



FASB-IASB Preliminary Views on Lessee Accounting

Lessees would have to put all leases on their balance sheets, including those currently classified as operating leases, recognizing a right-of-use asset and a finance liability for each lease, if preliminary views jointly developed by the FASB and IASB are subsequently adopted as final standards.¹ These significant changes would not, however, require lessees to recognize the entire leased property on the balance sheet. The Boards' goal is to issue final lessee accounting standards in 2011.

The preliminary views expressed in the Boards' Discussion Paper, the first due-process document in their lease-accounting project, respond in part to longstanding criticisms that lease accounting has been too permissive of off-balance-sheet treatment, overly complex, and too dominated by arbitrary rules.² The Boards decided to postpone consideration of lessor accounting because most of the criticisms of the current literature are directed at lessee accounting and because they were concerned that considering lessor accounting issues might significantly delay new lessee accounting standards. The Boards' preliminary views build on earlier work conducted by a team made up of members of the FASB, IASB, and standard setters from Australia, Canada, New Zealand, and the United Kingdom.³

The Discussion Paper does not contain the Boards' complete preliminary thoughts on lessee accounting, as the paper makes clear. Some questions remain to be resolved and are acknowledged, but not otherwise addressed in the paper, and others are still subject to further deliberations to resolve differences between the Boards on what is most appropriate.

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¹ FASB and IASB Discussion Paper, *Preliminary Views on Lease Accounting*, March 19, 2009, available at www.fasb.org or www.iasb.org.

² The criticisms of U.S. GAAP lease accounting requirements were recognized in a 2005 report prepared by the SEC staff. See Office of the Chief Accountant, Office of Economic Analysis, and Division of Corporation Finance, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, June 15, 2005, available at www.sec.gov/news/studies/soxoffbalancercpt.pdf.

³ G4+1 Discussion Papers, *Accounting for Leases: A New Approach – Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts* (1996), and *Leases: Implementation of a New Approach* (2000).

Scope: Definition of a Lease

IFRS and U.S. GAAP define “lease” differently.⁴ Some “leases” of intangibles are within the scope of the IFRS lease-accounting literature, whereas “leases” of intangibles are not within the scope of U.S. GAAP lease-accounting literature. The Boards’ preliminary view is that such differences need not be eliminated in order to issue converged lessee accounting standards. Arrangements currently accounted for as leases would therefore be within the scope of any standards that follow the preliminary views in the Discussion Paper, and all other arrangements would not. The Boards decided to include leases that are in-substance purchases (e.g., leases that automatically transfer title to the leased property to the lessee by the end of the lease term) in the scope of new lessee accounting standards, but have not yet decided whether to provide a scope exception for short-term lease contracts (e.g., month-to-month leases) or leases of “non-core” assets.

The Right-of-Use Model

The right-of-use model in the Discussion Paper abandons the idea that the asset obtained by the lessee and conveyed by the lessor is the leased property the lessee is to use. Instead the asset obtained and conveyed according to the model is the right to use the leased property. The Boards concluded that the right to use the leased property and the obligations incurred by a lessee in connection with a lease (e.g., rental obligations) meet the definitions of assets and liabilities in their conceptual frameworks.⁵

In order to avoid confusion with the right-of-use asset, this newsletter will use the term “leased property” to refer to the tangible or, in the case of leases accounted for in accordance with IFRS, intangible property

that is the subject of the lease.

The right-of-use model would require the lessee to recognize all leases essentially the same way that capital (finance) leases are currently recognized. The right-of-use model would require lessees to recognize an asset and liability for each lease. However, as explained in more detail later, the amount of the asset and liability usually would be only a fraction of the value of the underlying leased property (i.e., the entire leased property usually would not be recognized). The Boards agreed that the assets and liabilities recognized in connection with leases should not be recorded using a components approach. Lessees would therefore not be required to separately account for renewal and purchase options, except as already required by other authoritative literature, such as Statement 133.⁶ They would recognize a single asset and a single liability for each lease contract and adjust their measurements to reflect the various features or components in the contract.

The Boards believe that unless the lessee pays in full for the right-of-use asset at the inception of the arrangement, the lessee has financed its acquisition and should account for the financing obligation the same way that it accounts for the financed acquisition of other assets, by recognizing an increase in reported assets and liabilities.

More significant to many lessees would be the changes in the timing of expense recognition and the classification of the costs of the leasing transaction. Expenses would be accelerated or “front-loaded” because interest expense on the finance liability would be recognized by applying the effective-interest method, not the straight-line expense recognition associated with most operating

leases, and the right-of-use asset would be separately amortized or depreciated.

Initial Measurement

The right-of-use model would require lessees to initially measure the lease finance liability at the present value of the most likely amounts to be paid over the most likely lease term, discounted using the lessee’s incremental borrowing rate at lease inception. A right-of-use asset would be recognized for an amount equal to the finance liability plus any amounts paid up-front by the lessee for the right to use the leased property, a sum that usually would be only a fraction of the value of the underlying leased property. The Boards noted that such measurements would reasonably approximate fair value, but held that the method applied would be less complex than determining fair value. The lease-liability assessment would typically begin by determining the most likely lease term. The lessee would assess all contractual, noncontractual, and business factors. The Discussion Paper describes the factors further:

- Contractual factors are explicit contractual terms that could affect whether the lessee extends or terminates the lease, including the levels of rentals in any secondary period, residual-value guarantees, and termination penalties.
- Noncontractual factors are the financial consequences of a lessee’s decision to extend or terminate the lease that are not explicitly stated in the contract. Examples include significant leasehold improvements that would be lost if the lease were terminated or not extended, noncontractual relocation costs, and costs associated with sourcing an alternative item for use by the lessee.

⁴ The scope of the U.S. GAAP lease accounting literature is provided by FASB Statement No. 13, *Accounting for Leases*, and EITF Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*, both available at www.fasb.org. The scope of the IFRS lease accounting literature is provided by IAS 17, *Leases*, IFRIC 4, *Determining whether an Arrangement contains a Lease* and SIC 27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

⁵ FASB Statement of Financial Concepts No. 6, *Elements of Financial Statements*, available at www.fasb.org, and IASB, *Framework for the Preparation and Presentation of Financial Statements*.

⁶ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, available at www.fasb.org.

- Business factors are nonfinancial business factors that could affect the lease term, such as the leased property's location and nature (whether it is customized or core to the lessee's business operations) and industry practice.

The most likely lease term would enable the lessee to identify the certain and uncertain cash flows that would be the measurement basis for the lessee's obligation to pay for the right-of-use asset. For example, if a lease has a ten-year term with two optional five-year extensions, and the lessee determined that it was most likely that only one extension option would be exercised, the measurement of the lease obligation would include the payments to be made during both the initial noncancelable lease term and the first extension period. Alternatively, if the lease permitted the lessee to terminate the lease by paying a lump-sum fee and the most likely outcome was that the lease would be terminated after eight years, the lump-sum termination fee due at the end of the eighth year would be added to the payments due during the eight-year term in measuring the lease obligation. The most likely lease term for month-to-month leases would likely be greater than a month.

The lessee would be precluded from considering its historical practice and its intentions when assessing the most likely lease term. For example, if the lessee intends to exercise renewal options within a lease because it is convenient to do so, the lessee would be precluded from including the renewal periods in the most likely lease term if, at lease inception, an evaluation of the contractual, noncontractual, and business factors applicable to the lease indicates that it is most likely that the renewal options would

not be exercised. The maximum most likely lease term would be limited to the noncancelable term and any optional renewal periods even if the lessee has a practice of negotiating with the lessor for continued use of the leased property at the end of the contractual lease term. Such negotiated renewals would be accounted for as new leases.

The Boards identified two types of uncertain cash flows in lease arrangements: those that arise from optional lease payments and those that are based on contingencies. The following are some examples of uncertain cash flows that arise from optional lease payments, more than one of which could be included in a lease:

- Payments during optional periods of the lease term,
- Payments to terminate the lease before the end of the lease term, and
- Optional payments to purchase the leased property.

The Boards' preliminary view is that uncertain cash flows for optional lease payments should be initially measured at the present value of the most likely amounts to be paid over the most likely lease term.

The following are some examples of uncertain cash flows that are based on contingencies, more than one of which could be included in a lease:

- Obligations to pay variable rent (for example, increases or decreases in rental payments based on changes in interest rates or the consumer price index),
- Obligations to pay contingent rent (for example, percentage rents based on the level of retail sales or additional rents based on the use of the leased property), and

- Residual-value guarantees.

The Boards reached different preliminary views on how to measure obligations that result from uncertain cash flows that are based on contingencies. The FASB's preliminary view is that the lessee would measure the liability for such uncertain cash flows based on the present value of the most likely amounts to be paid over the most likely lease term. This approach would consider the likelihood of each possible outcome, but would not be probability weighted. The initial measurement of expected lease payments for rents that vary with changes in an index or rate would be based on the index or rate at the inception of the lease. The IASB's preliminary view is that the lessee would measure the liability for uncertain cash flows that are based on contingencies using a probability-weighted estimate of the possible outcomes.

If the Boards' preliminary views on initial measurement are included in their final standards, lessees may be inclined to structure future leases to minimize the amount of the lease obligation and associated right-of-use asset through a combination of features that might include short, noncancelable lease terms; no optional renewal periods; and residual-value guarantees of the entire expected value of the leased property at the end of the lease term. At the end of the noncancelable lease term, lessees with such lease provisions that wish to continue using the leased property would need to negotiate a new lease with the lessor, purchase the leased property, or lease replacement property. This could cause some lessees to reevaluate whether to buy or lease the property.

Under the right-of-use model leases would not necessarily be accounted for the same way as are other economically similar transactions. For example, if a lessee leases a truck with a value of \$50,000 for two years with payments of \$10,000 per year, provides a guarantee to the lessor of the expected residual value of the truck at the end of the lease term, and receives from the lessor the right to any excess value of the truck over its estimated residual value at the end of the lease term, the lessee might record an asset and a liability of only \$20,000 (ignoring the effect of discounting to present value, and assuming that the most likely amount expected to be paid under the residual value guarantee is zero). Conversely, if the lessee obtained a loan to purchase the truck, it would record an asset of \$50,000 and a liability of \$50,000. Assuming that the loan requires payments of \$10,000 per year for two years with repayment of the remaining balance due at the end of two years and that the lessee intends to sell the truck at the end of two years in order to repay the balance due on the loan, there is little, if any, economic difference between the two transactions.

Reassessment

Under the right-of-use model, lessees would remeasure the obligation to be paid under the lease each reporting period. The task would include reassessing both the most likely lease term and the estimated amount of any uncertain cash flows. As already noted, at the inception of the lease, the lessee is precluded from considering its historical practice and its intentions when determining the most likely lease term. However, the Boards have tentatively decided to require lessees to reassess the lease term at each reporting date, considering any new facts and circumstances, and the Discussion Paper

does not say whether the lessee would be precluded from considering its intentions and historical practice in the reassessment. The FASB's preliminary view is that the discount rate—the lessee's incremental borrowing rate at the inception of the lease—should not be reassessed. The IASB's preliminary view is that changes in the lessee's incremental borrowing rate should be reflected in the remeasurement of the lease obligation. However, the IASB did not reach a preliminary view on the frequency of the remeasurement (i.e., each reporting period or only for changes in cash-flow estimates).

Changes in the lease obligation caused by a change in the estimate of the most likely lease term would be recognized as an adjustment to the carrying amount of the right-of-use asset and the related liability, with no immediate effect on the income statement.

The Boards reached different preliminary views about accounting for changes in the lease obligation related to changes in uncertain cash flows that are based on contingencies. The FASB's preliminary view is that adjustments to the lease liability from updated expectations about such uncertain cash flows would be recognized immediately in earnings. For example, for rentals based on an index such as LIBOR, an increase in the index following lease inception would require the lessee to recalculate the liability using the increased index for the remainder of the lease term. The amount of the adjustment to the liability would be recognized immediately in earnings, a potentially significant change from current U.S. GAAP requirements, under which only the difference between the originally-estimated payments during the reporting period and the actual payments during the reporting period is recognized

currently in earnings. The FASB believes this approach would reduce complexity and help financial-statement users understand the transaction. The IASB's preliminary view is that such adjustments to the lease liability should result in a corresponding adjustment to the carrying amount of the right-of-use asset in order to be consistent with the accounting for changes in the most likely lease term and all other changes in estimates of uncertain cash flows.

Subsequent Accounting

Lessees applying the right-of-use model would depreciate or amortize the right-of-use asset over the shorter of the most likely lease term or the economic life of the leased asset unless the lease transfers title to the lessee by the end of the lease term, in which case the amortization period would be the economic life of the leased property. The depreciation or amortization would be based on the pattern of the lessee's consumption of the right-of-use asset's economic benefits (for example, straight-line).

Some Board members expressed an interest in pursuing a linked approach for the right-of-use asset and related obligation under which both the asset and liability would be amortized using mortgage-based amortization for certain leases. Under the linked approach, rent expense for leases that would be classified as operating leases using current lease-accounting standards would be recognized using the straight-line method over the most likely lease term, rather than recognizing interest and either depreciation or amortization expense. The Boards tentatively decided not to pursue the linked approach because it would make the right-of-use model more complex and introduce conceptual inconsistencies.

Lease-obligation payments would be apportioned between a finance charge (interest expense) and a reduction of the remaining lease liability using an amortized-cost-based approach (effective-interest-rate method).

The nearby table summarizes the right-of-use model’s treatment of payments under the lease agreement in determining the lease obligation and during subsequent remeasurement.

Presentation

Rental obligations would be presented as a financial liability within the statement of financial position. However, the Boards expressed different views on whether the financial liability should be presented separately from other liabilities. The IASB’s preliminary view is that separate presentation should not be required, and the FASB’s preliminary view is that separate presentation should be required because the lease obligation’s characteristics differ from those of other financial liabilities. The Boards’ joint preliminary view is that the right-of-use asset should be classified based on the nature of the leased property (e.g., property, plant, and equipment; buildings) and shown separately from owned assets.

Income-statement presentation would be based on the nature of the leased property. For example, the reduction of the carrying amount of the right-of-use assets that are presented as property, plant, and equipment would be shown as depreciation. Interest expense on the lease obligation would be presented separately if the liability was presented separately in the statement of financial position. It would otherwise be included in general interest expense.

Lessor-Accounting Issues

The Discussion Paper mentions some of the lessor-accounting issues that will need to be addressed and identifies two approaches to applying the right-of-use model to lessors—the finance-lease and the performance-obligation approaches.

Summary of the Right-of-Use Model’s Treatment of Lease Payments Initially and Subsequently		
Payment Type	Initial Measurement	Subsequent Remeasurement
Minimum nonvariable rental payments during the noncancelable lease term	Include most likely amounts to be paid over the most likely lease term.	Reassess the most likely lease term and the most likely amounts to be paid and remeasure the liability each reporting period. Offset adjustments to the liability against the corresponding right-of-use asset. <i>FASB View:</i> Do not remeasure for changes in the lessee’s incremental borrowing rate (i.e., the discount rate). <i>IASB View:</i> Changes in the lessee’s incremental borrowing rate should be reflected in the remeasurement of the liability.
Rental payments during optional periods of the lease term		
Optional payments to purchase the leased property		
Payments made to end the lease early		
Payments for obligations under variable rental provisions (based on changes in price or an index)	<i>FASB View:</i> Include payments based on the most likely amounts to be paid over the most likely lease term.	<i>FASB View:</i> Recognize immediately in earnings adjustments to the liability for changes in the most likely amounts to be paid over the most likely lease term. <i>IASB View:</i> Offset adjustments to the liability for changes in the probability-weighted estimate of possible outcomes against the corresponding right-of-use asset.
Payments for obligations to pay contingent rent	<i>IASB View:</i> Include payments based on the probability-weighted estimate of possible outcomes.	
Payments for residual-value guarantees		

The finance-lease approach is essentially the same as the U.S. GAAP direct-financing and sales-type lease accounting models and the IFRS finance-lease accounting model. The lessor would recognize revenue at the lease’s commencement based on the difference, if any, between the cost of the leased property and the sum of the present value of the lessor’s receivable for payments due from the lessee, the present value of the lessor’s interest in the residual value of the leased property, and any up-front payments by the lessee. The accretion of the lessor’s receivable for payments due from the lessee and its interest in the residual value of the leased property from their present values to their future values would be recognized as income over the lease term. The leased property would be removed from the lessor’s balance sheet and replaced by the lessor’s

receivable from the lessee (a financial asset) and its interest in the residual value of the leased asset (a nonfinancial asset).

Under the performance-obligation approach, the lessor would initially recognize a liability to deliver the right-of-use asset to the lessee equal to the sum of any up-front payments by the lessee and its receivable for payments due from the lessee. The lessor’s liability would be eliminated and recognized as income over the lease term. Because the lessor would be viewed as having an ongoing obligation to deliver and continue to permit the lessee to use the leased property, it would not be removed from the lessor’s balance sheet. The lessor’s receivable from the lessee and its performance obligation would increase the lessor’s assets and liabilities.



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The finance-lease approach may be most consistent with the concepts underpinning the right-of-use model and with the Boards' preliminary views on revenue recognition, which hold that a seller satisfies a performance obligation and accordingly recognizes revenue when it transfers a promised asset to the customer—that is, when the customer obtains control of the promised asset.⁷ In the right-of-use model, the lessee controls the right-of-use asset when the lease commences, which triggers recognition of that asset on the lessee's balance sheet. If the lessee controls the right-of-use asset, the lessor has transferred that asset to the lessee and should not recognize a performance obligation to do so.

The Discussion Paper also identifies the lessor-accounting issue of whether investment property should be excluded from the scope of the lease-accounting project. Under IFRS, companies that hold investment property are permitted to measure it at fair value or cost.⁸ Gains or losses from changes in the fair value of an investment property that a company elects to measure at fair value are recognized in earnings. U.S. GAAP does not permit companies to measure investment property at fair value.

Comment Deadline and Next Steps

Comments on the Discussion Paper are due by July 17, 2009.

The Boards hope to resolve their differences of opinion on several issues identified in the Discussion Paper as part of their development of proposed standards for public comment and will consider comments received on the Discussion Paper as well. In addition, the Boards will need to develop guidance on a number of matters that they have not yet addressed. The Discussion Paper does not consider, for example, accounting for sale-leaseback transactions, accounting for subleases, whether initial recognition of the lease occurs when the contract is executed or when the leased property is delivered, an impairment model for right-of-use assets, the treatment of payments for services within the lease payments, whether a lease's initial direct costs should be capitalized as part of the carrying amount of the right-of-use asset or expensed as incurred, and disclosure requirements.

The Boards expect to expose their proposed standards for public comment in the first half of 2010, and plan to issue final standards for lessee accounting by mid-2011.⁹ Before then the Boards will have to agree to an effective date and transition provisions for their proposed requirements. However, it is unlikely that the accounting for existing leases will be grandfathered. As a result, it will be important for companies to consider the changes proposed in the Discussion Paper as they evaluate possible new lease arrangements.

The descriptive and summary statements in this newsletter are not intended to be a substitute for the Discussion Paper, the cited FASB Statements, IFRS, or any other potential or applicable accounting literature or SEC regulations. Companies applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

⁷ Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, December 19, 2008, available at www.fasb.org.

⁸ IAS 40, *Investment Property*.

⁹ FASB and IASB, *Completing the February 2006 Memorandum of Understanding: A progress report and timetable for completion*, September 2008, available at www.fasb.org.