Leases

FASB-IASB joint project

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Ernst & Young
Quality In Everything We Do

Agenda

- Background
- Scope
- Lessee accounting
- Lessor accounting
- Other significant issues
- Effects of proposed changes

Background

- Joint project of FASB and IASB on leases
  - Objective is that lease contracts are recorded “on balance sheet”
  - Project responds to criticisms raised by the SEC in the June 2005 report on off-balance sheet arrangements
- Discussion paper on lessee accounting issued in March 2009
- Boards initially deferred consideration of lessor accounting but have subsequently deliberated a number of lessor accounting issues
- Current plan is to issue an exposure draft in 2010 and a final standard in 2011

Background (continued)

- Current accounting model for leases draws a fundamental distinction between finance (i.e., capital) leases and operating leases
- Criticisms of the existing accounting model focus on operating lease accounting:
  - Does not provide for the recognition of material assets and liabilities arising from operating leases
  - Distinction between operating leases and finance leases is arbitrary
    - Economically similar transactions can be accounted for very differently
  - Transactions are not reassessed when estimates change
    - A lease that provides a lessee with a renewal option that was not a bargain renewal option at inception of the lease, but becomes a bargain during the lease, would not be adjusted to reflect the renewal period in the lease term for classification or accounting purposes
- Boards have proposed a right-of-use model to be applied to all leases

Scope

- Boards have tentatively agreed to define a lease as follows:
  - A lease is a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration
  - Definition is similar to current definition used in US GAAP (ASC 840)
- Boards have tentatively agreed to retain much of the guidance relative to assessing whether an arrangement is, or contains, a lease
  - Guidance currently in ASC 840-10-15 (formerly EITF 01-8)
  - Requires an assessment, based on the substance of the arrangement, of whether:
    - Fulfillment of the arrangement depends on providing a specified asset
    - Arrangement conveys the right to control the use of a specified asset

Scope (continued)

- Consistent with current practice, the proposed new leases standard will apply only to leases of property, plant and equipment, and therefore, will not apply to:
  - Leases of intangible assets
  - Leases to explore for or use natural resources, such as minerals, oil and natural gas
  - Leases of biological assets
- Boards have tentatively decided not to provide an exclusion for leases of noncore assets or long-term leases of land
- Short-term leases (leases with a maximum possible lease term of 12 months or less) will be permitted to apply a simplified form of lease accounting

Scope (continued)

- Contracts that are purchases / sales are excluded from scope
  - A contract is a purchase or sale if at the end of the contract, one entity transfers to another entity:
    - Control of the underlying asset, and
    - All but a trivial amount of the risks or benefits associated with the underlying asset
  - Control of the underlying asset has generally been transferred/obtained in the following situations:
    - Title of the underlying asset transfers to the lessee automatically
    - Bargain purchase option exists
  - The determination of whether a purchase option is a bargain purchase option or not would be made at the inception of the lease and would not be reassessed

Scope (continued)

- Investment property accounted for under IFRS and measured at fair value excluded from scope
  - Under IFRS, certain real estate properties held to earn rentals (investment properties) are measured at fair value
  - IASB tentatively decided that if a lessor of investment property measures its investment property at fair value, it would not apply the new lessor accounting requirements to the lease
  - No special accounting for investment property exists under US GAAP
    - FASB has added a project to its agenda to consider whether entities should be given the option (or be required) to measure an investment property at fair value through earnings

Scope (continued)

- Arrangements that contain both service components and lease components would be included in the scope of proposed new leases standard
  - Both lessors and lessees would be required to evaluate whether lease payments should be allocated between service and lease components
    - Use revenue recognition principles (i.e., the principles developed as part of the joint revenue recognition project) to identify separate components and allocate payments
    - If the service component is not distinct from the lease component, the contract is accounted for as a lease
  - Increased significance of determining if an arrangement is or contains a lease
    - Recording all leases on balance sheet potentially results in significantly different accounting for lease arrangements in comparison to non-lease executory arrangements

Lessee accounting

- All leases would be recorded in a lessee's statement of financial position
  - Record an asset representing the right to use the leased item for the lease term
    - Single right-of-use asset that includes certain rights acquired under renewal options
  - Record a liability for obligation to make lease payments
    - Single obligation to make lease payments that includes obligations arising under contingent rental arrangements and residual value guarantees
- Initially measure and recognize asset and obligation at the present value of the expected lease payments to be made over the lease term
    - Right-of-use asset also includes initial direct costs incurred by lessee (e.g., legal fees and costs incurred negotiating lease terms)

Lessee accounting (continued)

- Recognized lease term would be the longest possible lease term that is more likely than not to occur
  - Step 1: identify each possible lease term taking into account the effect of any options to extend or terminate the lease
  - Step 2: estimate the probability of occurrence of each possible lease term
  - Lessee would consider all relevant factors in determining the lease term
    - Consider all contractual, non-contractual and business factors as well as lessee’s intentions and past practice
- Purchase options (that are not considered bargains) are only accounted for when they are exercised
  - A lease that includes a bargain purchase option would be excluded from the scope of the proposed new leases standard

Lessee accounting (continued)

- Example: lease term
  - Lessee A enters into a lease with a 5-year base non-cancelable term and two 5-year renewal options
    - Possible lease terms are 5 years (exercise no renewals), 10 years (exercise first renewal only) and 15 years (exercise both renewals)
  - Lessee A determines the individual and cumulative probability of each possible lease term as follows:

Possible lease terms	Individual probabilities	Cumulative probabilities
15 years	20%	20%
10 years	40%	60%
5 years	40%	100%

  - The longest possible lease term that is more likely than not to occur is 10 years

Lessee accounting (continued)

- Measure obligation to make lease payments for contingent rentals and residual value guarantees using an expected outcome technique
  - Lessees will consider all relevant factors in determining the lease payments required during the term
  - Lessees will be required to make a number of estimates to determine the expected lease payment amounts, including estimating payments contingent upon:
    - Lessee’s use of the underlying asset (e.g., miles flown or hours used)
    - Lessee’s performance (e.g., percentage of sales in a leased store)
  - If contingent rentals depend on an index or rate (e.g., CPI), lessee would determine the expected lease payments
    - Using readily available forward rates (if available)
    - If forward rates are not readily available, using the prevailing rates

Lessee accounting (continued)

- Example: contingent rents
  - Retailer A has a 1-year store lease that includes a contingent rental arrangement whereby Retailer A pays an additional $10,000 of rent for each $1 million of sales in the leased location up to a maximum of $30,000
  - Retailer A 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
< $1 M	$ 0	35%	$ 0
>$1 M and < $2 M	$10,000	50%	5,000
> $2 M and < $3 M	$20,000	10%	2,000
> $3 M	$30,000	5%	1,500
			$8,500

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

Lessee accounting (continued)

- Discount expected lease payments using the lessee's incremental borrowing rate as of the inception of the lease
  - Lessee's incremental borrowing rate is the rate of interest the lessee would have to incur to borrow over a similar term, and with similar security, the funds necessary to purchase a similar underlying asset
    - Rate lessee would pay on a borrowing secured by the underlying leased asset as collateral
  - May use interest rate implicit in the lease if it can be readily determined

Lessee accounting (continued)

- Amortized cost-based approach to subsequent measurement of asset and obligation
  - Right-of-use asset amortized over shorter of the lease term or economic life of the leased asset
  - Lease payments allocated as a reduction in the lease obligation and interest expense using the effective interest method
- Right-of-use asset would be considered for impairment by referring to existing applicable standards for amortizing intangible assets

Lessee accounting (continued)

- Reassess lease obligation each reporting period
  - Features of a lease that could result in a change in lease obligation include options to extend or terminate the lease, contingent rental arrangements and residual value guarantees
- Remeasure lease obligation at present value of expected lease payments using revised assumptions
  - Discount rate used is not revised
    - Original discount rate (i.e., the lessee's incremental borrowing rate at the inception of the lease) would be used for purposes of remeasuring the obligation for changes in expected payments
    - Only exception: if contingent rents are contingent on variable reference interest rates, then discount rate would be revised to take into account changes in the reference interest rates

Lessee accounting (continued)

- Reassess lease term
  - Lease term would be reassessed at each reporting date to the extent there has been a change in facts and circumstances
  - Changes in lease obligation due to changes in lease term would be reflected as an adjustment to right-of-use asset

Lessee accounting (continued)

- Example: reassess lease term
  - Lessee A entered into a lease with a 5-year base non-cancelable term and two 5-year renewal options and determined as of the inception of the lease that the longest possible lease term that was more likely than not to occur was 10 years
  - At the end of year 3, due to a change in facts and circumstances, Lessee A determines that the likelihood of exercise of the second renewal option has increased such that it is now (at the end of year 3) more likely than not that Lessee A will exercise the first and second renewal
  - Upon reassessment at the end of year 3, Lessee A would increase the obligation to make lease payments to include the present value of the additional lease payments (i.e., the lease payments for years 11 through 15)
  - The change in the obligation would be recorded as an adjustment to right-of-use asset and would affect amortization in subsequent periods

Lessee accounting (continued)

- Reassess contingent rentals and residual value guarantees
  - Obligation reassessed at each reporting date to the extent any new facts or circumstances indicate that there is a material change
  - Changes in lease obligation due to changes in amounts payable:
    - Arising from current or prior periods – recognized in profit and loss
    - All other changes – recognized as an adjustment to right-of-use asset

Lessee accounting (continued)

- Example: reassess contingent rentals and residual value guarantees
  - Retailer B has a 5-year store lease that includes a contingent rental arrangement whereby Retailer B annually pays contingent rent of 1% of sales from the leased store location
  - As of the inception of the lease, Retailer B determined lease payments required based on expected outcome
  - At the end of year 1:
    - Any difference between the amount paid for annual contingent rent for year 1 and the amount previously estimated would be recognized in profit and loss
    - Any change in the obligation to make lease payments due to changes in expectations regarding contingent rents to be paid in years 2 through 5 would be recorded as an adjustment to the right-of-use asset and would affect amortization in subsequent periods

Lessee accounting (continued)

- Presentation
  - Statement of financial position
    - Right-of-use asset presented with property, plant and equipment, but separately from other assets that are owned
    - Obligation to make lease payments would be presented separately from other financial liabilities
  - Income statement
    - Amortization and interest expense arising in lease contracts would be presented separately from other amortization expense and other interest expense
  - Statement of cash flows
    - Cash repayments of principal and interest arising in lease contracts would be classified as financing activities and shown separately

Lessee accounting (continued)

- Transition
  - Recognize an obligation to make lease payments and a right-of-use asset for outstanding leases at the date of initial application of the proposed new leases standard using a simplified retrospective approach
    - Obligation to make lease payments measured at the present value of the remaining lease payments, discounted using lessee's incremental borrowing rate at the date of transition
      - Lease term and lease payments would be determined as of the date of transition
    - Right-of-use asset measured on the same basis as the liability, subject to any adjustments for impairment
    - Additional adjustments for prepaid or accrued rentals should be made when lease payments are uneven over the lease term
  - Simple capital leases (leases without options, contingent rents and/or residual value guarantees) that are within the scope of the proposed new leases standard would continue to be accounted for under current model (i.e., not changed on transition)

Lessor accounting

- All leases within the scope of the proposed new leases standard would be recorded in a lessor's statement of financial position
  - Boards have decided that the accounting for a lessor should be broadly consistent with the accounting proposed for the lessee
  - Lessor records a receivable for the right to receive lease payments and that receivable would be determined in a manner consistent with the obligation recorded by the lessee
  - Hybrid model for lessor accounting whereby for each lease, one of two distinct approaches to lessor accounting would be applied
    - Performance obligation approach
    - Derecognition approach
  - Eliminates the use of leveraged lease accounting

Lessor accounting (continued)

- Hybrid model
  - Determine the approach to apply on the basis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset
  - Assess whether the lessor retains exposure to significant risks or benefits either:
    - During the expected term of the current lease contract; or
    - Subsequent to the term of the current lease contract
  - Apply the performance obligation approach to certain leases
    - Lessor that retains exposure to significant risks or benefits associated with the underlying asset should apply performance obligation approach
  - Apply the derecognition approach to all other leases
    - Lessor that does not retain exposure to significant risks or benefits associated with the underlying asset should apply derecognition approach
  - Assessment made at the inception of the lease and would not be reassessed

Lessor accounting (continued)

- Determining whether lessor retains exposure to significant risks or benefits associated with the underlying asset
  - Factors indicating lessor retains exposure to significant risks or benefits during the expected term of the lease contract
- Significant contingent rentals during the expected lease term that are based on the use or performance of the underlying asset
- Lessee optionality in the expected lease term
- Material nondistinct services provided under the current lease contract
  - Factors indicating lessor retains exposure to significant risks or benefits subsequent to the expected term of the lease contract
- Lease term is short in relation to the useful life of the asset
- A significant change in the value of the underlying asset at the end of the lease term is expected

Lessor accounting (continued)

- Under both approaches to lessor accounting
  - Recognized lease term would be the longest possible lease term that is more likely than not to occur
    - Symmetrical with the accounting by lessees for renewal options; however, may not result in same measurement (as lessee has control over renewal decision)
    - Example: Lessee may determine based on knowledge of its operations and plans that a renewal option is more likely than not to be exercised, whereas a lessor in the same arrangement may not have adequate insight to make the same determination
  - Lease receivable
    - Initially measure and recognize receivable at the present value of the expected lease payments to be received over the lease term
    - Includes amounts due under contingent rental arrangements and residual value guarantees (from lessee) using an expected outcome technique
      - Only include if can be measured reliably
    - Initial direct costs incurred by lessor are included in receivable (e.g., commissions, legal fees, costs of negotiating lease terms)
    - Discount expected lease payments using the interest rate that the lessor is charging the lessee

Lessor accounting (continued)

- Under both approaches to lessor accounting
  - Subsequent measurement of lease receivable would be at amortized cost using the effective interest method
    - Lease payments received would be allocated as a reduction in the lease receivable and interest income
  - Reassess the lease term
    - Lease term would be reassessed at each reporting date to the extent there has been a change in facts and circumstances
  - Reassess contingent rentals and residual value guarantees
    - Receivable reassessed at each reporting date to the extent any new facts or circumstances indicate that there is a material change

Lessor accounting (continued)

- Performance obligation approach
  - Underlying leased asset remains on the lessor's balance sheet and lessor would not recognize any revenue at the commencement of the lease (i.e., upon delivery of the leased asset)
  - Recognize a performance obligation for obligation to permit the lessee to use the underlying leased asset
    - Initially measured at transaction price (present value of expected lease payments to be received over the lease term)
  - Recognize revenue as the performance obligation is satisfied over the lease term
    - Amortize performance obligation based on the pattern of use of the underlying asset by the lessee (e.g., over time, based on hours of use, etc.)
  - Recognize interest income over the lease term using the effective interest method
  - Continue to depreciate the underlying leased asset which is subject to impairment

Lessor accounting (continued)

- Example: performance obligation approach
  - Lessor A enters into lease with Lessee B
    - Assumptions: leased asset has a cost basis of $360,000 and a useful life of 15 years; lease has a 2-year non-cancelable term and no renewal options; 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 performance obligation:

Lease receivable	$85,000	
Performance obligation		$85,000

    - During 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
Performance obligation	42,500	
Revenue		42,500
Cash	50,000	
Lease receivable		40,650
Interest income		9,350

Lessor accounting (continued)

- Performance obligation approach
  - Adjustments to the lease receivable for changes in the lease term would be recorded as an adjustment of the carrying amount of the performance obligation
  - Adjustments to the lease receivable for changes in expected lease payments for contingent rents or residual value guarantees would be treated as adjustments to the original transaction price and performance obligation
    - Changes arising from a satisfied performance obligation would be recognized in revenue
    - Changes arising from an unsatisfied performance obligation would be accounted for as an adjustment to the carrying amount of the performance obligation
    - Example: Lessor in a 5-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. At the end of two years, facts and circumstances indicate that the amounts of contingent rents are 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 carrying amount of the performance obligation as the lessor has satisfied 40% (2 years out of 5 years) of its performance obligation.

Lessor accounting (continued)

- Presentation – performance obligation approach
  - Statement of financial position
    - Leased asset, lease receivable and performance obligation presented separately and totaling to a net lease asset or a net lease liability
  - Income statement
    - Interest income, lease income and depreciation expense presented separately
      - FASB prefers including a total net lease income or net lease expense line item totaling the separate components
  - Statement of cash flows
    - Cash receipts from lease payments would be classified as operating activities and shown separately

Lessor accounting (continued)

- Derecognition approach
  - Underlying leased asset is partially derecognized at the commencement of the lease
    - Derecognize portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset
    - Determine the amount to derecognize on the basis of the proportion of the fair value of the rights that have been derecognized to the fair value of the rights that have been retained
  - Reclassify as a residual asset the portion of the underlying asset not derecognized (portion that represents the lessor's rights in the underlying asset that it did not transfer)
    - Measured at an allocation of the previous carrying amount of the underlying asset
    - Not subsequently remeasured, except for impairment
  - Recognize income or expense at the commencement of the lease for difference between lease receivable and portion of the underlying leased asset derecognized
  - Recognize only interest income over the lease term using the effective interest method

Lessor accounting (continued)

- Example: derecognition approach
  - Lessor A enters into lease with Lessee B for a computer
    - Assumptions: computer has a fair value of $3,300, a carrying amount of $2,500 and a useful life of 4 years; lease has a 3-year non-cancelable term and a 1-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 3 years (i.e., the renewal option is not more likely than not to be exercised)
    - Present value of three annual $1,200 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:
      - Carrying amount x (fair value of rights derecognized/fair value of asset)
      - 2,500 x (3,000 / 3,300) = $2,275 amount derecognized
    - Lessor A would allocate remainder of the carrying amount of the computer to the residual asset (residual asset = $225)

Lessor accounting (continued)

- Example: derecognition approach (continued)
  - At lease commencement, Lessor A would record a receivable and derecognize 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
Cost of sales	2,275	
Residual asset	225	
Inventory		2,500

  - For the first year of the lease, Lessor A would record interest income on the receivable:

Cash	$1,200	
Lease receivable		$900
Interest income		300

Lessor accounting (continued)

- Derecognition approach
  - Adjustments to the lease receivable for changes in the lease term would be treated as a new derecognition/re-recognition event
    - Lessor would derecognize/reinstate a portion of its residual asset
    - Example: Continuing from previous example of the lease of a computer under the derecognition approach, assume that 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 as follows:

Lease receivable	$980	
Revenue		$980
Costs of sales	225	
Residual asset		225

  - Changes in amounts receivable under all types of contingent rentals and residual value guarantees would be recognized in profit or loss

Lessor accounting (continued)

- Presentation – derecognition approach
  - Statement of financial position
    - Lease receivables presented separately
    - Residual assets presented separately with property, plant and equipment
  - Income statement
    - Income and expense presented either gross or net based on lessor's business model
      - Some lessors would present revenue and cost of sales gross (e.g., manufacturers and dealers) and others would present amounts net (e.g., financial institutions)
    - Interest income on leased assets presented separately from other interest income
  - Statement of cash flows
    - Cash receipts from lease payments would be classified as operating activities and shown separately

Lessor accounting (continued)

- Transition
  - Recognize and measure all outstanding leases as of the date of initial application of the proposed new leases standard using a simplified retrospective approach
    - Lessor's receivable measured at the present value of the remaining lease payments, discounted using original rate that the lessor is charging the lessee
      - Lease term and leases payments would be determined as of the date of transition
  - Performance obligation approach
    - Performance obligation measured on the same basis as the receivable
      - Adjustments for deferred or accrued income should be made when lease payments are uneven over the lease term
    - Previously derecognized leased assets reinstated at depreciated cost, adjusted for impairment as of date of initial application
  - Derecognition approach
    - Residual asset recognized at fair value

Other significant issues

- Accounting for subleases
  - Different measurement guidance will not be provided for assets and liabilities arising under subleases
  - In a sublease, an intermediate lessor leases an asset from one party and subleases that asset to another party
    - As a lessee in a head lease - account for assets and liabilities arising from the head lease in accordance with the lessee model
    - As a lessor in a sublease - account for assets and liabilities arising from the sublease in accordance with the lessor model
  - All assets and liabilities related to the head lease and sublease (except for the obligation to pay rentals) would be presented gross with a net subtotal
    - Obligation to pay rentals to the head lessor would be presented separately

Other significant issues (continued)

- Sale and leaseback transactions
  - Seller/lessee would consider whether the entire leased asset qualifies for derecognition/sales treatment based on whether or not the transfer meets the conditions for a sale
    - Considered a sale if at the end of the lease contract, the seller/lessee has transferred to the buyer/lessor:
      - Control of the underlying asset, and
      - All but a trivial amount of the risks or benefits associated with the underlying asset
  - If the transaction qualifies as a sale, derecognize the leased item and recognize a right-of-use asset and an obligation to make lease payments for the leaseback
  - If the transaction does not qualify as a sale, transaction would be accounted for as a financing
  - If a sale-leaseback transaction qualifies as a sale, but the sales prices or rental payments are not at market rates
    - Assets, liabilities, gains and losses would be adjusted to reflect current market rentals

Effects of proposed changes

- Key financial metrics affected – especially for operating leases under current accounting
  - Ratios (e.g., leverage, debt-to-equity) affected by increased assets and liabilities recorded related to leases
  - Lessee cash outflows classified as financing versus operating
  - Amortization and interest expense replaces rent expense for lessees
  - Portion of rental income is replaced with interest income for lessors
- Changes to recognition pattern of expense/revenue for leasing activity
  - Lessees – right-of-use approach will often result in acceleration of lease expense in comparison to current operating lease model
  - Lessors – performance obligation approach will often result in acceleration of lease income versus current operating lease model; derecognition approach may result in lower financing income than current direct finance lease model

Effects of proposed changes (continued)

- Processes, systems and controls enhancements
  - Accounting for leases under the proposed new leases standard will result in different information system needs
  - Processes will be required to perform the assessments and estimates as well as the periodic reassessments required
- Potential changes to lease transactions
  - Entities may change lease behavior as a result of the requirement to record all leases on balance sheet
    - Lessees may desire shorter lease terms
    - Lease versus buy decisions could be affected