt obligation because the UCC and IRS view them as interest-bearing contracts and a purchase of the leased asset. As such, the delinking of the asset and liability for subsequent accounting is appropriate. As with any financed purchase of a depreciable asset, the accounting will entail recording depreciation and interest on the obligation.

On the other hand, operating leases are executory contracts because periodic payments are consideration for the right to use the asset for the period. Executory contracts are not interest-bearing contracts, according to the UCC and IRS. The asset and liability that arise from the executory lease contract are not separable. Their values should decline at the same rate and the best proxy for the value at any time is the present value of the remaining payments. The authors recommend a modified SLE approach for all leases that are executory in nature (see an example in the sidebar, *Recommended Executory Contract Lease Accounting Method*). This recommended

RECOMMENDED EXECUTORY CONTRACT LEASE ACCOUNTING METHOD (MODIFIED TYPE B/SINGLE-LEASE EXPENSE [SLE] APPROACH)

Accounting using the authors' recommended modified SLE approach is compared to the accounting under the proposed Type A/interest and amortization (I&A) method under the second exposure draft.

Assumptions	
Base year annual rent	$450,000
Annual step up %	10%
Payment timing	Arrears
Term in years	10
Inception month	January
Lessee incremental borrowing rate	8%
Present value (PV) of rents	$4,531,604

Lessee's Supporting Calculations for ED2's Type A/I&A Lease				
	Capitalized Lease Obligation Amortization			
Year	**Obligation Balance**	**Rent**	**Imputed Interest**	**Right-of-Use (ROU) Asset Amortization**
0	$ 4,531,603.89			
1	$ 4,444,132.20	$ 450,000.00	$ 362,528.31	$ 453,160.39
2	$ 4,304,662.78	$ 495,000.00	$ 355,530.58	$ 453,160.39
3	$ 4,104,535.80	$ 544,500.00	$ 344,373.02	$ 453,160.39
4	$ 3,833,948.66	$ 598,950.00	$ 328,362.86	$ 453,160.39
5	$ 3,481,819.55	$ 658,845.00	$ 306,715.89	$ 453,160.39
6	$ 3,035,635.62	$ 724,729.50	$ 278,545.56	$ 453,160.39
7	$ 2,481,284.02	$ 797,202.45	$ 242,850.85	$ 453,160.39
8	$ 1,802,864.05	$ 876,922.70	$ 198,502.72	$ 453,160.39
9	$ 982,478.20	$ 964,614.96	$ 144,229.12	$ 453,160.39
10	$ (0.00)	$1,061,076.46	$ 78,598.26	$ 453,160.39
		$7,171,841.07	$2,640,237.17	$4,531,603.90

Journal Entries					
ED2's Type A/I&A Accounting			**Modified SLE Approach**		
Capitalize the Lease			*Capitalize the Lease*		
dr: ROU Asset	4,531,604		dr: ROU Asset	4,531,604	
cr: Capitalized Lease Obligation		4,531,604	cr: Capitalized Lease Obligation		4,531,604
Depreciation Expense – 1st Year			*Accrue 1st Year Rent Expense at Avg. Rent to be Paid*		
dr: Amortization Expense	453,160		dr: Rent Expense	717,184	
cr: ROU Asset		453,160	cr: Accrued Rent Payable		717,184
1st Year Rent Payment			*1st Year Rent Payment*		
dr: Interest Expense	362,528		dr: Accrued Rent Payable	450,000	
dr: Capitalized Lease Obligation	87,472		cr: Cash		450,000
cr: Cash		450,000			
			Reverse Last Year's Lease Capitalization Entry		
			dr: Capitalized Lease Obligation	4,531,604	
			cr: ROU Asset		4,531,604
			Re-Book Capitalized Lease at PV of Remaining Payments		
			dr: ROU Asset	4,444,132	
			cr: Capitalized Lease Obligation		4,444,132

approach is much simpler than the proposed I&A and SLE approaches. The authors agree with the I&A approach for all leases that are not executory contracts, but rather financed purchases.

In ED2, the boards intend for most equipment leases to be Type A leases and appear as financing arrangements, irrespective of their rental nature. In their deliberations, the boards decided that a lease ceases to be an executory contract when the lessor delivers the asset to the lessee. But this opinion cannot be legally supported, and, thus, should not be a determining factor in the analysis. The boards ignore the continuing executory nature of the lease where the lessor has performance obligations over the lease term to keep the asset free of liens and ensure the lessee's "quiet enjoyment" of the leased asset. These continuing performance obligations may seem insignificant, but they are not insignificant under the law. The AAA Financial Accounting Standards Committee's comments cautioned the boards against an overly simplified one-lease model:

> The approach should be robust to shifts in the contractual details of lease contracts when such shifts do not materially alter the economic substance of the arrangements. In particular, the approach should

RECOMMENDED EXECUTORY CONTRACT LEASE ACCOUNTING METHOD (MODIFIED TYPE B/SINGLE-LEASE EXPENSE [SLE] APPROACH) *(continued)*

Stepped Rents Case: Comparative Financial Statements

ED2's Type A/Interest and Amortization (I&A) Accounting

Balance sheet	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
ROU* asset	4,078,444	3,625,283	3,172,123	2,718,962	2,265,802	1,812,642	1,359,481	906,321	453,160	(0)
Cap. lease obligation	4,444,132	4,304,663	4,104,536	3,833,949	3,481,820	3,035,636	2,481,284	1,802,864	982,478	(0)
Net Assets (Liabilities)	(365,689)	(679,380)	(932,413)	(1,114,986)	(1,216,018)	(1,222,994)	(1,121,803)	(896,543)	(529,318)	0
Profit and Loss (P&L)										
ROU asset amortization	453,160	453,160	453,160	453,160	453,160	453,160	453,160	453,160	453,160	453,160
Interest expense	362,528	355,531	344,373	328,363	306,716	278,546	242,851	198,503	144,229	78,598
PT expense	815,689	808,691	797,533	781,523	759,876	731,706	696,011	651,663	597,390	531,759
Tax expense	–	–	–	–	–	–	–	–	–	–
Net after tax	815,689	808,691	797,533	781,523	759,876	731,706	696,011	651,663	597,390	531,759

Modified Single-Lease Expense (SLE) Approach

Balance sheet	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
ROU asset	4,444,132	4,304,663	4,104,536	3,833,949	3,481,820	3,035,636	2,481,284	1,802,864	982,478	(0)
Cap. lease obligation	4,444,132	4,304,663	4,104,536	3,833,949	3,481,820	3,035,636	2,481,284	1,802,864	982,478	(0)
Accrued rent payable	267,184	489,368	662,052	780,286	838,626	831,080	751,062	591,323	343,892	–
Net Assets (Liabilities)	(267,184)	(489,368)	(662,052)	(780,286)	(838,626)	(831,080)	(751,062)	(591,323)	(343,892)	–
P&L										
Rent expense	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184
Tax expense	–	–	–	–	–	–	–	–	–	–
Net after tax	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184
Rent paid	450,000	495,000	544,500	598,950	658,845	724,730	797,202	876,923	964,615	1,061,076

Comparative P&L – ED2's Type A/I&A versus Modified SLE Approach

P&L Pattern	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
Modified SLE Approach	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184
ED2 method	815,689	808,691	797,533	781,523	759,876	731,706	696,011	651,663	597,390	531,759
Difference	(98,505)	(91,507)	(80,349)	(64,339)	(42,692)	(14,522)	21,173	65,521	119,795	185,425
% Difference	–14%	–13%	–11%	–9%	–6%	–2%	3%	9%	17%	26%
Cumulative % Difference	–14%	–26%	–38%	–47%	–53%	–55%	–52%	–43%	–26%	0%

*ROU: right-of-use

require that substantially similar lease contracts be accounted for similarly and substantially dissimilar lease contracts not be forced into a misleading appearance of comparability.

The boards say that accounting for equipment leases should include the use of the interest method of accounting in cost allocation. In the authors' opinion, the present value calculation using a modified SLE approach (see the sidebar) is the appropriate way to determine the value of the capitalized equivalent of an executory lease. This is especially true for users who need an accurate figure for the debt-like operating lease liability; it is a pseudo-debt, because legally it is not the same as debt—this distinction is important to users of financial statements. The authors do not think the interest method should drive the accounting for a capitalized executory lease contract.

In practice, the only case where an executory contract lease contains a financing element is when the rents are back-ended—that is, when a future payment is made for the lessee's current ROU. That financing element is actually captured under current GAAP, because it requires a lessee to accrue the average rent, so a back-ended rent lease will have an accrued rent liability on the balance sheet until the rent is actually paid. It does seem illogical that most real estate leases are deemed Type B leases by the boards, and, consequently, do not have a financing element—even though most real estate leases have stepped-up or back-ended rent patterns. On the other hand, most equipment leases have level payments—yet ED2 deems that most equipment leases are Type A and have a financing element. Prior to ED2, this inconsistency was not discussed at any of the boards' deliberative public meetings. In the authors' opinion, the decision lacks conceptual grounding.

Under ED2 (see Exhibit 1), a lessee's equipment lease would most often be designated as a Type A lease. The designation causes a front-loading of lease costs by amortizing the ROU asset on a straight line, and imputing interest causes a mismatch with the tax treatment of an executory contract where rent is a deductible expense. This will create the need for complex deferred tax accounting for all executory leases with front-loaded costs. It also means large and permanent deferred tax asset balances for any entity that continues to lease. Users will be confused by the large deferred tax assets, which highlight the inconsistency of the ED2 cost methodology, when compared to the legal and tax view of executory leases. In addition, bank regulators have special capital rules regarding deferred tax assets: when the amount of deferral reaches a set limit, they force higher capital requirements to support deferred tax assets.

ED2 bases the classification tests on the extent to which the value of the underlying asset is consumed during the lease term. ED2 has different criteria for real estate leases (more like current GAAP) and for equipment leases (different from current GAAP). In the authors' opinion, there is no conceptual basis for this dichotomy. The AAA Financial Accounting Standards Committee's advice countered the boards' approach:

> The Committee believes the goal for lease accounting is to represent the value of the rights and obligations conveyed by the lease, not the value of the physical assets, unless there is no material difference between the value of the physical assets and the value of the rights and obligations.

For executory leases, the authors believe that entities should account for the values of the rights and obligations in a unified contract—not account for the value of the underlying asset. Focus on the underlying asset perpetuates a deficiency from current lease accounting GAAP.

Some Lessee Accounting Recommendations

Because the ROU asset in a Type A lease on the lessee's books amortizes faster than the ROU liability, any executory lease using Type A accounting will show a gain on early termination. This seems to be a clear indicator that the accounting method does not correctly value the asset and liability arising from the lease contract. The authors' recommendation is for the boards to do a conceptual analysis of capitalizing executory contracts. Furthermore, the authors recommend that the boards abandon the equipment/real estate lease types under ED2 (Exhibit 1) and use the executory/finance lease types (Exhibit 2), as well as modify ED2's SLE accounting and instead use the authors' recommended executory contract accounting method. In the sidebar's example, the following simple steps are used to account for a lease as a capitalized executory contact:

- Capitalize the present value of the lease payments on each reporting date as an ROU asset and a capitalized executory lease obligation, reversing the previous reporting period's entry.
- Accrue the average rent, charging rent expense and crediting accounts payable.
- Pay rent, charging accounts payable.
- Any impairment, initial direct costs, and lessor concessions would be set up as subaccounts of the ROU asset, amortized straight-line over the lease term and classified as a part of rent expense.

The boards have chosen a complex bookkeeping method for SLE lease accounting that, despite the boards' conclusion that there is no financing element, requires the calculation of an imputed interest portion of the expense and an asset amortization component of the lease cost (the sum of the two components results in a straight-line cost). The authors believe that the boards' complex method creates unintended consequences when impairment adjustments are made to the ROU asset. The method prevents a pattern other than straight-line, even when warranted by the leased asset's pattern of usage. Current GAAP allows for operating lease rent expense to be other than straight-line. The authors' recommended executory contact accounting method would avoid the unintended consequences of the proposed Type B/SLE bookkeeping method.

Sale Leasebacks with Non–Bargain Purchase Options

Sale leasebacks are common transactions. Three examples are land and buildings sold by the lessee and leased back; airplanes ordered by the lessee and paid for with the intention of leasing them when completed; and master lease arrangements, where the lessee orders and pays for many small ticket assets and the lessor does one monthly sale leaseback for convenience's sake. Even though these leases may contain non–bargain purchase options, ED2 currently looks to the decisions in the revenue recognition project to determine whether a transaction is a sale leaseback. If no sale has taken place, the transaction is a financing arrangement. The current decisions regarding the criteria to determine sale treatment in the revenue recognition project include denying sale treatment if there is a seller buyback option in a sale leaseback, regardless of whether the buyback option is a bargain. This treatment seems like a step backward from current GAAP, which allows sales treatment even when there is a non–bargain purchase option (using a risk-and-rewards analysis). The authors believe this is another case where lease accounting will be out of step with the legal and tax views of the transaction.

Lessor Classification

As a result of the boards' desire to simplify things, ED2 employs the notion that lessor lease classification and accounting should be symmetrical with lessee accounting. In the authors' opinion, this symmetrical treatment is not conceptually supportable, because the lessee and the lessor often have two completely different perspectives given the same transactions. For example, some financial lessors (e.g., banks, finance companies) view leases as a discrete investment and intend to sell the asset if the lessee returns it at lease expiry; in contrast, other lessors (e.g., commercial real estate and full-service rail car leasing companies) view the leased asset as their stock-in-trade, and they intend to lease the equipment beyond the first lease. In both cases, the lessors offer very similar terms to the lessee. A lessee, on the other hand, is typically only leasing to obtain the temporary right to use the asset and does not care whether the lessor will sell or re-lease the returned asset when their lease ends.

The lessor classification test should, in the authors' view, be based upon the business model of the lessor; that is how real estate assets are currently treated for lessors under International Accounting Standard (IAS) 40, *Investment Property*, and it is essentially carried over in ED2 as Type B leases. But because the Type B treatment is only for real estate assets and a few equipment leases, and not for equipment leases that would otherwise meet the definition of investment property, ED2 lacks a common principle for leases of any type of asset.

The principle under IAS 40 is a business model principle—that is, if a lessor manages the leased assets with the intention of re-leasing and selling the assets at the end of the first lease, the lessor is *not* a financial lessor, and the operating lease method provides the most useful information. Specifically, those investment property/operating lessors keep the physical asset on their books, rather than record a receivable and residual; they use the current operating lease method to account for their leases. They depreciate the asset over its useful life, and show rents and residual sales proceeds as revenue. Analysts want to see rent as revenue and the depreciation of leased assets (as well as service and maintenance costs) in the lessor's profit and loss (P&L).

Financial lessors, especially the banks that dominate the U.S. leasing market, should be using the R&R method proposed by ED2. This approach portrays the rent receivable as a financial asset and the residual as a physical asset like a balloon payment in a loan, albeit monetized by sale of the residual asset. This is similar to loan accounting and portrays the economics (revenue) of the transaction as it is priced and intended to play out. Financial lessors are measured by analysts using net revenue from funds invested as a key performance measure, and the R&R method results in financing income. It also avoids comingling the depreciation expense of leased assets (a result of the operating lease method) with the depreciation of assets used in the core business. Comingling the depreciation of leased assets with assets used by the financial lessor distorts the financial leverage measures used by analysts to measure the performance of financial institutions.

Residual Guarantees and Insurance Change the Nature of a Lessor's Residual

In the authors' opinion, all residual guarantees and residual insurance change the nature of a lessor's residual from a physical asset to a financial asset. This is the treatment under current GAAP for direct finance leases. The view in ED2 is that residual guarantees are included in the lessor's minimum lease payments in Type A and R&R leases only when the lessee is also entitled to any "upside" (gain) when the leased asset is sold for more than residual value, as in a lease containing a terminal rental adjustment clause (TRAC). This is another example of the lack of one principle to account for all types of guaranteed/insured residuals for lessors. It would seem that all residual guarantees and insured residuals represent a minimum lease payment, since the lessor is guaranteed the amount insured/guaranteed.

The importance of this is twofold. First, the amount of minimum lease payments affects up-front gross profit recognition in leases where the carrying value of the leased asset is less than fair value. This occurs, for example, when a manufacturer has a captive finance company to provide a lease option to customers. Second, it is also important when classifying the residual asset as a financial asset. Only financial assets can be securitized. Under current GAAP, guaranteed residuals are financial assets and part of asset securitizations—for example, with vehicle leases.

There are many possible types of residual guarantees and residual upside sharing. ED2 does not give any guidance or principle to deal with other forms of guarantee structures. How will partial guarantees, or partial upside sharing, be treated? How will first-loss or last-loss guarantees be treated?

Leveraged Lease Accounting: Netting, Tax Credits as Revenue, and Aftertax Yield Amortization

ED2 would eliminate existing leveraged lease accounting by the lessor and would also require the lessor to apply the R&R approach to existing leveraged leases retrospectively. This problematic stance eliminates what many consider to be an ideal accounting method for portraying the substantive economic effects of a leveraged lease. Furthermore, elimination of existing leveraged lease accounting will effectively eliminate an important means for lessors to arrange a lease for the use of very large assets with tax benefits, and to lease these assets at less cost than if the lessee were to lease the same asset under another lease structure.

The sophisticated U.S. capital markets, along with a tax system with incentives for equipment, led to the leveraged lease structure. The same elements are not in place yet in all IFRS countries; thus, there is no "common ground" for the boards to consider. ED2's elimination of the leveraged lease structure means that the United States gets a lowest common denominator set of rules for this type of transaction.

> If tax benefits are ignored in lease revenue recognition, there will be less comparability among lessors and financial institutions.

Leveraged lease accounting is unique because it includes the effects of income tax benefits directly related to the leased asset in revenue recognition. Tax cash flows directly related to the leased asset are viewed the same as rents and residual proceeds by the lessor in its lease pricing calculations. For example, significant tax credits available for certain alternative energy assets, like solar panels and wind turbines, are treated as revenue under current GAAP. By inference, tax credits are recognized as an element of revenue for nonleveraged leases. They are also treated as a cash flow in the calculation of the after-tax yield (also known as the multiple investment sinking fund [MISF] yield) that is used to recognize revenue in leveraged leases and in the calculation of the yield to recognize revenue in nonleveraged leases. There are tax cash flows related to the accelerated depreciation tax deductions (also known as modified accelerated cost recovery system [MACRS] deductions) and the cash basis income recognition treatment of R&R proceeds. The combination of accelerated depreciation, cash basis rents, and residual income creates a tax deferral. Tax cash flows resulting from the tax deferral are reflected in the net cash investment and thus the MISF yield.

Existing GAAP for leveraged leases reflects the true financial risk and the effects of taxes directly related to the investment. The assets presented are the net R&R (net of nonrecourse debt)—the two assets that are at risk to the lessor/preparer. Bank regulators view this net investment as the asset requiring regulatory capital. In addition, the net rent due to the lessor meets the definition of an asset, whereas the gross rent does not. The lessor/preparer cannot sell the rents or derive any other economic benefit from them because they belong to the leveraging debt lender per a three-party leveraged lease agreement. The lender reports the rents as an asset on its balance sheet; under ED2's proposal, the lessor would also show a receivable for the gross rents as an asset.

The rents cannot be an asset of two entities. The boards' conceptual framework—Elements and Recognition—has tentatively adopted the following working definition of an asset:

> An *asset* of an entity is a present economic resource to which the entity has a right or other access that others do not have (http://www.fasb.org/project/cf_phase-b.shtml).

The gross rent due to the leveraging lender would not meet this definition, but it must be recorded on a gross basis under ED2's R&R approach. In the authors' opinion, it is misleading to report assets and liabilities that are not assets or liabilities of the lessor and would not survive bankruptcy of the lessor.

In addition, it is the authors' opinion that the rents and debt service in a leveraged lease should qualify for set off because it meets the following four criteria:

- The amount of debt is determinable.
- The reporting entity has the "right" to set off.
- This right is enforceable by law.
- The reporting entity has the "intention" to set off.

The leveraged lease revenue recognition method under existing U.S. GAAP recognizes revenue in the lease at a constant rate of return, as opposed to the net cash invested in periods where the net cash investment is positive. In simple terms, this method matches the pattern of revenue recognition with the pattern of interest expense incurred by the lessor to fund its investment. The concept of matching income and expense has not been in vogue, as accounting has moved toward more of a fair value model (see "Matching and the Changing Properties of Accounting Earnings over the Last 40 Years," by Ilia D. Dichev and Vicki Wei Tang, *Accounting Review*, forthcoming, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134984, posted May 2008). Failure to reflect tax benefits in revenue recognition will severely distort revenue on leases where the leased asset has significant tax benefits.

If tax benefits are ignored in lease revenue recognition, there will be less comparability among lessors and financial institutions, as the revenue recognized under nontax transactions, including loans, will be at a constant rate as opposed to the investment. Revenue recognized from a lease with tax benefits—for example, a leveraged lease—will have no logical income pattern when compared to the amortization pattern of the lease investment. In fact, the income pattern will be back-ended, making the lease appear to be a poor investment in the early part of the term and a much better one towards the end of the term. In the authors' opinion, ED2 will be a step backward in lessor accounting by allowing for a converged standard that does not represent a better outcome for U.S. entities.

Consider the Alternatives

Current GAAP clearly lacks an accurate present value calculation of operating lease obligations because of the difficulty determining 1) the appropriate incremental borrowing rates for each lease, 2) the variable rents based on an index or rate, and 3) the expected payments under residual guarantees. These operating lease obligations are currently disclosed off–balance sheet, while most users employ estimates in their calculations to capitalize them and view them as a debtlike equivalent for purposes of measures and ratios.

ED2 could have dealt with this issue by simply capitalizing all operating leases had the boards decided to put the present value of operating lease payments on the balance sheet at each reporting date (i.e., the authors' modified Type B/SLE approach) while keeping the P&L cost and cash flow presentation unchanged. Such an approach would satisfy all preparers, most users, and the SEC. In addition, disclosures could have been expanded to include the weighted average discount rate for all capitalized operating leases and the amount of imputed interest expense included in the rent expense using the actual discount rates (incremental borrowing rates) in the capitalized operating leases. To satisfy those analysts who needed more, or different, information, a needs analysis could be done. If the costs justify it, further information could be disclosed to satisfy their specific needs without obscuring the true economic effects of leases in the financial statement presentation. ❑

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