

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised?

I do not agree.

Why or why not?

In the lead to this exposure draft, it is stated "models have been criticised for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual framework. The models also lead to a lack of comparability and undue complexity because of the sharp 'bright-line' distinction between finance leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

My issue relates mostly to equipment financing using a traditional FMV type lease. These lease are used today most specifically to move off balance sheet the true economics of the financing arrangement. Professionally, I have executed millions of dollars in FMV type leases.

There are three usual end of term options in an equipment lease. One of these three options must be exercised. These three end of term options are:

- 1) Return the equipment.
- 2) Extend the Lease.
- 3) Buy out the lease (buy the then current fair market value of the lease).

A minimum of research will show that less than 35% of equipment leases end with the return of the equipment. The most common end of term is an eventual buy out of the lease. This buyout may occur at the end of the first term or after one or more extensions.

To ignore this "more likely than not" payment in the valuation of the lease obligation is to perpetuate the current failure "to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions"

If not, how do you think that a lessee or a lessor should account for purchase options and why? Where the purchase option is the "more likely than not" expected outcome, the purchase option should be the final payment of the lease.

For example: Hospital X enters into an FMV lease to acquire an MRI worth \$1,900,000. The basic term of the lease is to pay 60 monthly payments of \$26,000 and then return the MRI, extend the lease or buy the MRI at the then current Fair Market Value. Based on current used equipment market and historical trends it is expected that the value of the MRI at the end of five years will be \$570,000 (or 30% of its original purchase price). Often we even know that the Lessor has taken a 30% residual position in the financing.

An additional fact that should be disclosed: There is a significant disruption to business to return the equipment such as to remove the MRI which is installed on a second floor requires the removal of exterior walls, expensive cranks and lifts, etc.

The lessee's "more likely than not" obligation under this lease is NOT just 60 payments of \$26,000. The Lessee knows that they are going to pay 60 \$26,000 payments and one payment estimated at \$570,000.

The difference in these two valuations at a simple 5% incremental borrow rate is about \$400,000 or a 23% difference. This is in my opinion what is meant when we professionals speak the words "omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual framework."