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Accounting for Leases: A White Paper on Significant Financial Reporting Changes for Lessees and Lessors

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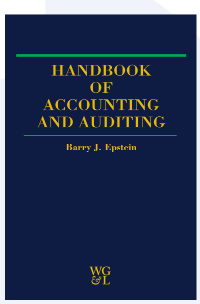

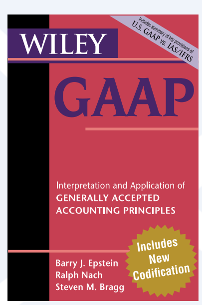

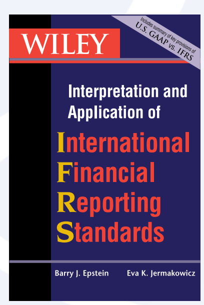

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New Lease Accounting Is Coming, With Universal Capitalization

I. BACKGROUND AND INTRODUCTION

The proper accounting for lease arrangements, both by lessees and by lessors, has been one of the more contentious areas of financial reporting theory for at least the past fifty years. A disproportionate fraction of all extant accounting guidance in many jurisdictions has been devoted to this matter, and it remains seemingly as controversial today as it was a half-century ago. Simply put, the issue is whether leases (with the possible exception of very short-term rentals) give rise to property rights – i.e., assets – as well as obligations that are to be reported by the lessee, with an analogous, if not necessarily totally symmetrical, accounting by the lessor.

Conceptually, it is clear that most leases are equivalent to installment purchases of property, or at least to long-term rights to use property, coupled with long-term payment obligations. If financial statements are to faithfully represent the economic position and results of operations of the reporting entity, logic demands that these assets and liabilities, and the corresponding effects on income and expense, be accurately portrayed. However, this ignores the fact that the incredible growth in popularity of leasing has been predicated, in significant part, on the "off the balance sheet" financing that it provided for lessees, which for many years was successful in portraying companies as being less leveraged, and thus more financially secure, than was true. There historically was, therefore, a substantial constituency for improper accounting for leases.

Over time, this has changed. Lenders and investors became more alert to the necessity for making adjustments to entity-produced financial statements to re-incorporate excluded debt items, and accounting practice, driven in part by concerns over growing litigation, became more committed to transparency and "substance over form" representations. We are now approaching the end of a tortuous road regarding major revisions to lease accounting requirements, involving a joint US FASB and IASB project dating from 2006 that has seen multiple proposals, two exposure drafts (2010 and 2013), extensive public hearings and board re-deliberations, and a likely final denouement in 2015.

The current draft offers a peculiar "hybrid" reporting solution for some of the leases – primarily those for which the lease terms are not effectively the entire remaining useful lives of the underlying assets – with "capital" treatment prescribed for the balance sheet (known more formally now as the statement of financial position) but essentially "operating" treatment for the income statement. This feature was adopted in the 2013 draft after the earlier draft was heavily criticized for imposing a non-straight-line pattern of expense recognition for virtually all leases.

Based on the 2013 draft, it is likely that, once implemented, the new rules will require that virtually all leases will be recognized as creating, for lessees, assets known as "rights-of-use," together with corresponding obligations. However, in terms of income statement effects, some of these will be given full "capital lease" ("financing") treatment, with generally constant amortization expense and declining interest charges over the lease terms, whereas others will still have income statement impact much the same as current "operating" (i.e., non-capitalized) leases. The treatment to be prescribed for lessors will be partially in mirror image of that for lessees, with some exceptions. Short-term leases could still be granted operating lease ("off-balance sheet") treatment.

II. NEW MODEL FOR LEASE ACCOUNTING – THE REVISED (2013) EXPOSURE DRAFT

What is a lease? The expected standard will define leases as arrangements that involve contractual rights to use assets (the "underlying assets") for a period of time, in exchange for consideration. Fulfillment of the contracts has to depend on the use of *identified assets*, and thus if the lessor has a substantive right to substitute the asset throughout the term of the contract, this criterion will not be met. A substantive right to substitute will be indicated if the supplier can replace with alternative assets without obtaining the customer's consent, and if there are no economic or other barriers that would prevent such substitution during the term of the contract.

However, even if a specific asset is not identified in the contract, absence of right to substitute may imply an identification of an asset that is sufficient to satisfy this requirement. A physically distinct part of an asset (e.g., a floor of a building) can serve as an identified asset, but a capacity portion (e.g., 50% of the floor space of the building, without designation of unique areas) generally would not qualify as being an identified asset.

Furthermore, to qualify as a lease, the contract must convey the *right to control the use* of an identified asset for a period of time in exchange for consideration, as demonstrated by the presence of both the ability to direct the use of the identified asset, *and* the ability to derive benefits from the use of the identified asset.

Regarding the ability to direct use of the asset, the lessee must have the right to make decisions regarding the asset's use that will most significantly affect the benefits to be derived from such use over the term of the lease. These decisions may actually precede the commencement date (e.g., by designing the configuration of the assets or terms of the lease contract), and will control the use over the lease term. However, incorporation of protective rights for the lessor (e.g., setting the maximum number of operating hours per month) that secure residual value for the lessor will not necessarily prevent the ability to control use of the leased asset. Conversely, the right to specify output from the asset does not necessarily imply the lessee's ability to control use of the asset.

Concerning the ability to derive benefits from the asset's use, the lessee should be able to obtain essentially all the benefits from the use of the asset over the lease term, which can be derived in various direct and indirect ways, such as by using, consuming or holding the asset, or by engaging in a commercial transaction with a third party. The ability to derive benefits will *not* exist, however, if the lessee can obtain the benefits only if the asset is used in conjunction with additional goods or services to be provided by the lessor and not otherwise separately available from other suppliers, *and* the asset is incidental to the delivery of services because the asset is designed to function only with the additional goods or services provided by the lessor.

Type A and Type B leases to be distinguished. The proposed standard will distinguish between so-called Type A and Type B leases, with the latter being "property" leases (what have historically been deemed to involve *real property*) – *unless* the arrangement covers essentially all the property's remaining economic life, or involves an obligation having a present value equal to most of the fair value of the underlying asset, in which case they will be Type A. Conversely, Type A leases would be for other-than-property (historically understood as involving *personal property*, such as machinery and automobiles) – *unless* the lease term were for an *insignificant* portion of the underlying asset's economic life, *or* if the present value of the fixed lease payments were *insignificant* relative to the fair value of the underlying asset, in which case the lease would be Type B. Among other things, this somewhat convoluted typology harkens back to the FASB's old, more mechanically prescriptive lease rules, which included the infamous "75% test" relating to useful life and "90% test" pertaining to the portion of the fair value of the asset/liability covered by the lease. Surprisingly, this is part of the joint IASB and FASB proposed solution, notwithstanding that it runs somewhat counter to the IASB's vaunted "principles-based" approach to accounting standards.

The main upshot of the Type A–Type B scheme is to prescribe disparate income statement recognition, depending on whether the lessee would be effectively consuming the entire asset and paying for its full value, or not. Thus, for Type B arrangements (most real estate leases, such as office leases, and a likely minority of equipment leases), total rental expense will be reported, generally, on a straight-line basis over time. Since this expense is a *composite* of amortization of the new "right-of-use" asset and interest expense imputed on the corresponding long-term debt obligation, some computational acrobatics will be required: the interest component (determined using the traditional constant return on the declining balance, or effective rate, method) portion will be decreasing over time, necessitating an *increasing* amortization charge in each successive period, so that the combined amount will be the same each period.

Type A arrangements (most equipment and automotive leases, and a minority of real estate leases) will be handled in a somewhat more familiar manner, akin to current finance ("capital") leases, with the lessee reporting amortization expense and interest expense (the former on a straight-line basis unless asset utility declines over time; the latter showing the usual decreasing charge pattern) in the income statement.

For lessors, some leases previously classed as operating will now be accounted for as transfers of rights-of-use, and this will result in the recognition of two distinct assets: the lease receivable and a residual asset (if applicable). The accounting for Type B leases would essentially follow current operating lease treatment. Thus, lessee and lessor accounting for some of the same transactions could diverge.

Both Type A and Type B leases will result in on-balance sheet presentation of assets (rights-of-use) and corresponding liabilities for lessees, and thus have effects similar to finance leases under SFAS 13, with customary corollary impacts on debt/equity ratios and other important financial measures. However, the pattern of expense recognition in the income statements will vary, with Type B leases having impact similar to that of operating (i.e., off-balance sheet) leases; thus, the accounting for Type B leases can be seen as being a hybrid. This feature was added in the 2013 exposure draft; the earlier (2010) version would have imposed what is now called Type A treatment on all leases, other than short-term (under one year) rental agreements.

If a lease component contains both land and building, the economic life of the building is gauged by the life of the underlying asset for purposes of ascertaining classification.

There will be an optional exemption for short-term (under one year) leases, which, if invoked, avoids balance sheet recognition of right-of-use assets and of related obligations for those arrangements. Notwithstanding the above criteria, if a lessee has a significant economic incentive to purchase the underlying asset under terms of an option, it is to be classified as a Type A lease.

Measuring the right-of-use asset. The right-of-use asset and corresponding liability (for the lessee in the case of either Type A or Type B leases) and the lease receivable (for the lessor in the case of Type A leases) would be computed with reference to the lease's non-cancelable period, together with periods covered by an option to extend the lease, *if* the lessee has a "significant economic incentive" to exercise the option, *and also* periods covered by an option to terminate the lease, *if* the lessee has a "significant economic incentive" to choose *not* to exercise the option.

The right-of-use asset and corresponding liability (for the lessee) and the lease receivable (for the lessor) would furthermore take into account both the fixed lease payments and those variable payments that are based on an index or rate (e.g., market interest rates, an inflation index), but would exclude any other variable payments unless in substance those are fixed. If variable lease payments are included in the initial determination of right-of-use or lease receivable assets, these would be based on the index or rate effective on the lease commencement date.

The lessee will be required to reassess the lease obligation, and the lessor would reassess the lease receivable, if *either* of these changes later occurs: in one of the relevant factors (affecting either the incentive to extend or the incentive to terminate, as for example the costs of negotiating a new lease or locating a suitable replacement right-of-use), causing a change in the lease term; *or* in the index or rate used to determine variable lease payments.

Contracts that are, or contain, leases are to be separated into component leases if *both* the lessee can benefit from the use of the component asset either separately or in conjunction with other resources readily available from other sources, *and* the underlying asset is neither dependent on, nor highly interrelated with, the other underlying component assets in the lease contract. Lessee accounting for separate components will depend upon whether there are observable stand-alone prices for each component, where prices mean either similar lease terms offered by other lessors or for the good or service sold on a stand-alone basis by vendors. If there are prices for each component, the relative stand-alone prices are used to allocate consideration among them. If there are stand-alone prices for some components, these are used to allocate consideration among them, with the residual assigned to the component not having a stand-alone price. If several components lack prices, these are combined into one reportable lease component. If no components have stand-alone prices, these are all treated as part of a single lease.

Other matters addressed by the proposed standard include amortization term (the lesser of useful life or lease term), impairment recognition (consistent with that for other long-lived assets), re-measurement of the lease obligation (if triggered by a change in an index or rate that is attributable to the current period, this would be reflected immediately in income, and not by an adjustment to the carrying value of the right-of-use asset), and changes in the discount rate (caused by a change in the lease term, in factors indicating that the economic incentive to exercise a purchase option has dissipated, or in a reference interest rate, if relevant to the variable lease payments to be made).

The proposal also details the actual bookkeeping procedures for both lessees and lessors, for both types of leases, and provides copious examples employing a variety of fact scenarios. Not addressed by the accounting standard, of course, are the procedures that auditors will need to adopt in order to verify the assorted assumptions being made by preparers. If past experience is any guide, there will be a steep learning curve for preparers, users and auditors to climb once this rule is promulgated, with the risk of error and even deliberate mis-application during the transition phase. Early attention thus should be paid to this forthcoming, fundamental change in financial reporting.

Effect of adopting the new standard. It is anticipated that the new standard will require retrospective application. This will present an arduous task for many reporting entities to undertake, but the alternative – phased-in application only as new lease arrangements are entered into – would have caused the transition period to be extended for decades, seriously impeding the ability to compare financial statements of otherwise similar companies engaging in different patterns of leases over time. Thus, making the change immediately, for both new and extant leases, is the only reasonable course of action.

Restatement to effect the change will require detailed analyses. For lessees, some leases that previously were accounted for as operating leases will be capitalized as right-of-use assets and associated debt obligations. It will be necessary to determine the "amortized" amounts of leased assets and obligations that are mid-cycle at the date of adopting the new rules. For lessors, some leases previously classed as operating would be accounted for as transfers of rights-of-use and the creation of two distinct assets: the lease receivable and a residual asset (if the latter is applicable). In comparative income statement presentations, both lessees and lessors would need to restate amortization expense and interest expense (lessees) and interest income and the accreting value of the residual, if any (lessors).

Calculations such as those attesting to loan covenant compliance would also need to be re-performed, using the adjusted amounts. Since the rights-of-use will be deemed intangible assets, there may be a need to seek clarifications or amendments to certain critical measures, such as tangible net worth. Independent accountants can usefully provide early assistance to clients in explaining the impact of these and other changes – ideally before bankers, using a "box check" approach, find borrowers in default, with predictably unpleasant consequences.

III. LEASE ACCOUNTING IN GREATER DETAIL UNDER NEW APPROACH

Accounting for Type A leases. A right-of-use asset and a lease liability will be recognized in the statement of financial position, initially measured at the present value of future lease payments. The present value is computed using the rate charged by the lessor, if that can be determined; otherwise, the lessee's incremental borrowing rate is used. The right-of-use asset is initially measured by reference to the initial measurement of the lease liability, *plus* any lease payments made at or before the commencement date, *less* any incentives provided by the lessor, and any initial direct costs incurred by the lessee (such as commissions, fees, payments to existing tenants, and other incremental costs).

The lease liability consists of all the following elements (to the extent relevant): fixed payments, less any incentives receivable from the lessor; variable lease payments that are governed by indexes or rates, initially given by those at the commencement date of the lease; any variable payments that are in-substance fixed payments; amounts expected to be due under a residual value guarantee; the exercise price of a purchase option if the lease offers significant economic incentive for its exercise; and lease termination penalty payments, if the term was defined to include early termination.

The unwinding (i.e., amortization) of the discount on the lease liability will be recognized separately from the amortization of the right-of-use asset. The unwinding of the discount (interest expense) would be computed as a constant rate on a declining loan balance, as with normal mortgage-type amortization (i.e., using the effective interest rate method). Since the interest component would be front-end loaded, total expense would be heavier in early years, lesser in later years, even if the right-of-use asset were being amortized straight-line.

Amortization of the right-of-use asset is to be effected by a systematic process consistent with the pattern by which the lessee expects to consume the asset's future economic benefits. This mirrors the logic and general requirement regarding amortization of other long-lived assets under GAAP. Straight-line amortization would appear to be the expected norm, but accelerated amortization could also be rationalized. The right-of-use asset would be amortized over the lesser of the lease term or the expected useful economic life of the asset, unless the lessee has a significant economic incentive to exercise the purchase option. If the lessee has a significant incentive to exercise the purchase option, amortization over the right-of-use asset's useful life is prescribed.

Impairment of the right-of-use asset would be recognized, as required, consistent with accounting for other long-lived assets under GAAP. Once impaired, recoveries in value may not be given recognition.

The lease liability would be adjusted if the lease term, factors pertaining to the incentives to exercise a purchase option, amounts due under residual value guarantees, or the index or rate used to determine variable lease payments change. In general, changes recorded for the lease liability would also be reflected in changes to the right-of-use asset. However, re-measurement triggered by a change in an index or rate that is attributable to the current period would be reflected immediately in income, and not by an adjustment to the carrying value of the right-of-use asset. If adjustments to the lease obligation and the concomitant adjustments to the right-of-use asset result in the carrying value of the asset being reduced to zero, any further adjustments would be reported in current income (i.e., the carrying value of the asset cannot be reduced below zero).

The discount rate is to be reassessed if there is a change in the lease term, in factors indicating that the economic incentive to exercise a purchase option has dissipated, or in a reference interest rate if relevant to the variable lease payments to be made. If the interest rate is reassessed, it is to be the rate the lessor would charge the lessee as of the date of the reassessment, if known, or the then-extant lessee's incremental borrowing rate, if not.

Accounting for Type B leases by lessees. A right-of-use asset and a lease liability would be recognized, initially measured at the present value of future lease payments (see above discussion). A single periodic lease cost would be recognized, combining the unwinding of the discount with the amortization of the right-of-use asset, on an aggregate straight-line basis. Thus, the impact on the income statement would be straight-line over the entire lease term. If the unwinding of the discount on the lease receivable were computed (as would seem logical) by employing the effective interest rate method, this would necessitate that the amortization of the right-of-use asset be calculated by an increasing-charge method, in order to make the sum of these constituent elements be equal each period.

Accounting for Type A leases by lessors. The underlying leased asset will be derecognized as if it had been sold. In its stead, two new assets would be recognized: a lease receivable and a separate residual asset, if appropriate.

The lease receivable would be measured by the present value of future fixed lease payments, discounted using the implicit lease interest rate, plus any initial direct costs, inclusive of (a) fixed payments, net of any incentive payments to be made to the lessee; (b) variable lease payments that depend on an index or a rate; (c) variable lease payments that are in-substance fixed payments; (d) lease payments structured as residual value guarantees; (e) the exercise price of any purchase option, if the lessee has a significant economic incentive to exercise it; and (f) termination penalty payments, if the defined lease term is predicated upon the termination option being exercised.

The separate residual asset would represent rights to the underlying asset that the lessor retained, including expected variable rental payments, with the residual asset being measured with reference to the present value of the amount expected to be derived from the underlying asset after the lease term ends, *plus* the present value of variable lease payments (if not included in the lease receivable), *less* any earned profit (described immediately below).

Any profit relating to the lease (the spread between the carrying value of the underlying asset being derecognized and its fair value at lease commencement) will be allocated between that reported in earnings at the inception of the lease and that added to the residual asset. The portion recognized in income would be determined by multiplying the spread between carrying value and fair value by the present value of lease payments to be received, divided by the fair value of the underlying asset. The portion recognized as part of the residual asset would be determined by reducing the spread between carrying value and fair value by amount reported in income at commencement of the lease.

The lessor under a Type A lease will re-measure the lease receivable and/or the residual asset under certain circumstances. If there is a change in lease term, or in the assessment of whether the lessee has a significant economic incentive to exercise the purchase option, the carrying amount of the residual asset is to be adjusted, with gain or loss recognized in income. If there is a change in lease term, or in the factors affecting the incentive to exercise the purchase option, the lease receivable will need to be revised. If there is a change in the index or rate used to drive the variable payments, the lease receivable also will be revised. Finally, the discount rate used to determine the present value of lease payments will be revised if there are changes in the lease term, changes in factors affecting the incentive to exercise the purchase option, or changes to the reference interest rate, if variable payments will be affected by such changes.

The carrying amount of the residual asset is to be accreted using the implicit rate in the lease.

If variable payments were included in the initial amount of the residual asset, the periodic amounts earned are removed from the residual asset and recognized in expense, using a cumulative computation at each reporting date.

If the lease receivable and/or residual asset is determined to have become impaired, the impairment is to be recognized currently, consistent with the accounting for other financial assets under GAAP. The value of any collateral held by the lessor would be given consideration in computing the value of the lease receivable (exclusive of cash flows pertaining to the value of the residual asset).

At the end of the lease term, the residual asset would be reclassified to the appropriate category of long-lived asset, valued at the carrying amount of the residual asset at that date.

In the event of an early termination, the lessor under a Type A lease would have to test the lease receivable for impairment under GAAP and recognize any impairment; reclassify the lease receivable and residual asset to appropriate categories, using the carrying values at that date; and account for the underlying asset as required under appropriate provisions of GAAP.

Accounting for Type B leases by lessors. The underlying property asset would continue to be recognized on the lessor's balance sheet. Lease income would be recognized over the lease term, probably on a straight-line basis, together with any initial direct costs deferred. Variable payments, if any, would be recognized in income as earned. The lessor thus reports the underlying (tangible, usually) asset on its balance sheet, and the lessee simultaneously reports the right-of-use asset regarding that same item on its balance sheet. Having essentially the same asset on two entities' balance sheets simultaneously will strike some as being wrong, but upon closer consideration it is clear that the physical asset only appears on the lessor's balance sheet, while the intangible right to use that asset, which is a different type of asset, appears on the lessee's balance sheet.

If contract terms are later modified, with substantive change to the existing lease, the modified lease is to be accounted for as a new lease as of the date the modifications become effective. Any differences between the then-carrying amounts of pertinent assets and liabilities from the predecessor lease and the corresponding amounts for the new lease are to be recognized in income immediately. Such changes could involve the lease term, or the amounts of contractual payments required under the lease, for example.

New presentation requirements for the lessee. The new rules, not surprisingly, include vastly expanded disclosure requirements. A lessee will either present in the statement of financial position or disclose in the notes the following: the right-of-use assets, distinguished from other assets; the lease liabilities, set forth separately from other liabilities; the right-of-use assets arising from Type A leases separately from right-of-use assets arising from Type B leases; and the lease liabilities arising from Type A leases separately from lease liabilities arising from Type B leases.

If a lessee does not present right-of-use assets and lease liabilities separately in the statement of financial position, it must do *both* of the following: present right-of-use assets within the same line item as the corresponding underlying assets would be presented if they were owned; *and* disclose which line items in the statement of financial position include right-of-use assets and lease liabilities.

In the statement of profit or loss and other comprehensive income, a lessee is to report as follows: for Type A leases, the unwinding (amortization) of the discount on the lease liability must be presented separately from the amortization of the right-of-use asset; and for Type B leases, the unwinding of the discount on the lease liability is reported together with the amortization of the right-of-use asset.

In the statement of cash flows, a lessee is to classify lease items as follows: repayments of the principal portion of the lease liability arising from Type A leases is presented within financing activities; the unwinding of the discount on the lease liability arising from Type A leases is to be reported in accordance with the requirements relating to interest paid set forth by SFAS 95 – i.e., in operations; payments arising from Type B leases are to be reported within operating activities; and variable lease payments and short-term lease payments not included in the lease liability are to be reported within operating activities.

Presentation requirements. The proposed presentation requirements for the lessor are as follow. First, the lessor is to present lease assets (i.e., the sum of the carrying amounts of lease receivables and residual assets) separately from other assets in the statement of financial position. Second, the lessor is also to either present in the statement of financial position or disclose in the notes the carrying amount of lease receivables and the carrying amount of residual assets.

Third, a lessor will either present in the statement of profit or loss and other comprehensive income or disclose in the notes the income arising from leases. If a lessor does not present lease income in the statement of profit or loss and other comprehensive income, the lessor is to disclose which line items include the income in the statement of profit or loss and other comprehensive income.

And fourth, the lessor is to present any profit or loss on the lease recognized at the commencement date in a manner that best reflects the lessor's business model(s), such as by one of the following: if a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor should present revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently; or, if a lessor uses leases for the purposes of providing finance, it will present the profit or loss in a single line item.

In the statement of cash flows, a lessor is to classify cash receipts from lease payments within operating activities.

For a lessor having Type B leases, lease payments are to be reported as lease income over the lease term, on either a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset. The lessor is to recognize initial direct costs as an expense over the lease term on the same basis as lease income. A lessor is to recognize variable lease payments in income in the period in which that income is earned. It is to continue to measure and present the underlying asset subject to a Type B lease in its balance sheet accordance with other applicable GAAP. In the statement of cash flows, a lessor is to classify cash receipts from Type B lease payments within operating activities.

Lessee disclosures. The objective of the disclosure requirements is to enable users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases. To do so, a lessee is to disclose qualitative and quantitative information about all of the following: its leases (general characteristics and natures, including those that have yet to commence); the significant judgments made in applying the standard to those leases (e.g., discount rates, terms); and the amounts recognized in the financial statements relating to those leases.

A lessee will be required to consider what level of detail will be necessary to satisfy the disclosure objective, and how much emphasis to place on each of the various requirements. Aggregation or disaggregation of disclosures is to be optimized so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics. The lessee will be required to disclose information about the nature of its leases, with appropriate identification of any sub-leases incorporated, including a general description of those leases; the basis, and terms and conditions, on which variable lease payments are determined; the existence, and terms and conditions, of options to extend or terminate the lease; narrative disclosure about the options that are recognized as part of the right-of-use asset and lease liability and about those that are not; the existence, and terms and conditions, of residual value guarantees provided by the lessee; and the restrictions or covenants imposed by leases, e.g., those relating to dividends or incurring additional financial obligations.

Also required to be disclosed will be information about leases that have not yet commenced but that will create significant rights and obligations for the lessee. Additionally, there will need to be disclosure of information about significant assumptions and judgments made in applying the new standard, which may include the determination of whether a contract contains a lease; the allocation of the consideration in a contract between lease and non-lease components; and the determination of the discount rate.

A lessee will have to disclose a reconciliation of opening and closing balances of right-of-use assets by class of underlying asset – separately for Type A leases and for Type B leases – setting forth items that are useful in understanding the change in the carrying amount of right-of-use assets, such as additions due to leases commencing or being extended; reclassifications when a lessee exercises a purchase option; reductions due to lease terminations; re-measurements relating to a change in an index or a rate used to determine lease payments; amortization; the effects of business combinations; and impairment.

A lessee is to disclose a reconciliation of opening and closing balances of the lease liability, separately for Type A leases and Type B leases, to include the periodic unwinding of the discount on the lease liability and other items that are useful in understanding the change in the carrying amount of the lease liability, e.g., liabilities created due to leases commencing or being extended; liabilities extinguished due to leases being terminated; re-measurements relating to a change in an index or a rate used to determine lease payments; cash paid; foreign currency exchange differences; and the effects of business combinations.

A lessee is furthermore to disclose costs that are recognized in the period relating to variable lease payments not included in the lease liability.

The lessee must also disclose information about the acquisition of right-of-use assets in exchange for lease liabilities, arising from both Type A leases and Type B leases, as a supplemental non-cash transaction disclosure (per SFAS 95). In lieu of the maturity analyses otherwise required by GAAP, a lessee is to disclose a maturity analysis of the lease liability, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. The undiscounted cash flows are to be reconciled to the lease liability recognized in the statement of financial position – i.e., by adding the discount pertaining to time value of money.

Lessor disclosures. Proposed disclosure requirements applicable to lessor financial reporting are summarized as follow. First, there must be sufficient information to enable users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases. This is achieved by presenting qualitative and quantitative information about: its leases; the significant judgments made in applying GAAP to those leases; and the amounts recognized in the financial statements relating to those leases. The lessor is to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. It also is to aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

Next, the lessor is to disclose information about the nature of its leases, including: a general description of those leases; the basis, and terms and conditions, on which variable lease payments are determined; the existence, and terms and conditions, of options to extend or terminate the lease; and the existence, and terms and conditions, of options for a lessee to purchase the underlying asset.

Additionally, information about significant assumptions and judgments made in applying the new standard is to be provided, which may include how it had been determined whether a contract contains a lease; how the allocation of the consideration in a contract between lease and non-lease components was accomplished; and how the initial measurement of the residual asset was performed.

The lessor is also to disclose lease income recognized in the reporting period, in a tabular format, to include, for Type A leases: profit or loss recognized at the commencement date (gross or net); the unwinding of the discount on the lease receivable; and the unwinding of the discount on the gross residual asset. For Type B leases, the information required will be lease income relating to lease payments; lease income relating to variable lease payments not included in the measurement of the lease receivable; and short-term lease income.

Specific additional disclosures applicable to Type A leases by lessors include a reconciliation of the opening and closing balances of the lease receivable, including such items as: additions due to leases commencing or being extended; receivables derecognized due to leases being terminated; cash received; the unwinding of the discount on the lease receivable; foreign currency exchange differences; the effects of business combinations; and changes to the loss allowance.

A lessor will also have to disclose a reconciliation of the opening and closing balances of the residual asset, citing items such as: additions due to leases commencing; deductions due to leases being extended; reclassifications at expiry or termination of a lease; the unwinding of the discount on the gross residual asset; the effects of business combinations; and impairment.

Except as described in the immediately following point, a lessor is to disclose information relating to risks arising from leases, as required under GAAP.

In lieu of the maturity analyses required by GAAP for long-term debt, a lessor will have to provide a maturity analysis of the lease receivable, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. The lessor will be required to reconcile the undiscounted cash flows to the lease receivable recognized in the statement of financial position. It will also need to disclose information about how it manages its risk associated with residual assets. In particular, a lessor is to disclose all of the following: its risk management strategy for residual assets; the carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor; and any other means by which the lessor reduces its residual asset risk (e.g., buy-back agreements or variable lease payments for use in excess of specified limits).

The new, specific additional disclosures relating to Type B leases by lessors will include a maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years, separately from the maturity analysis required for Type A leases.

Sale-leaseback transactions. A common financing arrangement is to sell owned property subject to a leaseback commitment. The proposed accounting for sale/leaseback transactions will depend on whether the sale leg of the arrangement qualifies as a sale under the anticipated new GAAP pronouncement on revenue recognition. The existence of a leaseback (i.e., the transferor's right to use the asset for a period of time) will not, per se, prevent the transferee from obtaining control of the asset. However, if the leaseback provides the transferor with the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset, then the transferee does not obtain control of the asset and the transfer is not a sale.

The transferor is considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, if *either* the lease term is for the major part of the remaining economic life of the asset; *or* the present value of the lease payments accounts for substantially all of the fair value of the asset.

If a transferee obtains control of the asset in accordance with the requirements for determining when a performance obligation is satisfied under the proposed revenue recognition standard, then the transferor (lessor) will account for a sale in accordance with applicable GAAP and for the lease in accordance with lessee accounting in the new lease standard. The transferee (lessee) will account for a purchase in accordance with applicable GAAP and for the lease in accordance with lessor accounting in the new standard.

If the consideration for the sale of an asset is *not* at fair value or the lease payments are not at market rates, the reporting entity will have to make certain adjustments to recognize the sale at fair value. The transferor will measure the right-of-use asset and the gain or loss on disposal of the underlying asset to reflect current market rates for lease payments for that asset. The transferor will subsequently account for the lease to reflect those current market rates. The transferee will measure the lease receivable and the residual asset for Type A leases, or the underlying asset for Type B leases, to reflect current market rates for lease payments for that asset. The transferee will subsequently account for the lease to reflect those current market rates.

If the transferee does not obtain control of the asset in accordance with the requirements for determining when a performance obligation is satisfied in the proposed new revenue recognition standards, then the transferor will not derecognize the transferred asset and will have to account for any amounts received as a financial liability in accordance with applicable GAAP, and the transferee will not recognize the transferred asset and will account for the amounts paid as a receivable in accordance with applicable GAAP.

Regarding disclosure of sale/leaseback transactions, if a transferor or a transferee enters into a sale and leaseback transaction that meets the new (2014) revenue recognition criteria, it will provide the disclosures required by the proposed lease accounting standards. In addition to the required lease accounting disclosures, a transferor that enters into a sale and leaseback transaction will also disclose *both* the main terms and conditions of that transaction, *and* any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

Short term leases. As noted, leases with terms of less than one year may optionally be excluded from the new capitalization accounting requirements. A lessee may elect, as an accounting policy, not to apply the requirements of the proposed standard to short-term leases, but may instead recognize the lease payments in profit or loss on a straight-line basis over the lease term. A lessor may elect, as an accounting policy, not to apply the requirements of the proposed standard to short-term leases, but may instead recognize the lease payments in profit or loss over the lease term on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which income is earned from the underlying asset. The accounting policy election for short-term leases will have to be made by class of underlying asset to which the right of use relates. If an entity accounts for short-term leases in accordance with these elective options, it must disclose that fact.

IV. LEASE ACCOUNTING AND THE RISK OF FINANCIAL REPORTING FRAUD

Historically, lease accounting, although somewhat complicated, has not been a major mechanism for financial reporting fraud, although there have been some notable instances, such as Xerox Corp.'s aggressive treatment of lessor accounting rules in the late 1990s, which resulted in its paying a then-record $10 million civil fine and ultimately restating (i.e., allocating to different periods) over $6 billion in revenues. That company's infractions involved the way in which it allocated revenues associated with "bundled" machine leases, service contracts, and supplies, thereby inappropriately front-loading revenues. The new lease requirements, if enacted as currently envisioned, will not change the risk that future lessors might misallocate bundled revenue streams, and this will remain a matter of concern for auditors (this being a rather specialized aspect of revenue recognition, which is, in general, the most commonly-cited area of abuse in financial reporting frauds).

Under previous lease accounting rules (FASB Statement 13 and its scores of amendments and other forms of interpretive guidance), the major concern regarding financial reporting by lessees was that they were able to cleverly craft lease terms in order to avoid capitalization, by having the present value of lease commitments fall slightly below the 90%-of-fair-value threshold and/or having the term fall under the 75%-of-economic-life threshold, thus preserving operating lease treatment. This was seen as being highly desirable because it kept the leased asset, and, more importantly, the related long-term debt obligation, off the balance sheet, creating, it was thought, the image of a less financially leveraged enterprise. Bank lenders and many other interested parties, including securities analysts, became rather adept at recasting those balance sheets, using supplementary information found in footnote data, so as to gain a more accurate picture of the entity's true economic performance and financial condition, thereby making any misperceptions increasingly less likely to be maintained. The new standard will force capitalization of virtually all leases (those under one year in duration at inception may optionally be excluded, but these are of trivial significance), thus foreclosing the opportunity to window dress the balance sheet in that manner.

A range of somewhat prosaic financial reporting fraud opportunities involving leases will nonetheless still exist. Some of these are analogous to fraudulent accounting devices that have been observed in non-lease circumstances, such as manipulating the economic lives of the enterprise's assets in order to impact the amortization expense being recognized in a given year. This tactic works equally well whether the assets are owned and accounted for as property and equipment, or leased and, under the new standard, treated as the intangible, right-of-use asset. (In one well-known fraud, for example, Waste Management capriciously extended the purported depreciable lives of its landfills in order to boost earnings via lower depreciation charges.) For lessees, the right-of-use assets will need to be amortized over the lesser of useful lives or lease terms, and there may be a temptation for some to use the lease term, if longer, in order to ameliorate the earnings impact of the more rapid amortization dictated by the leased asset's useful life. Auditors will continue to be alert to such schemes.

Another possible area of abusive accounting would involve imputing a too-high interest rate on the lease obligation, which would understate the initial debt amount, thereby masking the extent of the reporting entity's financial leverage, although the corollary to this would be an exaggeration of the amounts of interest expense to be recognize over the term of the lease, which would have to be front-loaded using the constant return on a declining balance method required under GAAP.

For lessees willing to engage in blatant fraud, concealing the existence of the long-term lease would, in theory, allow recognition of rental expense without capitalization of either asset or obligation, thereby obscuring the extent of financial leverage undertaken. If there are properly designed controls in place (e.g., allowing execution of lease agreements by only authorized parties, triggering the necessary accounting), and if the independent auditors are appropriately alert, any would-be short-term rental expenditures will be closely examined to guard against overlooked rights-of-use and corresponding obligations that needed to have been booked.

Once a weakness or an absence of internal controls is admitted as a possible condition, of course, the range of possible frauds that can befall a company is great, including collusive frauds involving equipment that is – or in some cases is not – leased to it. Equipment can be overvalued, and entirely bogus rental invoices can be presented for payment by a corrupt confederate, as is also true for a variety of commonplace vendor fraud schemes. The company may also fall victim to duplicate payment schemes and other means of extracting excessive disbursements for otherwise legitimate expenditures. Good internal control is the main means of preventing these and similar abuses from occurring.

For lessors, there are also the usual range of fraud risks, such as the unauthorized sale of assets and theft of proceeds, under-billing of lessees by a corrupt lessor agent in exchange for kickbacks of a portion of the lessee's savings, outright abstraction of rental payments received, and substitution of lower-quality assets for those originally acquired for leasing business, with theft of the excess value paid for.

In general, the new requirements are not anticipated to increase risk of accounting fraud beyond what already exists, once the rules have been understood and fully implemented. During the learning curve phase, risk will be increased. On the other hand, the risk of accounting fraud is always a concern, and auditors continue to struggle with public perceptions regarding their obligations to detect such occurrences. The new lease standard will just add to the need to continually refine and improve auditing techniques.

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