

FASB Emerging Issues Task Force

Issue No. 08-3

Title: Accounting by Lessees for Maintenance Deposits under Lease Agreements

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FASB Staff: Nickell (ext. 282)/Leverenz (ext. 258)

EITF Liaison: Jay Hanson

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References:

FASB Statement No. 5, *Accounting for Contingencies* (FAS 5)

FASB Statement No. 13, *Accounting for Leases* (FAS 13)

FASB Statement No. 29, *Determining Contingent Rentals* (FAS 29)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property* (FIN 19)

FASB Staff Position, No. AUG AIR-1, *Accounting for Planned Major Maintenance Activities* (FSP AUG AIR-1)

International Accounting Standard 17, *Leases* (IAS 17)

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. Under certain equipment lease agreements, a lessee is legally and contractually responsible for repair and maintenance of the leased asset throughout the lease term. Additionally, certain lease agreements include provisions requiring the lessee to make deposits¹ to the lessor in order to financially protect the lessor in the event the lessee does not properly maintain the leased asset.

2. Under a typical arrangement, those deposits are calculated based on a performance measure, such as hours of use of the leased asset, and are contractually required under the term of the lease to be used to reimburse the lessee for required maintenance of the leased asset upon the completion of that maintenance. If the amount on deposit is sufficient to reimburse the lessee for the maintenance costs paid by the lessee, the lessor is contractually required to reimburse the lessee for the maintenance. Reimbursements are generally limited to the lesser of the available deposits associated with the specific maintenance activity for which the lessee is requesting reimbursement or the amount of accumulated maintenance deposits.

3. The maintenance deposits made under the lease agreement do not transfer to the lessor either the obligation to maintain the asset or the cost or quality risk associated with the maintenance activities. Whether or not there are available reimbursable deposits, the lessee remains legally responsible for maintaining the leased asset throughout the lease term pursuant to the applicable provisions of the lease.

4. There may be situations in which the total cost of cumulative maintenance events over the term of the lease is less than the cumulative deposits, resulting in excess amounts on deposit at the expiration of the lease. In those cases, some lease agreements provide that the lessor is entitled to retain such excess amounts (nonrefundable maintenance deposit); whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee (refundable maintenance deposit).

¹ Lease agreements often refer to these deposits as "maintenance reserves" or "supplemental rent." However, the lessor is required to reimburse the deposits to the lessee upon the completion of maintenance activities that the lessee is contractually required to perform under the lease agreement.

5. Diversity in practice exists with respect to the accounting for nonrefundable maintenance deposits. Some account for the payments as a deposit. When the underlying maintenance is performed, the deposit is expensed or capitalized in accordance with the lessee's maintenance accounting policy. Once it is determined that an amount is not probable of being used to fund future maintenance expense, it is recognized as additional expense at the time such determination is made. Others account for the payments as contingent rent expense or maintenance expense when the initial payment is made. When the underlying maintenance is performed, maintenance expense is recorded and any reimbursement is credited to rent expense (or maintenance expense).

Accounting Issue and Alternatives

Issue: Whether lessees should account for maintenance deposits as a deposit or as contingent rental expense.

6. The staff understands that practice is not diverse with respect to the accounting for refundable maintenance deposits and that current practice is consistent with View A. As such, the views presented below address the accounting for nonrefundable maintenance deposits.

View A: All nonrefundable maintenance deposits should be accounted for as a deposit.

7. Proponents of View A believe that because the maintenance deposits (a) are contractually and substantively related to maintenance of the leased asset and (b) do not meet the definition of minimum lease payments or contingent rentals under FAS 13, payment of such deposits should be accounted for as executory costs (maintenance costs) in accordance with the lessee's maintenance accounting policy. Accordingly, the maintenance deposit made to the lessor should be accounted for as a deposit and expensed or capitalized (determined in accordance with the lessee's maintenance accounting policy) when the underlying maintenance is performed. In the case of a nonrefundable maintenance deposit, if it is determined that an amount is not probable of being used to fund future maintenance expense, it is recognized as additional rent expense at the time such determination is made.

8. Paragraph 5(j) of FAS 13 defines minimum lease payments as the payments that the lessee

is obligated to make or can be required to make in connection with the leased property; however, the definition specifically excludes contingent rentals and the lessee's obligation to pay executory costs, such as maintenance in connection with the leased property. Proponents of View A acknowledge that executory costs are not specifically excluded from the definition of contingent rent; however, contingent rents are defined in FAS 13 as the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease. View A proponents do not believe that executory costs are excluded from FAS 13 only when those costs are fixed at the inception of the lease. That is, executory costs (maintenance costs) should be accounted for as a deposit until the underlying maintenance is performed and then in accordance with the lessee's maintenance accounting policy regardless of whether the payments related to the maintenance are fixed or variable.

9. Proponents of View A further believe that because (a) the lessor is contractually required to use the deposits to reimburse the lessee upon the lessee's performance of required maintenance activities (activities that the lessee may be legally required to perform in order to be able to continue to utilize the leased asset in certain situations, such as with a leased aircraft) and (b) the payments do not transfer to the lessor either the obligation to maintain the leased asset or the cost or quality risk associated with the maintenance activities, such payments should be recorded as a deposit on the balance sheet to the extent recoverable through future maintenance activities. When the underlying maintenance is performed, it would be accounted for as maintenance expense or capitalized in accordance with the lessee's maintenance accounting policy.

10. Proponents of View A note the lessee contractually has the full responsibility for the maintenance and bears the risk associated with the cost and quality of such maintenance. A cash deposit to the lessor does not change the lessee's obligation to perform the maintenance and should not determine the timing of the recognition of maintenance expense in the lessee's financial statements. View A proponents view the maintenance deposit as a means to secure the lessee's performance under the lease (similar to a deposit for potential damages). Proponents note that View B would inappropriately accelerate operating expenses in the early periods of the lease prior to when the maintenance activities actually occur and result in a smoothing of the maintenance expense over the lease term.

11. View A proponents cite paragraph 44 of FAS 5 as support for recording a deposit when the payment to the lessor does not transfer the obligation to maintain the leased asset to the lessor. Paragraph 44 states,

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such. [Footnote reference omitted.]

12. When the lessee's deposit is a nonrefundable maintenance deposit, and the lessee believes it is probable² that the deposit will be utilized for maintenance activities (that is, the deposit will be returned to the lessee because it is probable that future maintenance activities will occur) and therefore will not be available to be retained by the lessor at the end of the lease, proponents of View A believe that the deposit still represents a valid asset and should be accounted for as a deposit. However, the application of the deposit method would require that once it is determined that amounts on deposit with the counterparty are not probable of being used to fund future maintenance expenditures, they should be recognized as additional expense at the time such determination is made.

View B: Nonrefundable maintenance deposits should be accounted for as contingent rental expense.

13. Proponents of View B believe that nonrefundable maintenance deposits under a lease agreement should be accounted for as contingent rentals and recognized as an operating expense as they become payable to the lessor, regardless of the underlying purpose of the payments or whether the obligation to maintain the leased asset or the cost or quality risk associated with the maintenance activities are transferred to the lessor. Proponents of View B believe, however, that refundable maintenance deposits should be accounted for as deposits.

² As defined in FAS 5

14. Proponents of View B point to paragraph 5(n) of FAS 13, which states that lease payments that depend on a factor directly related to the future use of leased property, such as machine hours of use, are contingent rentals. Nonrefundable maintenance reserves, which are often termed additional basic rent or supplemental rent in lease agreements, vary based on usage of the leased asset. Therefore, proponents of View B believe that nonrefundable maintenance deposits are, or are similar to, contingent rentals. Paragraph 12 of FAS 13 provides that contingent rentals should be included in the determination of income as accruable. Accordingly, proponents of View B believe that nonrefundable maintenance deposits should be recognized as expense over the lease term as they become payable.

15. View B proponents also analogize to paragraph 3 of FIN 19, which states that "a lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals...." View B proponents believe that the usage-based payment made to the lessor is indicative of the fact that the lessee's maintenance obligations are essentially compensation to the lessor for wear and tear on the leased asset. View B proponents believe that this maintenance obligation is incurred as the asset is used, and the "supplemental rent" to the lessor reflects that fact. View B opponents observe that View B essentially results in the lessee's application of the "accrue-in-advance method" of accounting for planned major maintenance activities, which is prohibited under FSP AUG AIR-1.

16. Opponents of View B also observe that FAS 13 provides specific guidance for the accounting for contingent rentals, but does not provide any guidance for the accounting for executory costs. Opponents of View B do not believe it is appropriate to account for an executory cost as though it was a contingent rental.

International Convergence

17. The definition of minimum lease payments and contingent rent in IAS 17 is similar to the definition in FAS 13. There is currently no other guidance specific to the issue raised in this Issue Summary in IFRS. The FASB and IASB have a joint project to reconsider the lease

accounting guidance on their current agendas.

Effective Date and Transition

18. The staff recommends that the consensus on this Issue be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. The Task Force will be asked to consider the following transition alternatives:

Alternative A: Retrospective Application—The consensus should be applied retrospectively to all prior periods presented consistent with the guidance in FAS 154. The cumulative effect of the change in accounting principle on periods prior to those presented should be recognized as of the beginning of the first period presented. An offsetting adjustment should be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period, presented separately.

Alternative B: Entities should recognize the effect of the change as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for all arrangements existing at the effective date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately.

Alternative C: Prospective Application—The consensus should be applied prospectively for payments made on or after the effective date of this Issue.

19. Alternative A is consistent with paragraph 7 of FAS 154, which requires retrospective application to changes in accounting principles. In addition, retrospective application is the transition method that best achieves consistency of financial information between periods and facilitates comparability of accounting data. Proponents of Alternative A cite paragraph B7 of FAS 154, which states that

The Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data.

Alternative A would be the most costly to achieve from the preparers' perspective but the comparability that would result provides the most benefit to the financial statement user. Alternative A would require preparers to identify maintenance deposit payments for all lease arrangements and determine in which periods those payments were expensed. Depending on which view is selected by the Task Force preparers would also need to assess (retrospectively) the probability of a payment being used for maintenance expense, and preparers would need to identify the discrete period in which the probability assessment changed. Proponents of Alternative A observe that it is not unreasonable to assume preparers' accounting records would include adequate information to identify payments for maintenance deposits (and when those payments were expensed). Alternative A proponents also believe that information would exist to substantiate preparers' probability assessments for previous maintenance deposits. Proponents of Alternative A also observe that the use of hindsight for this Issue would most likely result in a better reflection of the substance of prior period transactions. If the Task Force opted for Alternative A, and depending on when a consensus in this Issue is finalized, it may need to reconsider the suggested effective date of fiscal years beginning after December 15, 2008.

20. Alternative B carries the benefit of consistency and comparability for the current year and future years without the burden of recasting prior years' amounts (which would alleviate some of the concerns expressed by opponents of Alternative A). Alternative B requires entities to evaluate only the arrangements in effect at the effective date of this Issue. The staff acknowledges that with the reduced costs and burdens of Alternative B comes less consistency and comparability for years prior to the year of adoption. In particular, Alternative B could result in some entities recognizing rent or maintenance expense under the same arrangement twice, that is, in periods before the effective date and after the transition date.

21. Proponents of Alternative C note that retrospective application of a View A consensus under this Issue would require an assessment of probability for payments made in prior periods.

The Board noted that retrospective application also would be impracticable if it would require assumptions about management's intent in a prior period that cannot be independently substantiated. The Board was concerned that retrospective application in that case might require an inappropriate use of hindsight and decided to provide an exception from the general principle of retrospective application in those circumstances.

Alternative C proponents also cite the same concerns as opponents to Alternative A, and they observe that retrospective application could represent a significant challenge for a lessee with a large number of leases. Alternative A proponents note the use of hindsight does not preclude retrospective application provided that it does not change the substance of transactions recorded in prior periods.