Exposure draft on Lease Accounting

The end of finance-operating lease distinction

All leases to come on the balance sheet

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It has been for several years (14 years approx) that the G4 +1 approach to lease accounting, linked to Australian scholar Warren McGregor, has been in circulation. However, it is only after Enron's collapse and more so after the recent crisis that the US SEC prodded the FASB to speed up on the project on lease accounting improvement that was started about 4 years ago. Suddenly, the lease accounting project that was put on backburner gathered interest, and both IASB and FASB came out with a discussion paper, engaged in a spate of public meetings, and finally, the effort culminated in publication of a new exposure draft on 17th August 2010.

In brief, the ED seeks to replace the existing lease accounting standards (IAS 17, FAS 13) with a completely different approach. The present approach is based on a distinction between financial and operating leases. A financial lease is taken as a financing arrangement and is accounted for like a loan. An operating lease is regarded as a renting arrangement.

The distinction is completely going away. Hence, leases will come on the balance sheet of the lessee without distinguishing between a financial and operating lease. This leads to a very significant impact on lessee accounting. As far as lessor accounting is concerned, except for terminology and matter of detail, there does not appear to be a significant impact, with the rider that the wording of the present exposure draft has sufficient scope for artificial inflation of lessor profits in case of the present-day financial leases (owing to computation of the fraction of fair value of lessee interest and fair value of lessor interest – see later).

The existing approach and the leasing industry:

Anyone who knows the leasing industry would understand that the operating lease/finance lease distinction, prevalent for nearly 35 years now, has shaped the leasing industry over the years. Not only have tax rules in many countries been drawn based on the accounting definition, the industry has developed residual value-based products. In technology-intensive industries, there are billions-worth lease contracts where lessors take risk on residual values. There are numerous lease contracts where lessors are residual value investors. There are lots of residual value insurance products too.

Needless to emphasize, the accounting approach that has lived for more than 3 decades has been responsible for this development.

Problems with the existing approach:

Perhaps the only conceivable issue with the existing approach could be the following:

- Quite often, parties contrive to construct lease contracts which are in-substance financing contracts but made to fit into the mechanical definition of an operating lease.
- The infamous use of synthetic lease contracts, satisfying the accounting definition of an operating lease and yet the tax definition of a capital lease.
- Various lease products exist in the market which thrive on the distinction between a financial and operating lease – for example, financial lease out, operating lease in, and so on.

In short, the problem of the standard-setters might have been the existing definition of a financial lease, which is easy to maneuver. There was, therefore, a scope to tighten the definition, But the key question remains – was there a reason to completely scrap the definition and move to an ROU-based definition?

Understanding the new approach: Lessee accounting

The most significant impact of the new method is that all leases come on the balance sheet, based on an asset representing the right of use, and a liability to make lease payments to the lessee.

Elements of a lease: from lessee viewpoint

Each lease gives rise to the following:

- Right of use of the asset (ROU)
- lease payments liability (LPL)

ROU gives rise to benefit of use – this is an asset. The LPL is a liability. Based on intuition, the value of the asset on inception is the discounted value of the cashflows arising out of ROU. However, under the proposed standard, the value of the ROU asset is made equal to the value of the liability, that is to say, at the inception of the lease, the ROU and LPL have the same value.

The value of the liability is the discounted value of LPL.

Illustration of the basic approach:

Assume an asset having a cost of $ 1000 is given on lease

(a) for a tenure of 3 years, at a rental of $ 300 per year. Residual value expected at the end of 3 years is $ 400. Accordingly, lessor's IRR works out to 12.26%.

(b) for a tenure of 5 years, at a rental of $ 300 per year. Residual value expected at the end of 5 years is $ 100. Accordingly, lessor's IRR works out to 17.23%. Assume the lessee has been given an option to renew the lease for another 3 years.

Assume in either case, the lessor provides no services with respect to the asset.

Under existing approach:

Under the present approach of lease accounting standards, lease (a) will qualify as an operating lease. Lease (b) will be a financial lease. In case of lease (b), the asset will be capitalized at its fair value (that is, cost) in the books of the lessee, with a corresponding loan-type liability.

Under the new approach:

Under the new approach, both the above leases will be on-the-balance sheet, as follows:

Lease (a)

- We first choose a discounting rate. As discussed separately, the discounting rate in case of the lessee is the lessee's incremental borrowing rate. Say, we estimate that rate to be 12%. The present value of a rental of $ 300 per year for 3 years comes to $720.55. In the example above, we have stated the lessor's IRR as well, but in cases like this, the estimation of the residual value by the lessor is his own concern, and hence, the lessee may not logically be aware of the lessor's IRR.
- The same is the value of the LPL also.
- So, at the inception, the lessee books an asset and a liability equal to $ 720.55
- The liability to make lease payments will be amortised , with the interest part being debited to P/l account and the remaining part reducing the liability.
- The ROU asset will be amortised on a systematic basis.
- Assuming the amortization of the ROU asset in on straight line basis over the lease term, the position that emerges is as follows:

lessee financials	Debit to P/L	Lease liability		ROU asset		Net impact on P/L
		amortisation	Closing value	amortisation	Closing value	
0			$720.55		$720.55	
1	$86.47	$213.53	$507.02	$240.18	$480.37	$326.65
2	$60.84	$239.16	$267.86	$240.18	$240.18	$301.02
3	$32.14	$267.86	$0.00	$240.18	$0.00	$272.33

Lease (b)

- The discounted value of lease payments, discounting at incremental borrowing rate of 12%, for 5 years, comes to $1081.43. Though the amount exceeds the fair value of the asset, this is perfectly alright from lessee's viewpoint.
- The rest of the computations go exactly as in case of Lease (a). The following numbers show the result:

lessee financials	Debit to P/L	Lease liability		ROU asset		Net impact on P/L
		amortisation	Closing value	amortisation	Closing value	
0			$1,081.43		$1,081.43	
1	$129.77	$170.23	$911.20	$216.29	$865.15	$346.06

2	$109.34	$190.66	$720.55	$216.29	$648.86	$325.63
3	$86.47	$213.53	$507.02	$216.29	$432.57	$302.75
4	$60.84	$239.16	$267.86	$216.29	$216.29	$277.13
5	$32.14	$267.86	$0.00	$216.29	$0.00	$248.43

In the books of the lessor

The new standard makes the lessor accounting part look very complicated, which it is, in case of performance-based leases, but for a typical dry lease prevailing in the leasing industry, the new standard will not mean much difference.

Elements of a lease from lessor's viewpoint:
The elements of a lease from the lessor's viewpoint are as follows:

- Right to receive lease payments: The LPL is from lessee viewpoint is the receivable from lessor viewpoint
- At the end of the lease term, the lessor has a residual interest in the leased asset: this is also an asset from lessor viewpoint.
- In addition, variety of leases may impose on the lessor performance obligations – these are the lessor's liabilities.

Understanding performance obligation leases: old wine in new bottle?

So, let us understand two types of leases:
- Performance-obligation leases
- Other leases

The performance-obligation lease is one where the lessor is exposed to asset-based risks/returns. The asset-based risks/returns may arise either during the lease term, or at the end of the lease term. During the lease term, the risks/returns arise either because the lease rentals are contingent upon performance, or the lessor is required to maintain the asset, etc. At the end of the lease terms, such risks will arise if the original lease was not a full payout lease and therefore, the lessor will have to redeploy the asset to earn residual returns.

In short, the financial lease that we know today will not be a performance-obligation lease. The operating lease as we know today will be a performance obligation lease.

Treatment in case of non-performance-obligation leases:

Under the current treatment, in financial leases, the lessor retains a current asset on his books equal to the present value of lease receivables, plus estimated residual value. The net impact of the new standard for such leases is the same. However, this net result comes out of a convoluted series of computations:

1. First, the lessor recognizes the asset as he acquires it (or the asset is already on his books)
2. Now, the lessor de-recognizes the leased asset to the extent of (fair value of lessee-ROU to total benefits from the asset).
3. The net of 1 and 2 is classified as residual asset.

Sounds perplexing? The perplexity is caused by Para 50 providing for splitting the amount representing lessee ROU and lessor benefits, in proportion to "to the fair value of the rights that have been transferred and the fair value of the rights that have been retained by the lessor".

These words may cause confusion. Suppose an asset costing $ 1000 has an expected life of 8 years, and lessor has leased the asset for 5 years, with no renewal option. Assuming that the benefits of use of the asset are equal over the lease term, it would be possible to say that 5/8th of the fair value of the asset has been transferred to the lessee. Hence, 5/8th of $ 1000 may qualify for de-recognition and 3/8th remains as residual interest in the leased asset. This, however, would lead to over-statement of lessor's profits. The right approach would be, the estimated residual value of the asset is the lessor' interest in the asset, and the remaining fair value of the asset is the lessee's interest in the asset.

Assume the lease receivables are $ 250 for 5 years. At the end of 5 years, estimated residual value is, say, $ 300. Hence, the IRR of the transaction is 14.52%. At this rate, the present value of lease receivables comes to $ 847. If the proportion representing the lease term was to be applied, the 5/8th of the leased asset de-recognised comes to $ 625. The net of the two, that is, $ 222 is taken to P/L rightaway. In other words, the income for the entire lease term is upfronted. However, if the present value of the residual value is taken as the lessor' interest, the lessor's interest comes to $153. Hence, the part of the leased asset that is de-recognised is the same as the present value of lease receivables, leaving no upfront profits.

Performance obligation leases:

While most of the leases in the leasing industry would be non-performance-obligation leases, the accounting treatment is simpler and more rational in case of performance-obligation leases.

In this case, at the inception, the lessor brings on book a lease asset equal to the present value of the lease rentals. Note that this is over and above the fixed asset which the lessor may either be acquiring or holding. Corresponding to the lease receivables, it is presumed that there is a lease liability too, as the rentals are contingent upon performance. The lease rentals are amortised over time, with the interest income going to the P/L and the capital portion reducing the leased asset. The lease liability is also amortised, as the lessor performs the obligation based on which rentals are receivable. The amoritisation of the liability will follow a systematic pattern based on the usage of the asset. If the usage pattern is not discernible, the liability will be amortised on straight line basis. That is to

say, there may be a gap between amortization of the lease asset and the lease liability, leaving an impact on Income statement of the lessor.

Lessee books: Treatment over the lease term:

In case of the lessee, at the inception, an ROU asset and LPL liability are created at the inception.

The ROU is amortised over the lease term. The amortisatoin of the ROU asset is done on a systematic basis representing the benefits arising out of use, or a straight line basis. This part of the new standard is a continuity over the existing standard.

The LPL liability was based on discounted value of future committed payments. Hence, the discount is unwound over time by debiting an interest component. That is, the amortization of the liability happens at the effective interest rate or the IRR charged by the lessor.

The ROU asset is subject to revaluation, amortization and impairment as any other fixed asset.

Illustration of lessor accounting: Comparison of performance-obligation lease and non-performance obligation lease:

Assume an asset costing $ 1000 is given on lease for 5 years, with annual rentals being $ 250 per year. Estimated residual value at the end of the lease term is $ 200. The economic life of the asset is 8 years. On these facts, the lessor's IRR comes to 12.54%.

The lease rentals may be:

(a) based on performance obligation of the lessor
(b) not based on performance obligation

Under the Non-performance obligation approach, the following are the steps:

At the inception:

- Lessor first recognizes the asset of $ 1000, as having been bought for cash.
- Next, we determine the amount of leased to be de-recognised. The right to use the asset for the 5 year period has been transferred to the lessee. The lessor has interest in the asset to the extent of its residual value. Hence, the present value of the residual value is the residual interest of the lessor, and the balance is lessee's interest. The PV of residual value comes to 11.08%. Hence, 88.92% of the asset will be de-recognised, and transferred to the P/L.
- The present value of lease receivables comes also to the same amount, that is, 88.92%. That is to say, there is no upfront income recognized in the instant case.

Over term of the lease

- The interest part of the lease receivables goes to P/L.
- There is no question of depreciating the residual value as the same is anyway measured based on its estimated fair value.

- In short, the booking of income by the lessor, except for terminology differences, is the same as in case of existing finance leases.

Under the performance-obligations approach, the treatment is as follows:

- At the inception, the lessor acquires an asset worth $ 1000.
- A lease asset equal to $ 889.2 is recognized
- Correspondingly, a lease liability equal to $ 889.2 is recognized.

Over the term of the lease:

- The rentals will be taken against the lease asset. Interest part will be brought into the Profit and Loss a/c.
- In absence of any other measure, the liability will be amortised equally over the lease term.
- Depreciation will be charged on the asset as usual. In workings below, we have charged depreciation so as to write off (1000-200) over the 5 year term.

The result looks as follows:

	Income	amortisation of liability	Depreciation	Net income
1	$125.42	$177.84	160	$143.27
2	$109.80	$177.84	160	$127.64
3	$92.21	$177.84	160	$110.06
4	$72.42	$177.84	160	$90.27
5	$50.15	$177.84	160	$67.99

The result above is certainly better than the existing operating lease approach, where the entire rental would have been taken as income, and depreciation on straight-line basis would have been charged.

However, as may be clearly seen, the write-off of the lease liability on straight-line basis does not reflect proper view of the lessor’s financials and amounts to deflation of profits.

Matters of details:

Scope of the new standard:

- Lease of intangible assets will be excluded from the new standard. Hence, software leases will remain out. Software leases will continue to be governed by accounting standards for intangible assets.
- It is notable that with-service leases, or so-called wet leases, will also be covered by the new standard.
- Leases involving contingent payments are also dealt with by the standard.
- An important exception is that leases which substantively transfer all risks/rewards to lessees will not be covered by the new standard. This exception is

contained in para 8 (a), referring to leases that transfer control over the asset, except trivial risks/rewards on the asset. A typical hire purchase transaction transferring an asset at nominal value may qualify under this exception.

- As regards hire purchase contracts, para 8 (b) provides an exception to a hire purchase contract only after the purchase option has been exercised by the hirer. This would create an unreasonable burden since in most of the hire purchase contracts, the purchase option is on such nominal terms where it is almost certain that the option will be exercised. **Appropriately, the exception should be extended to all such contracts where the purchase option, at the inception of the lease, is most likely to be exercised**. If not, an artificial distinction will remain between contracts that lead to automatic transfer of title, and those where title is reserved merely for the same of security.
- **Use of discounting rate**:
    - In case of lessee, the lessee's incremental borrowing cost is the discounting rate. If the lessor's IRR is discernible, then the lessor's IRR may be used. This is a continuation of the existing standard.
    - In case of the lessor, the discounting rate is either the lessee's incremental borrowing cost, or the lessor's IRR (including the estimated residual value as an inflow) or, in case of property leases, the yield on the property.

Conclusion:

The new standard will require tremendous learning effort as it is a complete rewrite of a standard that has existed for decades. The overall impact on the statement of financial position and profit statements for both lessors and lessees is positive – it leads to better accounting. However, the big question is – are the benefits commensurate with the huge learning costs?