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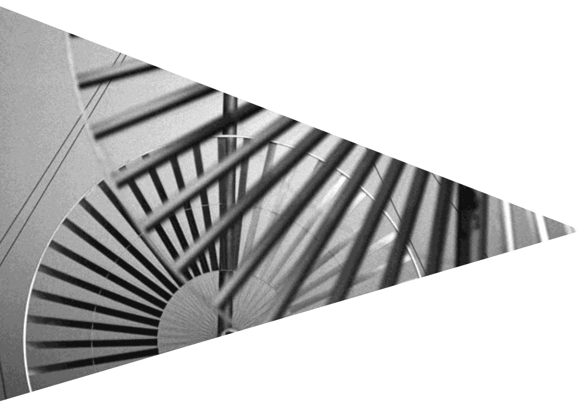
Technical Line

Technical guidance on standards and practice issues



Proposed leases guidance exposed

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Highlights

Substantial changes to the accounting for leases were proposed yesterday in the Exposure Draft (ED) issued by the FASB and IASB (the Boards) on their joint leases project. The ED proposes a single model that will be applied to most leases that will effectively end off-balance sheet reporting for leases. The proposed model also will require entities to make a number of estimates and periodically reassess those estimates in accounting for leases. As proposed, the guidance will affect existing leases at transition and no leases will be grandfathered.

The proposed changes have taken years to develop and they address some of the more frequent criticisms of the current model including:

- Economically similar lease transactions result in different accounting
- Material assets and obligations arising from operating leases are not recorded
- Estimates at inception of a lease are not reassessed

While the proposed model addresses several of the criticisms of the current model, it introduces several new concerns including:

- Uncertain future lease payments that are neither contractually required nor reasonably assured of occurring are recognized as assets and liabilities based on estimates that require periodic reassessment
- Inconsistent accounting for rights to use tangible versus intangible assets
- Lessees will apply a uniform accounting model to all leases, whereas lessors are provided two distinct models to apply in recognition of the inherent differences between various types of leases

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Scope

The ED defines a lease as a contract in which the right to use an asset is conveyed, for a period of time in exchange for consideration. The proposed model retains much of the current guidance[1] relative to assessing whether an arrangement is or contains a lease. As a result, arrangements that are considered leases under existing accounting standards generally will be considered leases under the proposed standard. The proposed guidance would only apply to leases of property, plant and equipment. The following arrangements would not be in scope:

- Leases of intangible assets
- Leases to explore for or use natural resources (such as minerals, oil and natural gas)
- Leases of biological assets

In addition, contracts that are considered to be the purchase or sale of the underlying asset are excluded from the scope of the ED. As a result, leases that provide for the automatic transfer of title to the underlying asset to the lessee and those that contain bargain purchase options will not be accounted for as leases under the ED. It is not clear how these arrangements will be accounted for when they are no longer considered leases, and the ED does not discuss transition provisions for such arrangements.

The proposed guidance will apply to leases embedded within other arrangements (e.g., service contracts), and the ED addresses the accounting for such arrangements. Both lessors and lessees will use revenue recognition principles to identify the separate components of such arrangements and allocate payments between the service and lease components.

How we see it

Although the criteria for determining what is or is not a lease is not changing, that determination for many arrangements will take on increased importance. As the current accounting for operating leases and service contracts is often similar, determining that a service arrangement contains a lease classified as an operating lease generally does not result in significantly different accounting for the arrangement. That is, a service arrangement with an embedded operating lease is often accounted for similarly to a service arrangement that does not contain a lease. As such, entities may not have scrutinized the assessment of whether an arrangement contained a lease under the current guidance when it is clear that any potential embedded lease would be classified as an operating lease. Under the proposed guidance, any embedded lease in an arrangement will result in the recognition of lease assets and liabilities. As such, the determination of whether an arrangement contains a lease and the allocation of payments between components in such an arrangement will have significant accounting implications under the proposed model.

Although the ED neither distinguishes between leases of assets that are incidental versus those considered essential to the operations of the entity nor excludes long-term leases of land, a simplified form of lease accounting for short-term leases (i.e., leases with a maximum possible lease term of 12 months or less) will be permitted. But in the "be careful what you wish for" category, the simplified accounting results in a lease asset and liability being recorded by the lessee at a larger amount than would be recognized otherwise. Under the simplified accounting for short-term leases, lessees will measure the right-of-use asset and the liability to make lease payments at the undiscounted amount of the lease payments. Lessors applying the simplified accounting will recognize lease payments into income over the lease term and will not recognize lease assets or lease liabilities or derecognize any portion of the underlying asset.

[1] ASC 840-10-15 (formerly EITF 01-8).

Under IFRS, certain real estate properties held to earn rentals or for capital appreciation (investment property) can be measured at either historical cost or fair value. The IASB tentatively decided to exclude investment property measured at fair value from the scope of the proposed model. No special accounting for investment property exists under US GAAP. However, the FASB is working on a project that considers whether to permit or require fair value accounting for investment property. See our Hot Topic, *Changes to be proposed for investment property* (23 July 2010, SCORE No. BB1977), for further details on this project.

Lessee accounting

Lessees will be required to record a liability for the present value of the obligation to make lease payments and an asset representing the right to use the leased item for the lease term (the right-of-use asset). The lease asset and liability to be recorded for each lease will be based on the expected payments to be made over the lease term. Measurement of the expected payments will require estimates and judgments about uncertain future events and conditions including consideration of renewal options and contingent payments to be made over the lease term.

Lease term

To estimate the expected payments over the lease term, lessees first must determine the lease term. The lease term is the longest possible lease term that is more likely than not to occur — that is, the longest possible lease term with a probability of occurrence in excess of 50%. Lessees should only consider contractual lease terms for purposes of evaluating the possible lease terms. For example, assume that a lessee enters into a lease for retail space with a non-cancellable term of 10 years and two 5-year renewal options. The lessee will only consider possible lease terms of 10 years, 15 years and 20 years. Determining the lease term may be challenging as lessees will need to evaluate all relevant factors, including contractual, non-contractual, business and lessee-specific factors such as:

- Expectations regarding future business operations
- Residual value guarantees
- Termination penalties
- Existence of significant leasehold improvements
- Tax consequences
- Lessee's intentions and past practices

The following example illustrates how a lessee will determine the lease term for a lease:

Example: lease term

A lessee enters into a lease for office space with a five–year non-cancelable lease term and two five-year optional renewal periods. The possible lease terms are 5 years (exercise no renewals), 10 years (exercise first renewal only) and 15 years (exercise both renewals). In evaluating the facts and circumstances, the lessee determines the individual probability of occurrence for each possible lease term and determines the cumulative probability of occurrence for each possible lease term as illustrated below.

Possible lease terms	Individual probability of occurring (%)	Cumulative probability of occurring (%)
15 years	20%	20%
10 years	40%	60%
5 years	40%	100%

The lease term for this lease will be 10 years because this is the longest possible lease term more likely than not to occur (cumulative probability in excess of 50%).

Options to purchase the underlying asset are accounted for only when they are exercised (i.e., not included in lease term or lease payments); however, as noted above, a lease that includes a bargain purchase option (or automatic transfer of ownership) would be excluded from the proposed guidance.

Lease payments

Lessees initially will measure the lease liability at the present value of lease payments to be made over the lease term discounted using the lessee's incremental borrowing rate at the inception of the lease.

How we see it

While many of the terms used in the ED are the same as those used in the current model, the application can be quite different. Lease payments arising under a lease contract include rentals, contingent rentals, amounts payable under residual value guarantees and termination penalties. The incremental borrowing rate is the rate the lessee would have incurred to borrow over a similar term, and with similar security, the funds necessary to purchase a similar underlying asset.

Lessees will estimate the amount payable under residual value guarantees and make a number of other estimates to determine the expected lease payment amounts, including estimating payments contingent upon:

- The lessee's use of the underlying asset (e.g., miles flown or hours used)
- The lessee's performance (e.g., percentage of sales in a leased store)

If contingent rents depend on an index or rate (e.g., CPI), lessees will determine the expected lease payments using readily available forward rates. If forward rates for the applicable index are not readily available, lessees will use the prevailing rate.

Contingent amounts will be measured using an expected outcome technique (i.e., probability-weighted estimate).

How we see it

Estimating such contingent amounts looks to be one of the more challenging aspects of the proposed model as it may require lessees to forecast activities in periods beyond their normal planning or budgeting cycle, and the calculation can be complex if a lease has multiple contingent features.

The following example illustrates how a lessee will determine lease payments for contingent rents:

Example: contingent rents

A retailer is a lessee in a 1-year store lease that includes a contingent rental arrangement whereby the lessee pays an additional $10,000 of rent for each $1 million of sales in the leased location up to a maximum of $30,000. The lessee determines the probability of the sales for the leased store generating each of the various contingent rental amounts as follows:

Sales	Contingent rents	Probability	Probability-weighted amount
Less than $1 million	$ 0	35%	$ 0
> $1million and < $2 million	$ 10,000	50%	5,000
> $2 million and < $3 million	$ 20,000	10%	2,000
> $3 million	$ 30,000	5%	1,500
			$ 8,500

Contingent rent of $8,500 would be included in lease payments.

Lessees will measure the right-of-use asset at the amount of the liability to make lease payments plus certain initial direct costs incurred by the lessee.

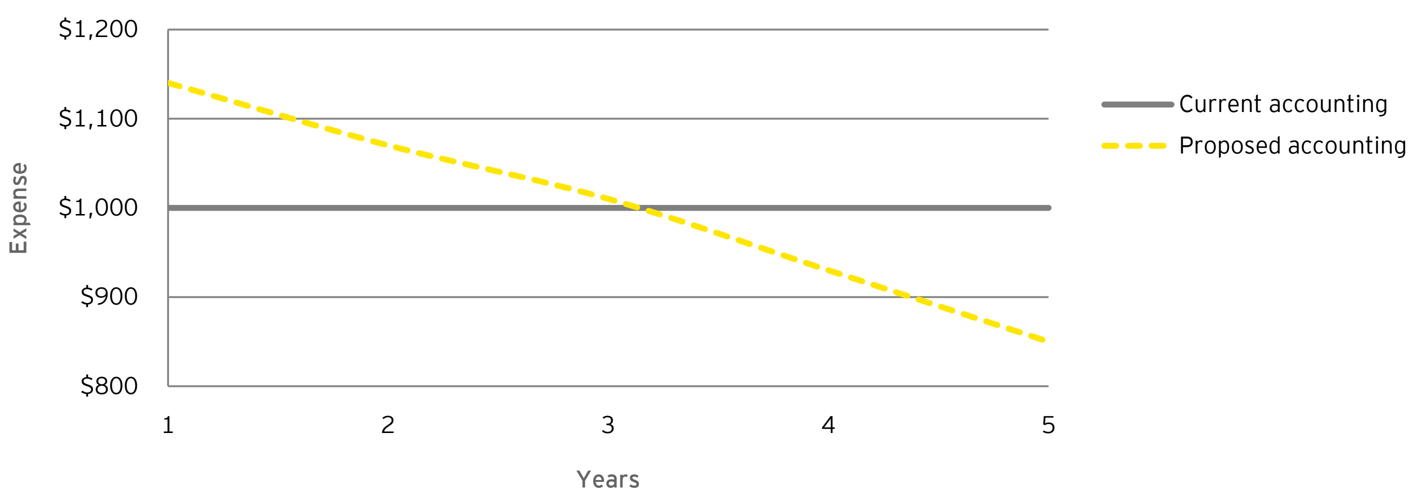
Subsequent measurement

The right-of-use asset is subsequently measured on an amortized-cost basis. The right-of-use asset is amortized over the lease term (or the useful life of the underlying asset if shorter) and would be subject to the impairment guidance for amortizing intangible assets. Interest expense on the liability to make lease payments would be recognized using the effective interest method, and lease payments would reduce the liability. For many leases, the total expense recognized (i.e., the sum of amortization and interest expense) will be higher in earlier periods of the lease and lower in later periods of the lease. The following example illustrates the difference in timing of expense recognition between an operating lease under the current accounting model and the same lease under the proposed ED.

Example: expense recognition

A lessee enters into a lease to rent office space for $1,000 per year for five years. Payments are due at the beginning of each year. The lessee's incremental borrowing rate is 8.5%.

Assuming the lease is classified as an operating lease under the current accounting model, the lessee would not initially record any amounts on its balance sheet for the lease and would record rent expense on a straight-line basis (i.e., $1,000 per year). Under the proposed model, the lessee would record both an asset and a liability for the present value of the expected lease payments over the lease term (approximately $4,250 in this example). In addition, the lessee would record both amortization expense (presumably on a straight-line basis) and interest expense. As illustrated below, the proposed model will result in an acceleration of expense when compared to the current accounting model.



Lessees will be required to reassess the estimates and judgments used in determining the liability to make lease payments each reporting period and make adjustments to reflect changes in the liability due to changes in facts and circumstances.

How we see it

Entities would not be required to perform a detailed analysis of all lease arrangements each reporting period; however, processes would need to be established to identify changes in facts and circumstances that may affect the estimates and judgments used to determine lease obligations.

Features of a lease that could result in a change in lease obligations include options to extend or terminate the lease, contingent rental arrangements and residual value guarantees. Changes in the lease obligation due to changes in contingent amounts payable arising from current or prior periods would be recognized in profit and loss (i.e., the liability would be adjusted and the difference would be recognized as income or expense). Changes in the lease obligation due to all other changes, including those due to a change in the lease term, would be recognized as an adjustment to the right-of-use asset (i.e., the liability would be adjusted and the difference would be recorded as an increase or decrease in the asset).

When reassessing the liability to make lease payments for changes in facts and circumstances, one input that typically will remain constant is the discount rate used by the lessee. The discount rate used (i.e., the lessee's incremental borrowing rate at the inception of the lease) should not be revised unless the contingent rentals are based on variable reference interest rates (e.g., Libor).

How we see it

Note that under the proposed model, accounting for a contractual renewal will be different than accounting for a newly negotiated lease. In other words, the asset and liability recognized for a lease renewal will be measured differently than the asset and liability that would have been recognized had a new lease with the same terms been executed.

The following example illustrates application of the right-of-use model for lessee accounting:

Example: lessee right-of-use model

Lessee A, a retail company, enters into a lease for a new store location with a five-year non-cancelable base term and two five-year optional renewal periods. Rents under the lease consist of fixed annual base rent and contingent rent based on sales from the leased store location as follows:

Base term (years 1–5):	\$1,000 + 1% of sales
First renewal period (years 6–10):	\$1,200 + 1% of sales
Second renewal period (years 11–15):	\$1,400 + 1% of sales

At inception of the lease, based on an assessment of all relevant factors, Lessee A determines that the longest possible lease term that is more likely than not to occur is 10 years (i.e., lease term includes the first renewal period only). Lessee A performs a probability-weighted assessment of contingent rents based on projections of sales for the leased store location over the 10-year period. Lessee A estimates that the contingent rent will be \$100 for the first year and will increase modestly each year as sales from the store increase. Lessee A's incremental borrowing rate as of the inception of the lease is 8.5%.

Lessee A determines that the present value of the expected payments (i.e., both base and contingent rents for years 1 through 10) at the inception of the lease is \$8,000. The following journal entry would be recorded:

Right-of-use asset	8,000	
Obligation to pay rentals		8,000

To initially record the asset and liability arising under the lease (present value of expected payments over the lease term)

Year one

In the first year of the lease, the leased store location performs consistent with Lessee A's original expectations and there are no changes in facts or circumstances that affect Lessee A's expectations regarding renewal options or contingent rents for future periods. The following journal entries would be recorded:

Amortization expense	800	
Right-of-use asset		800

To record amortization of the right-of-use asset

Interest expense	680	
Obligation to pay rentals		680

To record interest expense on the obligation to pay rentals using the effective interest method

Obligation to pay rentals	1,100	
Cash		1,100

To record cash paid for rents (base rent of $1,000 and contingent rent of $100)

Year two

In the second year of the lease, sales at the leased store location were significantly higher than originally estimated. As a result, actual contingent rents for year two of the lease were greater than originally projected (i.e., estimated contingent rent was $110 and actual contingent rent was $150). At the end of year two, Lessee A adjusts forecasted sales for future years from the leased store location to reflect the higher than previously anticipated sales. In addition, based on the expected continuation of the higher sales at the leased store location, Lessee A determines that it is now more likely to exercise the second renewal option and that the longest possible lease term that is more likely than not to occur is 15 years (i.e., lease term includes both renewal periods).

Lessee A would record the following entries to amortize the right-of-use asset and recognize interest expense in year two:

Amortization expense	800	
Right-of-use asset		800
Interest expense	644	
Obligation to pay rentals		644

Lessee A would record the excess contingent rent incurred for year two as an expense in year two:

Contingent rent expense	40	
Obligation to pay rentals		40

To record change in the obligation to pay rentals for changes in contingent rents related to the current period

Total cash payment made for year two would reduce the obligation:

Obligation to pay rentals	1,150	
Cash		1,150

To record cash paid for rents (base rent of $1,000 and contingent rent of $150)

Lessee A reconsiders the expected payments (both base and contingent rents) over the revised lease term and adjusts the obligation to pay rentals to the revised amount using the original discount rate (i.e., the incremental borrowing rate at the inception of the lease). The following entry is recorded:

Right-of-use asset	4,300	
Obligation to pay rentals		4,300

To record change in the obligation to pay rentals due to change in lease term and for changes in contingent rents related to future periods

Year three

In the third year of the lease, the leased store location performs consistent with Lessee A's revised expectations and there are no changes in facts or circumstances that affect Lessee A's expectations regarding renewal options or contingent rents. The following journal entries are recorded:

Amortization expense	823	
Right-of-use asset		823

To record amortization of the right-of-use asset (based on adjusted right-of-use asset and revised lease term)

Interest expense	970	
Obligation to pay rentals		970

To record interest expense on the obligation to pay rentals (based on adjusted obligation and original discount rate)

Obligation to pay rentals	1,170	
Cash		1,170

To record cash paid for rents (base rent of $1,000 and contingent rent of $170 — consistent with revised estimates)

The following table summarizes the cash payments made and expense recognized in each of the first three years of the lease and demonstrates the effect that a longer lease term and increased contingent payments can have on the periodic expense recorded under the proposed model.

	Year 1	Year 2	Year 3
Cash payments:			
Base rent	1,000	1,000	1,000
Contingent rent	100	150	170
	1,100	1,150	1,170
Expense:			
Amortization expense	800	800	823
Interest expense	680	644	970
Excess contingent rent expense	–	40	–
	1,480	1,484	1,793

Note that under current lease accounting, periodic rent expense for each of the first three years will likely be equivalent to the cash payment amounts.

Presentation

The following table summarizes how amounts related to leases will be presented on the financial statements of lessees:

Financial statement	Lessee presentation
Statement of financial position	► Right-of-use asset presented within property, plant and equipment but separately from assets that the lessee does not lease ► Liabilities to make lease payments presented separately from other financial liabilities
Income statement (or disclosed in notes)	► Lease related amortization and interest expense presented separately from other amortization expense and other interest expense
Statement of cash flows	► Cash payments for leases classified as financing activities and shown separately

Transition

Lessees will need to recognize a liability to make lease payments and a right-of-use asset for outstanding leases at the date of initial application of the proposed guidance using a simplified retrospective approach. The date of initial application is the beginning of the first comparative period presented in the first financial statements in which the entity applies the new guidance. For example, if the new guidance was first applied for the year ended 31 December 20X9 by an entity presenting three-year comparative income statements, the date of initial application would be 1 January 20X7. As of the date of initial application, lessees would determine the lease term as well as contingent rents and expected payments under termination penalties and residual value guarantees. The liability to make lease payments will be measured at the present value of the lease payments discounted using the lessee's incremental borrowing rate at the date of initial application. The right-of-use asset will be measured on the same basis as the liability, subject to any adjustments for impairment. Additional adjustments may be required for prepaid or accrued lease payments.

Simple capital leases will not be affected significantly by the proposed leases model. That is, the measurement of the right-of-use asset and liability to make lease payments for capital leases without options, contingent rentals and/or residual value guarantees generally will not result in measurements that are significantly different from current accounting for capital leases. Therefore, the right-of-use asset and the liability to make lease payments at transition for simple capital leases will be the carrying amount of the lease asset and liability under the current accounting model for capital leases. As noted above, leases with an automatic transfer of title or bargain purchase option would be excluded from the scope of the proposed new leases standard; therefore, some simple capital leases under current US GAAP may not be in scope. It is not clear in the ED how such arrangements will be accounted for or what the transition provisions (if any) will be for such arrangements; however, we expect them to be accounted for as a financed purchase of an asset.

Lessor accounting

The ED proposes that lessors apply a right-of-use model using one of two approaches. For each lease, lessors will apply either the performance obligation approach or the derecognition approach depending on their exposure to risks or benefits associated with the underlying asset. Under both approaches lessors will record an asset on the balance sheet representing their right to receive lease payments from the lessee. Leveraged lease accounting is not preserved.

Exposure to significant risks or benefits

Lessors will account for leases under the proposed model based on their exposure to significant risks or benefits related to the underlying asset. A lessor will use the performance obligation approach to account for leases when it has retained exposure to significant risks or benefits associated with the underlying asset. The derecognition approach will be used when the lessor has not retained exposure to significant risks or benefits associated with the underlying asset.

At the inception of a lease, the lessor will evaluate whether it has retained exposure to significant risks or benefits associated with the underlying asset either during the expected lease term or subsequent to the lease term. The ED provides the following indicators for a lessor to consider in determining if it retains exposure to significant risks or benefits associated with the underlying asset during the expected lease term:

- Significant contingent rentals that are based on the use or performance of the underlying asset
- Options to extend or terminate the lease
- Material non-distinct services provided under the current lease contract

A lessor also will evaluate whether it has the expectation or the ability to generate significant returns by re-leasing or selling the underlying asset subsequent to the expected term of the lease. All relevant facts and circumstances should be considered in determining the most appropriate approach.

Right to receive lease payments

Under both the performance obligation approach and the derecognition approach, the lessor's receivable will be recognized based on the lease payments expected to be received over the lease term. The recognized lease term will be the longest possible lease term that is more likely than not to occur. To the extent that they can be measured reliably, the amounts that a lessor expects to receive for contingent rents and residual value guarantees will be included in lease payments using an expected outcome technique. An estimate of expected payments from the lessee under termination penalties will also be included. The lessor will discount the estimated payments over the lease term using the interest rate that the lessor is charging the lessee. Interest income on the lease receivable will be recognized using the effective interest method, and lease payments will reduce the lease receivable.

How we see it

The measurement basis of the expected lease payments by lessors and lessees is generally the same (i.e., determination of the lease term and the lease payments are generally consistent). However, the estimates and judgments used to determine the receivable recognized by the lessor and the liability recognized by the lessee are based on different perspectives. For example, a lessee that has an option to renew a lease is in control of the exercise of the option and has a more complete understanding of its own plans than the lessor. The lessee may determine that a renewal option is more likely than not of being exercised, while the lessor may not have adequate insight to reach that same conclusion. In addition, amounts for contingent rents and residual value guarantees are only included in lease payments by lessors to the extent those amounts can be measured reliably, whereas lessees include estimates of such amounts without any restriction. As such, the lessor's asset will not necessarily mirror the lessee's liability.

The lease receivable will be reassessed each reporting period and will be adjusted to reflect changes in facts and circumstances, similar to how lessees reassess their liability to make lease payments. For example, a lessor's receivable would be reassessed if any new facts or circumstances indicate that there is a material change in estimates or judgments regarding contingent rents or residual value guarantees or adjustments to the lease term. Additionally, lessors will evaluate their lease receivables for impairment each reporting period using the guidance in ASC 310, *Receivables*.

Performance obligation approach

Under the performance obligation approach, the underlying leased asset is considered to remain the lessor's economic resource, and the lessor is committed to allow the lessee to use the underlying leased asset during the term of the lease. The lessor will retain the leased asset on its balance sheet and will record a lease liability (performance obligation) for its obligation to permit the lessee to use the leased asset. The lease liability will initially equal the lease receivable (less any initial direct costs incurred by the lessor), and the lessor will recognize revenue as the lease liability is satisfied over the term of the lease. Revenue is recognized by the lessor as the lease liability is reduced in a systematic and rational manner based on the pattern of use of the underlying asset by the lessee (e.g., over time, based on hours of use). A lessor will not recognize any revenue at the commencement of the lease (i.e., upon delivery of the leased asset) under this approach. Under the performance obligation approach, lessors generally will recognize lease revenue on a straight-line basis similar to the accounting for operating leases under the current model. Lessors will continue to depreciate the leased asset, and the asset will be subject to impairment.

The following example illustrates the application of the performance obligation approach:

Example: performance obligation approach

Lessor A leases equipment to Lessee B. The equipment has a cost basis of $360,000 and a useful life of 15 years. The lease has a two-year non-cancelable lease term and no renewal options. The annual rent is $50,000 due at the end of each year. Lessor A is charging Lessee B interest at 11%.

At lease commencement, Lessor A would record a receivable and lease liability:

Lease receivable	85,000	
Lease liability		85,000

To initially record the liability and asset arising under the lease (present value of expected payments over the lease term)

In the first year of the lease, Lessor A would continue to depreciate the asset, recognize revenue as it satisfies its performance obligation and record interest on the receivable:

Depreciation expense	24,000	
Accumulated depreciation		24,000

To record depreciation of the underlying asset ($360,000 cost basis/15-year useful life)

Lease liability	42,500	
Revenue		42,500

To record the reduction of the lease liability and recognize revenue on a straight-line basis ($85,000/2-year lease term)

Lease receivable	9,350	
Interest income		9,350

To recognize interest income under the effective interest method

Cash	50,000	
Lease receivable		50,000

To record cash received for lease payments

Adjustments to the lease receivable for changes in the estimated lease term will be recorded as an adjustment to the lease liability. Adjustments to the lease receivable for changes in expected lease payments for contingent rents or expected payments under termination penalties and residual value guarantees will be treated as adjustments to the original transaction price. If a change relates to a satisfied obligation, the change will be recognized in revenue. If a change relates to an unsatisfied obligation, the lease liability would be adjusted.

Example: reassessment under performance obligation approach

Lessor in a five-year lease that includes contingent rents estimates the amount of reliably measureable contingent rents using an expected outcome approach as of the inception of the lease. The lease liability is reduced on a straight-line basis over the lease term. At the end of two years, facts and circumstances indicate that the amounts of contingent rents will be higher than originally expected. Lessor would adjust the amount of the receivable to reflect the higher rents and recognize 40% of the adjustment as revenue and 60% as an adjustment to the lease liability as the lessor has satisfied 40% (2 years out of 5 years) of its performance obligation.

Derecognition approach

Under the derecognition approach, economic benefits associated with the underlying leased asset are considered to transfer to the lessee at the commencement of the lease. The lessor will derecognize a portion of the carrying amount of the leased asset that represents the lessee's right to use the underlying asset during the term of the lease. The remaining portion of the carrying amount of the underlying asset will be allocated to a residual asset. The allocation of the carrying amount between the derecognized amount and the residual asset will be determined on a relative fair value basis at the inception of the lease. The residual asset will not be subsequently remeasured except for impairment or when reassessment of the right-to-use asset results in a change to the residual asset. The derecognition approach could result in the lessor recognizing some measure of income (or loss) as of the start of the lease.

The following example illustrates the application of the derecognition approach:

Example: derecognition approach

Lessor A enters into lease with Lessee B for a computer. The computer has a fair value of \$3,300, a carrying amount of \$2,500 and a useful life of 4 years. The lease has a three-year non-cancelable term and a one-year renewal option. Annual rent is \$1,200 due at the end of each year. Lessor A is charging Lessee B 10% interest in the lease.

Lessor A determines that the longest possible lease term that is more likely than not to occur as of the inception of the lease is three years (i.e., the renewal option is not more likely than not to be exercised). The present value of three \$1,200 annual payments discounted at 10% is \$3,000.

Lessor A would allocate the carrying amount of the computer to the amount to be derecognized as follows:

$$\$2{,}500 \text{ (carrying amount) x } \left(\frac{\$3{,}000 \text{ (fair value of right to receive lease payments)}}{\$3{,}300 \text{ (fair value of underlying asset)}} \right) = \$2{,}275$$

Lessor A would allocate the remainder of the carrying amount of the computer to the residual asset (residual asset = \$225)

At lease commencement Lessor A would record a receivable and derecognized the asset. The carrying amount of the asset would be allocated to residual asset and cost of sales. A net profit of $725 would be recognized:

Lease receivable	3,000	
Revenue		3,000

To initially record the lease receivable and recognize revenue at the present value of the expected lease payments at lease inception

Cost of sales	2,275	
Residual asset	225	
Inventory		2,500

To reclassify a portion of the carrying amount of the underlying asset to the residual asset and derecognize the remaining portion as cost of sale

In the first year of the lease Lessor A would recognize interest income on the receivable and record receipt of lease payments as follows:

Lease receivable	300	
Interest income		300

To recognize interest income under the effective interest method

Cash	1,200	
Lease receivable		1,200

To record cash received for lease payments

The accounting for a reassessment of the expected lease term under the derecognition approach will be treated as a new derecognition/re-recognition event. That is, the lessor will derecognize/reinstate a portion of its residual asset. Changes in amounts receivable under all types of contingent rentals, termination penalties and residual value guarantees will be recognized in net income. Continuing from the example above, the following illustrates the accounting for a change in the lease term under the derecognition approach:

Example: derecognition approach reassessment

At the end of year 2, due to changes in facts and circumstances, Lessor A determines that the renewal option is more likely than not to be exercised. Lessor A would record an increase in the lease receivable for the present value of the lease payment for year 4, derecognize the remaining residual asset (assuming that the computer has no residual value at the end of its economic life) and recognize profit for the difference. The present value as of the end of year 2 of the $1,200 lease payment for year 4 is $980.

Lessor A would account for this reassessment of the lease term as follows:

Lease receivable	980	
Revenue		980

To record the lease receivable and recognize revenue at the present value of the reassessed expected lease payments

Cost of sales	225	
Residual asset		225

To derecognize the residual asset

Presentation

The following table summarizes the how amounts related to leases will be presented on the financial statements of lessors:

Financial statements	Performance obligation approach	Derecognition approach
Statement of financial position	► Leased assets, lease receivables and lease liabilities presented separately and totaling to a net lease asset or a net lease liability	► Lease receivables presented separately ► Residual assets presented separately within property, plant and equipment
Income statement	► Lease income, interest income, and depreciation expense presented separately and totaling to a net lease income or a net lease expense (Note: IASB does not propose to include total)	► Lease income and lease expense presented either gross or net based on lessor's business model ► Interest income on lease receivable presented separately from other interest income

Transition

Lessors will need to recognize lease receivables for all outstanding leases as of the date of initial application using a simplified retrospective approach. Lessors will determine the lease term as well as contingent rents and expected payments under termination penalties and residual value guarantees as of the date of initial application. The lease receivable will be measured at the present value of the lease payments discounted using the rate charged in the lease, determined at the inception of the lease, subject to any adjustments to reflect impairment.

For leases under the performance obligation approach, lessors will recognize a lease liability and reinstate any previously derecognized underlying assets. The lease liability will be measured on the same basis as the receivable, and previously derecognized assets will be measured at depreciated cost, adjusted for impairment as of the date of initial application.

For leases under the derecognition approach, the lessor will recognize the residual asset at fair value, determined at the date of initial application.

Other proposed changes

Sale-leasebacks

Sale-leaseback transactions will no longer provide off-balance sheet financing as all leases would be recorded on the balance sheet under the proposed model. In addition, the ED establishes criteria that must be met in order for the parties in a sale and leaseback transaction to apply sale-leaseback accounting (i.e., separately account for both the sale/purchase of the asset and the lease). To qualify for sale-leaseback accounting under the proposed model, the underlying asset must be deemed to have been sold based on an assessment that at the end of the contract, both control of the asset and all but a trivial amount of the risks and benefits associated with the asset have been transferred to the buyer-lessor.

How we see it

The ED includes implementation guidance similar to the stringent rules that currently exist for sale-leasebacks of real estate; however, these criteria will be applicable for all sale-leasebacks (i.e., sale-leaseback of both real estate and non-real estate assets). A transaction that does not meet the criteria to apply sale-leaseback accounting would be accounted for as a financing transaction by both the seller-lessee and the buyer-lessor. The criteria included in the ED could result in many more transactions being accounted for as financings (i.e., as a borrowing by the seller-lessee and a lending by the buyer-lessor) than under current practice.

The seller-lessee will recognize gains or losses on sales transactions that qualify as sale-leasebacks.

Subleases

In a sublease arrangement one party (the intermediate lessor) will act as both the lessor and lessee of the same asset. That is, one party will obtain the right to use the underlying asset under the head lease, and it will act as the lessor in the sublease whereby it conveys the right to use the underlying asset to a different party for the same or a shorter term. The ED does not provide different measurement guidance for the assets and liabilities that arise in a sublease. The lessee accounting model will be applied to the assets and liabilities that arise in the head lease, and the lessor accounting model will be applied to the assets and liabilities that arise in the sublease. As such, the intermediate lessor in a sublease could recognize on its balance sheet a right-to-use asset and a liability to make lease payments, as well as a lease receivable and a lease liability, all related to the same underlying asset.

Example: subleases

Entity A leases office space that it no longer needs and decides to sublease that office space to Entity B. Entity A would include the following on its balance sheet:

- Right-to-use asset for the head lease
- Lease receivable from Entity B for the sublease
- Lease liability to allow Entity B to use the underlying asset under the sublease
- Liability to make lease payments under the head lease

Disclosures

The ED includes fairly extensive disclosure guidance that will require entities to disclose quantitative and qualitative financial information that:

- Identifies and explains the amounts recognized in its financial statements arising from leases
- Describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows

Disclosures proposed in the ED are significantly more robust than currently required disclosures.

Looking ahead

The ED does not specify an effective date. Instead the effective date will be considered as part of another project for all major joint projects underway. The Boards have requested that all comments on the ED be received by 15 December 2010. The Boards currently plan to issue a final standard on leases in 2011. The proposed model represents a significant change from current practice, and determining the effects of these changes on an entity that leases assets may involve a considerable undertaking. We encourage companies to analyze the proposed model and the effect it may have on them and to submit comment letters to the Boards expressing their views on the proposed model and any concerns identified or recommendations developed in assessing the proposed model and its effect on their business.

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