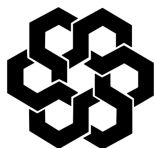

International Accounting Standards Board

Financial Accounting Standards Board

This document is provided as a convenience to observers at IASB/FASB joint international working group meeting on leasing, to assist them in following the working group's discussion. It does not represent an official position of the IASB or the FASB. IASB and FASB Board positions are set out in their respective Standards.

Note: These notes are based on the staff paper prepared for the IASB/FASB working group. Paragraph numbers correspond to paragraph numbers used in the staff paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Meeting: **Joint International Working Group on Leasing**
15 February 2007, London

Topic: **HISTORY OF LEASE ACCOUNTING (Agenda Paper 2)**

Purpose of this memo

1. The purpose of this memo is to consider the history of lease accounting with a particular focus on the underlying models and bases for conclusions used in standards issued prior to Statement 13 and IAS 17. This memo briefly considers the criteria used to categorize leases as operating or capital. Where explicitly noted within early lease accounting standards, this memo considers the correspondence between lease accounting models and the prevailing definitions of an asset. This memo also briefly summarizes lease accounting guidance after the initial issuance of Statement 13 and IAS 17. This memo is intended to facilitate initial discussion of conceptual models at the early stages of the current lease accounting project.

2. The following lease accounting standards and studies will be considered:

Year	*Author*	*Doc*	*Title*
1949	AICPA	ARB 38	*Disclosure of Long-Term Leases in Financial Statements of Lessees*
1962	AICPA	ARS 4	*Reporting of Leases in Financial Statements*
1964	APB	APB Opinion 5	*Reporting of Leases in Financial Statements of*

Year	Author	Doc	Title
			Lessee
1966	APB	APB Opinion 7	*Accounting for Leases in Financial Statements of Lessors*
1972	APB	APB Opinion 27	*Accounting for Lease Transactions by Manufacturer or Dealer Lessors*
1973	SEC	ASR 132	*Reporting of Leases in Financial Statements of Lessees*
1973	SEC	ASR 141	*Interpretations and Minor Amendments Applicable to Certain Revisions of Regulation S-X*
1973	APB	APB Opinion 31	*Disclosure of Lease Commitments by Lessees*
1973	SEC	ASR 147	*Notice of Adoption of Amendments to Regulation S-X Requiring Improved Disclosure of Leases*
1974	FASB	DM	*An Analysis of Issues Related to* Accounting for Leases
1975	FASB	ED	*Accounting for Leases*
1976	FASB	ED (revised)	*Accounting for Leases*
1976	FASB	FAS 13	*Accounting for Leases*
1980	IASC	ED (E19)	*Accounting for Leases*
1982	IASC	IAS 17	*Accounting for Leases*
1997	IASC	ED (E56)	*Leases*
1997	IASC	IAS 17 (revised)	*Leases*
2003	IASB	IAS 17 (revised)	*Leases*
1996	G4+1	Special Report	*Accounting for Leases: A New Approach*
1999	G4+1	Special Report	*Leases: Implementation of a New Approach*

Lease accounting models prior to Statement 13 and IAS 17

ARB 38

3. In October 1949, the Committee on Accounting Procedure of the American Institute of Accountants issued ARB No. 38, *Disclosure of Long-Term Leases in Financial Statements of Lessees*. Later, in 1953, this ARB was restated almost verbatim in chapter 14 of ARB No. 43, *Restatement and Revisions of Accounting Research Bulletins*.

4. In ARB 38, the Committee posited that long-term leases were often nothing more than substitutes for ownership and mortgage borrowing, sometimes referred to as an installment purchase of property. As a result, the Committee worried that companies using such leases often failed to show assets and related indebtedness on the balance sheet. Although this view of long-term leases focused on the omission of both assets and liabilities, the Committee seemed more concerned about the omission of liabilities when they explained that

"…material amounts of fixed rental and other liabilities maturing in future years under long-term leases…are material facts affecting judgments based on the financial statements of a corporation…" (ARB 38, par. 5). The Committee made no similar statement about the importance of omitted assets.

5. Given its concern that liabilities were not being reported, the Committee required that material long-term leases (not explicitly defined in the standard) be disclosed in the financial statements or notes, including (a) the annual amounts payable, (b) the periods over which amounts were payable, and (c) any obligations assumed or guarantees made in connection with the lease. Such disclosures were required for the entire duration of a lease (not just in the year of inception), and additional details surrounding important sale-and-lease transactions were required in the year of inception.

6. The Committee chose not to apply ARB 38 to short-term leases, presumably because short-term leases did not typically require lessees to assume the costs and obligations of ownership, although the Committee did not explicitly offer this rationale. The Committee explicitly rejected the rationale of not recording a leased asset and corresponding obligation simply because the lessee did not hold legal title to the property. Instead, the Committee expressed the opinion that where clear evidence suggested a lease was in substance a purchase, the entity should recognize a leased asset and corresponding liability.

7. ARB 38 did not reference any generally accepted definition of assets or liabilities in its arguments or conclusions, nor did it propose any such definitions.

ARS 4

8. In 1962, the AICPA published Accounting Research Study (ARS), No. 4, *Reporting of Leases in Financial Statements,* which reexamined the facts about leasing and its development since the late 1940s. John H. Myers, the author of the study, contended that since the issuance of ARB 38 (and its restatement in ARB 43) leases had grown in importance, disclosures were rarely meeting the requirements of ARB 43, financial analysts were seeking more information than that required by ARB 43, and presentation on the balance sheet of leases that were in substance purchases was almost non-existent.

9. In a series of examples illustrating how leases can vary from a clear in-substance ownership and mortgage-borrowing arrangement to a more traditional rent arrangement, Myers

introduced a different accounting model from that used in ARB 43. Instead of considering how closely a lease corresponds to an ownership and mortgage-borrowing arrangement, Myers argued that a lease conveys rights to use property, even if those rights are not perfectly aligned with or even close to ownership rights. Consequently, the rights obtained through a lease could still be considered an asset, even if the lease term was for a relatively short duration.

10. Myers argued that defining a lease as the conveyance of rights not necessarily equivalent to ownership rights was still consistent with existing definitions of an asset. For example, Myers cited the following definition of an asset from Kohler's *Dictionary for Accountants* (Second Edition):

> Any owned physical object (tangible) or right (intangible) having a money value;…
>
> …The accounting meaning of "ownership" as applied to an asset is usually legal ownership, but there are exceptions; an equity in an item of property, coupled with possession and use, is…an asset to the owner of the equity…. [ARS 4, p. 39]

Myers explained,

> Although Kohler defines an asset in terms of ownership, he recognizes that, in certain cases, an asset may be represented by rights less than ownership in the common sense of the term. [ARS 4, p. 39]

11. Based on this property-rights conception of a lease, Myers recommended that all leases be recognized on the balance sheet at the discounted present value of cash flows that were to be paid for by the property right. Payments made for typical executory costs were not included in this calculation. Although Myers (and one commentator to his study) believed that distinguishing among these two purposes for cash payments might be difficult some times (e.g., determining what portion of a rent payment goes toward property taxes that are being paid by the lessor), estimating those numbers would be a reasonable expectation of accountants.

12. Myers also recommended that lessors account for a transfer of property rights by "transfer[ring] an asset out of the 'fixed asset' section to the 'receivable' area of the balance sheet" (ARS 4, p. 64). This recommendation relied on a symmetry argument wherein the

lessee's acquisition of a property right would necessarily result from the lessor's disposition of a property right.

Opinion 5

13. In September 1964, the Accounting Principles Board (APB) issued Opinion No. 5, *Reporting of Leases in Financial Statements of Lessee*, which replaced ARB 43, Chapter 14. The APB noted that no consistent pattern had emerged with respect to lease disclosures and relatively few instances of capitalization of leased property and recognition of the related obligation had occurred. The APB concluded from these observations that "…the criteria for determining when a lease is in substance a purchase require clarification" (Opinion 5, par. 3).

14. In making this conclusion, the APB revealed a preference for the purchase model (a.k.a., ownership and mortgage-borrowing model) over the property rights model recommended in ARS 4. Specifically, the APB stated,

> …the nature of some lease agreements is such that an asset and a related liability should be shown in the balance sheet, and that it is important to distinguish this type of lease from other leases. The Board believes, however, that the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists. [Opinion 5, par. 5]

15. The central question the APB felt it needed to address was whether "…assets and liabilities are created by leases which convey the right to use property if no equity is accumulated in the property by the lessee" (Opinion 5, par. 6). The APB argued that leases that convey merely a right to use property in exchange for future rental payments are executory contracts in which no equity in the leased property was created for the lessee. Because the rights and obligations associated with unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements, the APB concluded that nonequity-creating leases would also result in no recognized assets or liabilities. Instead, such leases would be described within the footnotes.

16. Although the APB did not explicitly define *equity* in this standard, the criteria for determining whether a lease would be capitalized under Opinion 5 clarified the intended meaning of the word. By *equity*, the APB meant any amount of excess rent paid over and above the property's fair rental value, or the rent the property could command in the market

place. If a lessee made such excess payments and then had the option of purchasing the property or renewing the lease at an amount less than the fair market value or rent, the lessee would be said to have created equity in the asset by making those early excess rental payments. The APB considered such equity creation coupled with a bargain purchase or renewal option to be evidence of a purchase arrangement.

17. Leonard Spacek's dissent to Opinion 5 also clarified the APB's intended meaning of equity. Mr. Spacek felt it was inappropriate to record a lease liability "…only when the lease, because of an element of prepaid rent (referred to in this Opinion as 'equity') arising from the early lease payments, is interpreted to be an agreement to purchase" (Opinion 5, dissent). The Opinion further explained Mr. Spacek's dissent:

> It is incorrect to assume that only when rental charges are thus determined to be excessive in early periods does a recordable obligation for future payments results, since this leads to the unsupportable conclusion that the payment of prepaid rent creates a liability and the nonexistence of prepaid rent eliminates the liability. [Opinion 5, dissent]

18. The APB provided a few additional examples meant to describe situations that were representative of purchase arrangements (e.g., property acquired by a lessor to meet the special needs of the lessee and that was likely usable only by the lessee), but if material equity was not created by the lease in these arrangements, the APB still did not require capitalization. Thus, the primary criterion in the purchase model of Opinion 5 for determining lease accounting was whether the lease created equity for the lessee.

19. When Opinion 5 was issued, the same definitions of an asset referred to in ARS 4 were in general use. However, the APB appears to have decided that the property rights conveyed by a lease did not in and of themselves meet the definition of an asset. Instead, only when the lessee created equity in the leased asset by some form of rent prepayment could the leased asset be considered the lessee's asset because such equity evidenced an in-substance purchase arrangement.

Opinion 7

20. In May 1966, the APB issued Opinion No. 7, *Accounting for Leases in Financial Statements of Lessors*, which was the first standard to deal explicitly with lessor accounting. The APB described the primary problem for lessors as how to allocate revenues and expenses to the

accounting periods covered by a lease. The purpose of this Opinion was therefore to produce a fair measurement of the lessor's periodic income during the term of the lease with little apparent concern for the resulting balance sheet presentation.

21. As in Opinion 5, Opinion 7 adopted a purchase model of lease accounting. After providing examples of the risks of ownership (e.g., obsolescence, unprofitable operation, unsatisfactory performance, idle capacity, and dubious residual value) and the rewards of ownership (e.g., profitable operation and gain from appreciation in value at end of lease), Opinion 7 attempted to fit the existing financing and operating methods of lessor accounting to this model.

22. Without providing any formal criteria, the Opinion simply described types of companies that tend to enter into leases with the aim of passing all or most of the usual ownership risks and rewards to the lessee. Lease arrangements similar to those entered into by such companies should be treated as a financing lease by the lessor. Then, the Opinion described other companies (e.g., the owner-operator of an office building and the lessor of automotive equipment on short-term leases) that typically retain the usual risks and rewards of ownership and prescribed the operating method for leases similar to those entered into by such companies. No more explicit criteria were provided anywhere in the Opinion.

23. Opinion 7 briefly considered the balance sheet presentation of leases by the lessor, but provided no rationale or model for its conclusion. Opinion 7 required that leased assets be reported separately from other assets simply because "the investment in leasing activities is neither a conventional loan or receivable, nor in the same category as facilities employed in a typical manufacturing or commercial operations" (Opinion 7, par. 13). This argument only begged the question—how are leased assets different, and why does the difference merit separate reporting?

24. It is noteworthy that the requirements for a lessor to treat a lease as a sale do not reference the lessee's creation of equity in the leased asset—the fundamental criterion in Opinion 5 requiring lessees to report a leased asset and corresponding liability on their balance sheet. The APB dismissed this inconsistency in criteria by noting that the focus of lessor accounting was to allocate "revenue and expense to accounting periods covered by the lease in a manner that meets the objective of fairly stating the lessor's net income…" (Opinion 7, par. 18), which would best be achieved if leases meeting the criteria in Opinion 7 were accounted for by lessors as financing leases.

25. In contrast, the APB argued that capitalizing other leases that were not in substance purchases "…may not be necessary [for lessees] in order to state net income fairly since the amount of the lease rentals may represent a proper charge to income" (Opinion 7, par. 18). This argument did not explain why failure to account for an in-substance sale by the lessor as a financing lease would affect net income any differently than failure to account for an in-substance purchase by the lessee as a financing lease would affect net income. As a result, the argument did not satisfy many of the critics of Opinions 5 and 7.

26. Opinion 7 did not refer to any specific definitions of an asset or liability. However, its focus on risks and rewards of ownership implied an asset definition that encompassed the notions of access to or control over ownership risks and rewards.

Opinion 27

27. In November 1972, the APB issued Opinion No. 27, *Accounting for Lease Transactions by Manufacturer or Dealer Lessors*, to clarify issues that had arisen in relation to Opinion 7. Specifically, the APB issued this opinion "…to determine when a manufacturer or dealer lessor should recognize a lease transaction with an independent lessee as if it were a sale" (Opinion 27, par. 3).

28. Opinion 27 continued the use of the purchase model. To clarify when a lease arrangement was in substance a sale of property by the lessor, the APB specified criteria it believed reflected a transfer of usual ownership rewards and risks. A lessor could account for the lease as a sale if (a) collectibility of payments was reasonably assured, (b) no important uncertainties regarding future costs remained, and (c) any one of the following four conditions was present:

    (1) The lease transferred title to the lessee by the end of the fixed, non-cancelable term.

    (2) The lease gave the lessee the option to acquire the title for nominal cost by the end of the fixed, non-cancelable term.

    (3) The leased property, or like property, was available for sale, and the present value of required rental payments for the fixed, non-cancelable term plus any related investment tax credit retained by the lessor was equal to or greater than the normal selling price or fair value of the leased property.

(4) The fixed, non-cancelable term was substantially equal to the remaining economic life of the property.

29. Opinion 27 was the first opinion to provide such explicit criteria for determining whether an in-substance sale/purchase had occurred. Still, the purchase model supported by these criteria was identical to the purchase model in earlier standards, with ARS 4 (which proposed a property rights model) being the only exception.

30. As with most prior standards, Opinion 27 did not explicitly reference any definition of assets or liabilities. However, its focus on criteria that evidenced the transfer of ownership risks and rewards continued to suggest an asset definition that encompassed the access to or control over ownership risks and rewards.

ASR 132

31. In November 1972, the SEC issued ASR No. 132, *Reporting of Leases in Financial Statements of Lessees.* In it, the SEC addressed how a lessee should account for a lease in which the lessor had "no real economic substance other than to serve as a conduit by which debt financing can be obtained by the 'lessee'" (ASR 132, par. 1). The SEC focused particularly on those situations referred to in Opinion 5, paragraph 12(c), where the "lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations." The SEC clarified that the relationship referred to in this paragraph need not be one of equity ownership. Indeed, a lessee and lessor would be considered related if the lessor were created "at the direction of the lessee and exist[ed] as an economic entity because of the lease agreement entered into with the lessee…" (ASR 132, par. 6). As a consequence, the SEC concluded that such arrangements should be considered purchase arrangements by the lessee, and the lease should be capitalized.

32. This release did not introduce any new models by which to account for lease arrangements. Instead, it relied on the purchase model within Opinion 5 and clarified one instance in which a lessee would be considered to have effectively purchased the leased property from the lessor. Referring to the many other questions that had come up in regard to lease accounting in general, the SEC noted that it had "urged that the new Financial Accounting Standards Board place this item high on its agenda for consideration early in 1973."

ASR 141

33. In February 1973, the SEC issued ASR No. 141, *Interpretations and Minor Amendments Applicable to Certain Revisions of Regulation S-X*. In this release, the SEC clarified that the disclosure regarding non-cancelable leases specified in Rule 3-16(i) part (2) "…may be limited to such leases which have a noncancelable term of one year or longer." No rationale was given for this rule, although practicality and cost-benefit would certainly seem likely explanations.

34. ASR 141 also clarified the type of subsidiary activities that would be characterized as financial or non-financial for purposes of consolidation. The SEC determined that a "…leasing subsidiary with both financing and nonfinancing types of leases is a financial activity…." Again, no rationale was given for this view. It is also difficult to extract any implications for lease accounting models from this release.

Opinion 31

35. In June 1973, the APB issued Opinion No. 31, *Disclosure of Lease Commitments by Lessees*. Opinion 31 called for more extensive and more uniform disclosure of rental commitments for non-capitalized leases. Specifically, Opinion 31 required disclosure of minimum rental commitments for "…(a) each of the five succeeding fiscal years, (b) each of the next three five-year periods, and (c) the remainder as a single amount" (Opinion 31, par. 9). Opinion 31 also required disclosures regarding the basis for calculating rental payments, terms of renewal or purchase options, the nature and amounts of guarantees and obligations, and other sundry information.

36. Some constituents at the time had requested that the APB require disclosure of the present value of non-capitalized leases. Other constituents argued that requiring this disclosure would "…improperly [imply] that such lease commitments should have been recorded as debt and resulted in capitalization of the related assets" (Opinion 31, par. 4). The APB ultimately encouraged disclosure of this number, but did not require it.

37. Opinion 31 did not introduce any new lease accounting models or bases for conclusions that differed from those in earlier standards. Nor did it introduce or clarify any existing definition of an asset or liability.

ASR 147

38. In October 1973, the SEC issued ASR No. 147, *Notice of Adoption of Amendments to Regulation S-X Requiring Improved Disclosure of Leases.* In it, the SEC criticized the APB for requiring substantially less disclosure in Opinion 31 than that previously identified by the SEC as needed by investors. Consequently, the SEC provided the most extensive recognition and disclosure requirements to date for lease accounting. In contrast to Opinion 31, the SEC required disclosure of the "…present value of financing leases and of the impact on net income of capitalization of such leases…" (ASR 147, Sec. A). The SEC also provided other lease accounting guidance related to renewal options, determining whether a lessor's investment was recovered, fair market value of leased assets, minimum rentals, net lease payments, implicit interest rates, and materiality.

39. ASR 147 did not provide any significant new conceptual model for lease accounting. It did, however, define a financing lease to be "…a lease which, during the non-cancelable lease period, either (i) covers 75 percent or more of the economic life of the property or (ii) has terms which assure the lessor a full recovery of the fair market value…of the property at the inception of the lease…(ASR 147, Sec. C). These criteria were roughly equivalent to those in Opinion 27, except that the SEC substituted the 75 percent test for the substantially-equal-to-the-remaining-useful-life test. No new rationale or models were given to justify the recognition or disclosure of lease arrangements.

1974 FASB Discussion Memorandum

40. In July 1974, the Financial Accounting Standards Board issued a Discussion Memorandum, *An Analysis of Issues Related to* Accounting for Leases (DM). In this DM, the Board discussed conceptual models (e.g., whether a lease should be capitalized on the premise that it gives rise to an asset or on the premise that it gives rise to a liability) separately from implemental issues (e.g., how to determine whether an asset or liability results from a lease agreement and, if so, how to measure them). The Board discussed five specific models that could be used to justify or preclude recognition of a lease arrangement in financial statements.

41. *Purchase Model.* The Board first discussed the installment purchase (or simply purchase) model, but did not elaborate on its conceptual underpinnings beyond what previous standards had already done. Instead, the Board pointed out that "even the opponents of capitalizing

other leases generally agree that leases which are in substance installment purchases should be accounted for as such" (DM, par. 35). Although this model appeared conceptually sound and widely accepted, the Board noted that the real difficulty was determining the criteria that would indicate that a lease was in effect an installment purchase. These criteria are discussed later in this section.

42. *Legal Debt Model.* The Board next discussed a legal debt model, wherein a lease would be capitalized only if it gave rise to debt in the strict legal sense. This model would capitalize many of the same lease arrangements that the purchase model would capitalize. However, the outcomes of these two models might diverge in some instances. The key conceptual distinction between these models is that the purchase model focuses on the degree to which the risks and rewards of ownership are transferred to the lessee while the legal debt model focuses only on whether the lease agreement gives rise to debt in a legal sense. The Board did not clarify what it meant by debt in a legal sense.

43. *Property Rights (Asset) Model.* The Board next discussed the property rights model or asset model wherein a lease would "…be capitalized on the premise that the acquisition, through a lease, of an intangible property right gives rise to a recordable asset…" (DM, par. 38). This model was identical to that proposed by Myers in ARS 4. Because a lease agreement conveys a right to an economic resource (e.g., the use of property over a period of time), it gives rise to an asset. This model does not consider whether the creation of a liability should result in lease capitalization. It simply focuses on the existence of an asset as justification for capitalization.

44. *Liability Model.* The Board next discussed a liability model wherein a lease would "…be capitalized on the premise that the incurrence of lease obligations gives rise to a recordable liability even if they are not legal debt…" (DM, par. 38). In contrast to the property rights model, this model focused on whether a recordable liability would be created by a lease agreement as the principal criterion for capitalization. This model differed from the legal debt model in that it considered whether an obligation met the definition of an accounting liability, not a legal liability. Often, application of those two models would have similar outcomes.

45. *Executory Contract Model.* The Board last discussed an executory contract model that portrayed a lease agreement as an executory contract in which at any given time, the two

sides of the contract are proportionately unperformed. Because generally accepted accounting had generally treated executory contracts as non-events with no recognition in the financial statements, this model proposed that ordinary leases (i.e., those that are clearly not in-substance purchase arrangements or do not give rise to legal debt) also not be recognized (that is, capitalized). The Board noted that opponents of this view believed that the lessor has performed once the property has been turned over to the lessee. Because opponents believed a lease agreement was no longer executory once the lessor delivered or provided access to the property, they believed an asset should be recognized.

46. After discussing these models, the Board proposed a list of criteria that might be used for some or all of the models above to determine whether a lease should be capitalized. The Board considered these criteria implemental issues that were distinct from the broader conceptual models mentioned above. The Board asked constituents to indicate which of these criteria might be used as conclusive or suggestive evidence that a lease should be capitalized, and under what conceptual model or premise the criteria would apply. That list of criteria, all of which have been considered with earlier standards, follows:

    a. Lessee builds up a material equity in the leased property.
    b. Leased property is special purpose to the lessee.
    c. Lease term is substantially equal to the estimated useful life of the property.
    d. Lessee pays costs normally incident to ownership.
    e. Lessee guarantees the lessor's debt with respect to the leased property.
    f. Lessee treats the lease as a purchase for tax purposes.
    g. Lease is between related parties.
    h. Lease passes usual risks and rewards to lessee.
    i. Lessee assumes an unconditional liability for lease rentals.
    j. Lessor lacks independent economic substance.
    k. Residual value at end of lease is expected to be nominal.
    l. Lease agreement provides that the lessor will recover his investment plus a fair return.
    m. Lessee has the option at any time to purchase the asset for the lessor's unrecovered investment.
    n. Lease agreement is noncancelable for a *long term*.

47. Later in the DM, the Board discussed lessor accounting. In addition to the conceptual models mentioned above, the Board also considered lessor revenue recognition, symmetry between

lessor and lessee accounting, and related party lease transactions. The Board also considered implemental issues, including the following criteria meant to determine whether lessors should treat a lease as a sale:

a. Lease transfers title to the property to the lessee by the end of its fixed noncancelable term.
b. Lease term is substantially equal to the remaining economic life of the property.
c. Lease provides for a bargain purchase or a renewal option at bargain rates.
d. Lease passes ownership risks to lessee.
e. Lease is *full payout*.
f. Leased property is special purpose to the lessee.
g. Lease is treated as a sale for tax purposes.
h. Collection of the rentals called for by the lease is reasonably assured.

1975 FASB Exposure Draft

48. In August 1975, the FASB issued an Exposure Draft, *Accounting for Leases* (1975 ED). In the basis for conclusions, the Board noted that two primary conceptual models underlay the conclusions in the Exposure Draft.

49. The first model was a combination of the property rights model and the liability model discussed in the DM. According to this model:

> …the lessee has acquired a resource representing the potential service to be obtained from using the property. The lessee has agreed to pay for that resource through periodic payments. Financial statements should report as assets the resources being used in the business and as obligations the agreement to pay for them.
>
> The lessor has relinquished service potential inherent in the property. He has disposed of a resource at a price. Financial statements should report the result of substituting one resource for another. [1975 ED, par. 50]

50. This model was equivalent to that proposed by Myers in ARS 4. By citing that model, the Board appeared to acknowledge its conceptual soundness and noted that the adoption of the criteria in the 1975 ED would be "…a practical advance in recognizing in financial statements the essential nature of the resources of lessees and lessors and the obligations of

lessees" (1975 ED, par. 51). However, the criteria in the 1975 ED were better geared to capture those leases described by the second model than by the first.

51. The second model was the purchase model or installment purchase model, which had guided all previous lease accounting standards. The Board stated:

> …a lease that transfers substantially all of the benefits and risks incident to ownership of property should be accounted for as an acquisition of a tangible asset by the lessee and as a sale or financing by the lessor. All other leases are in substance executory contracts and should be accounted for in a manner consistent with that accorded other executory contracts, namely, as operating leases.
>
> It is recognized that all noncancelable leases convey some portion of the benefits and risks incident to the property. However, it is only in those leases that transfer all, or a sufficiently large proportion, of the benefits and risks, that the economic effect on the parties closely approaches that of an installment purchase. It is that economic effect, and that alone, which justifies the classification of some leases as capital leases by the lessee and as sales-type or direct financing leases by the lessor. [1975 ED, par. 52 and 53]

52. Unlike its predecessors, the Board did not outright reject the property rights model in favor of the purchase model. Instead, the Board noted the persuasiveness of the property rights model and argued that adoption of the criteria in the 1975 ED would move financial statements closer to a property rights model. To the degree that more leases were capitalized under the new criteria, that would certainly be true because the property rights model advocated capitalizing substantially *all* noncancelable leases at the present value of lease payments. Despite the apparent acknowledgement of the conceptual soundness of the property rights model, the Board effectively relied on the purchase model in the 1975 ED.

53. Some constituents advocated capitalization of leases that give rise to debt in a strict legal sense. However, the Board noted that the determination of debt legality rested with the courts and was typically decided in cases involving bankruptcy, reorganization, or taxation. The Board concluded that "…legal distinctions of this nature were apt to be neither relevant nor practical in application to the accounting issue of lease capitalization" (1975 ED, par. 61).

54. The Board adopted the following criteria in the 1975 ED, any one of which would require capitalization by the lessee:

    a. The lease transfers title to the property to the lessee by the end of lease term.

b. The lease contains a bargain purchase option.
c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
d. The estimated residual value of the leased property is less than 25 percent of the property's fair value at the inception of the lease.
e. The leased property as a whole is special purpose to the lessee.

55. The Board also decided that a lessor should use capital lease accounting if it met any one of the above criteria and both of the following criteria:

    a. Collectibility of the payments required from the lessee is reasonably predictable; and
    b. No important uncertainties surround the amount of costs yet to be incurred by the lessor under the lease.

56. In some form or another, each of these criteria had been proposed in prior accounting standards or SEC guidance. Thus, the 1975 ED did not represent a dramatic departure from existing accounting literature. The Board did, however, specifically reject the material-equity criterion proposed in Opinion 5 because it was "…too limiting to represent the central basis for lease capitalization by lessees" (1975 ED, par. 63). The Board believed that the proposed criteria would capture those leases in which material equity was created while also capturing many other lease arrangements that were effectively installment purchase agreements. By rejecting the material-equity criterion, the Board expected the accounting for leases to become more symmetric between lessors and lessees.

1976 FASB Exposure Draft

57. In July 1976, the FASB issued a revised Exposure Draft, *Accounting for Leases* (1976 ED). The Board continued to rely primarily on the purchase model as the basis for this Exposure Draft. However, the Board noted that some of its members who supported the 1976 ED:

> …hold the view that, regardless of whether substantially all the risks and rewards of ownership are transferred, a lease, in transferring for its term the right of possession and use of property, gives rise to the acquisition of an asset and the incurrence of an obligation by the lessee which should be reflected in his financial statements. Those members nonetheless agree with this Statement because, to them, (i) it clarifies and improves the guidelines for implementing the conceptual

> basis currently underlying accounting for leases and (ii) it represents an advance in extending the recognition of the essential nature of leases. [1976 ED, par. 62]

58. In essence, the Board was split in its decision to rely on the purchase model or the property rights model. However, those members who supported the property rights model decided they would still support the proposed Statement because it clarified and improved prior guidance based on the purchase model and it would likely require recognition of a greater percentage of existing leases.

59. In the 1976 ED, the Board continued to underscore the conceptual notion that lease classification should be symmetric between the lessor and lessee, with the exceptions of the collectibility and remaining cost uncertainty criteria for lessors. The Board believed that "…this Statement remove[d] most, if not all, of the conceptual differences in lease classification as between lessors and lessees…" (1976 ED, par. 61).

60. The Board adopted the following four criteria in the 1976 ED, any one of which would require capitalization by the lessee:

    a. The lease transfers title to the property to the lessee by the end of lease term.
    b. The lease contains a bargain purchase option.
    c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
    d. The present value of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor over any related investment tax credit retained by the lessor.

61. The last criterion replaced the 25 percent residual value criterion, which required lease capitalization if the non-discounted residual value of the leased property was less than 25 percent of the property's fair value at lease inception. The Board decided that it was not appropriate to ignore the time value of the residual value because this would not distinguish between leases with different terms. However, instead of a criterion that compared the present value of the residual value to the fair value of the leased property at inception, the Board adopted the 90 percent of fair value criterion, which was essentially the complement of the residual value test. The 90 percent criterion responded to suggestions for a recovery criterion in which the transfer of ownership risks and rewards would be determined by the

degree to which the fair value of the leased property was recovered by the lessor or paid by the lessee through minimum lease payments.

62. The Board also dropped the special purpose criterion from the 1975 ED. The Board explained that "special purpose property" is difficult to define objectively. The Board also noted that just because a property is special purpose for the lessee, it does not imply that all risks and rewards of ownership are transferred to the lessee. Ultimately, the Board believed that lessors of special purpose equipment would often structure a lease to transfer most risks and rewards of ownership and that such a structure would likely meet one or more of the criteria for capitalization in the 1976 ED.

63. The Board still required that two additional criteria be met by the lessor to treat a lease as a capital lease. These two criteria were the same as those proposed in the 1975 ED—collectibility being reasonably predictable and no uncertain costs remaining.

64. In addition to the changes noted above, the Board also decided that lessees would use the lower of the lessor's implicit interest rate or the lessee's incremental borrowing rate when discounting minimum lease payments. The lessor would use its own implicit interest rate. In the 1975 ED, the Board required both the lessor and the lessee to use the lessee's incremental borrowing rate. The Board explained that it would often be difficult for the lessor to determine the lessee's incremental borrowing rate, and even if it could, "…it would yield a present value at variance with the known fair value of the leased asset" (1976 ED, par. P-6).

65. The Board also reached new decisions on lease amortization periods, balance sheet presentation of operating leases and related lessee footnote disclosures, gross profits on sales-type leases, footnote disclosure by lessors, leases involving real estate, leases of only part of a building or complex, sale-leaseback transactions, subleases, and criteria for identifying a leveraged lease by lessors. This memo does not report the details and rationales for these decisions.

Statement 13

66. In November 1976, the FASB issued Statement No. 13, *Accounting for Leases,* with only minor changes to the 1976 ED. The conceptual grounding and the implemental issues discussed previously remained virtually unchanged in this standard. There were no further

developments in the definitions of assets or liabilities explicitly referenced in the new standard.

1980 IASC Exposure Draft (E19)

67. In October 1980, the IASC issued Exposure Draft 19, *Accounting for Leases* (E19). This document was very similar to Statement 13 as it was based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. E19 provided the following four criteria for a lease to be classified as a finance lease:

    a. The lease transfers ownership of the asset to the lessee by the end of the lease term.

    b. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable; that, at the inception of the lease, it is reasonably certain that the option will be exercised.

    c. The lease term is for the major part (normally 75 percent or more) of the economic life of the asset. Title may or may not eventually be transferred.

    d. The present value at the inception of the lease of the minimum lease payments is greater than or equal to substantially all (normally 90 percent or more) of the fair value of the leased asset net of grants and tax credits to the lessor at the inception of the lease. Title may or may not eventually be transferred.

IAS 17

68. The 1980 IASC Exposure Draft led to the issuance of IAS 17, *Accounting for Leases,* in 1982 with only minor changes to the 1980 ED. One of the changes from E19 to IAS 17 was the removal of the “bright-line” tests noted in parentheses in criteria (c) and (d) above.

Lease accounting guidance after Statement 13 and IAS 17

Amendments to Statement 13

69. Since the issuance of Statement 13, there have been numerous amendments, interpretations, and additional authoritative guidance issued that provide specific guidance to that Statement. This paper does not intend to focus on that specific interpretive guidance.

Revisions to IAS 17

70. In June 1996, the IASC Board approved a project to revise IAS 17 to address certain essential issues communicated to IASC by the International Organisation of Securities Commissions (IOSCO). IOSCO suggested, among other items, that the IASC, as a long-term potential project, should consider new approaches for lease capitalization (for example, the capitalization of all leases with a term of over one year, including leases that are currently classified as operating leases). At the time, the Board believed that an approach consistent with the definitions of assets and liabilities contained in the Framework would lead to recognition of assets and liabilities arising under most lease contracts, not just contracts that met the definition of a finance lease. However, the Board noted that, at the time, the most common approach to the recognition of assets and liabilities adopted by standard-setters was to classify leases as finance leases or operating leases based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or lessee. When the IASC Board adopted the project in 1996 to revise IAS 17, it decided that new approaches for lease capitalization should be considered at a later stage.

71. The IASC issued Exposure Draft E56 in 1997 to address the issues raised by IOSCO. As a result Exposure Draft, IAS 17 (revised) was issued in December 1997. IAS 17 (revised 1997) expanded the guidance related to the classification of leases by providing additional indicators to further facilitate the classification process. There were no fundamental changes to the approach to the accounting for leases.

72. IAS 17 was revised again in 2003 by the IASB as part of its project on Improvements to International Accounting Standards. The Board's main objective was a limited revision to IAS 17 to clarify the classification of a lease of land and buildings and to eliminate accounting alternatives for initial direct costs in the financial statements of lessors. Once again, the Board did not reconsider the fundamental approach to the accounting for leases contained in IAS 17.

G4+1 Special Reports

73. The G4+1 was a group consisting of representatives of accounting standard-setters from Australia, Canada, New Zealand, the United Kingdom, the United States, and the International Accounting Standards Committee (IASC). A working group consisting of Board members and senior staff members from the G4+1 Group was established to undertake

a study on leasing. That work resulted in two Special Reports that were published by the G4+1 member bodies (one in 1996 and another in 1999). Those reports examined the deficiencies in existing national and international accounting standards on leasing and explored a conceptual approach to accounting for leases based on certain principles adopted by the representatives of the standard-setting bodies in the G4+1 Group.

74. The 1996 Special Report, *Accounting for Leases: A New Approach*, concluded that the distinction between operating leases and finance leases required by existing accounting standards is arbitrary and unsatisfactory because lessees' balance sheets omit material assets and liabilities arising from operating leases. This affects, for example, reported levels of indebtedness, debt-to-equity ratios, return on assets employed, and interest coverage. The 1996 Special Report suggested that the comparability (and hence usefulness) of financial statements would be enhanced if the present treatment of operating leases and finance leases were replaced by an approach that applied the same requirements to all leases. That conceptual study was followed by a second study aimed at developing proposals for how the "conceptual foundation" might be reflected in an accounting standard. That second effort resulted in the 1999 Special Report, *Leases: Implementation of a New Approach*.

75. The 1999 Special Report proposed that the objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease (measured by the fair value of the consideration given by the lessee, including the liabilities incurred, except where the fair value of the asset received is more clearly evident).

76. The 1999 Special Report reflects the working group's conclusion that leases that are now characterized as operating leases (and therefore not included on the balance sheet) would give rise to assets and liabilities—but only to the extent of the fair values of the rights and obligations that are conveyed by the lease.

77. Taken together, the two Special Reports proposed the following:

    a. At the beginning of the lease term, the objective for lessees should be to record the fair value of the rights and obligations that are conveyed by leases.

    b. Leases that are now characterized as operating leases (and therefore not included in the lessees' balance sheet) give rise to assets and liabilities—but only to the extent of the fair values of the rights and obligations that are conveyed by the leases. Thus, if a lease is for a small part of an asset's economic life, only that part would be reflected

in the lessee's balance sheet (some refer to the approach as an "assets and liabilities approach" or a "components approach").

c. The fair value of the rights obtained by a lessee would generally be measured as the present value of the minimum payments required by the lease, plus any other liabilities incurred.

d. Lessors should report financial assets (representing amounts receivable from the lessee) and residual interests as separate assets, since they are subject to different risks. The amounts reported as financial assets by lessors would, in general, be the converse of the amounts reported as liabilities by lessees.

Conclusion

78. This memo has considered the conceptual models and bases for conclusions in lease accounting standards from ARB 38 to Statement 13 and IAS 17 as well as the various criteria used in prior standards to classify leases as operating or capital. This memo also has briefly summarized the conclusions of the G4+1 Special Reports. This memo should provide an understanding and appreciation of prior lease accounting models and criteria considered to prepare the staff and the Boards for making progress on a new lease accounting standard.