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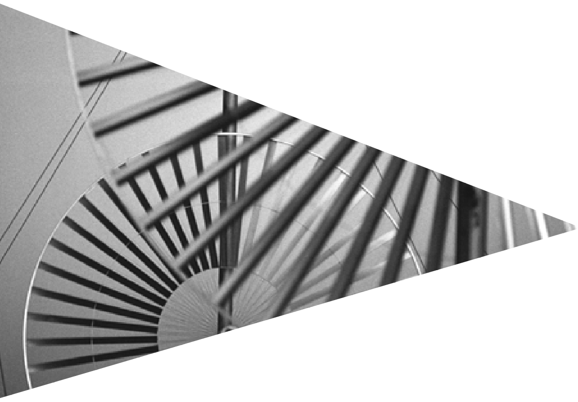
Technical Line

Technical guidance on standards and practice issues



The joint leases project — change is coming

What you need to know

- The proposed changes to the accounting for leases are substantial and may significantly affect the financial statements, processes, controls and business operations of both lessees and lessors.
- Off-balance sheet financing through operating leases will be eliminated and all leases will be recognized on balance sheet.
- Proposed changes will incorporate a number of estimates and periodic revisions to those estimates will be required.
- All existing leases will be affected by the proposed standard — no leases will be grandfathered.

An exposure draft is on the horizon that will significantly change the accounting for leases. Most leases will receive similar accounting treatment under the proposed model and classifying a lease as capital versus operating will be a thing of the past. The proposed model is the result of a joint project between the FASB and IASB (the Boards) to address criticisms of current lease accounting guidance, most notably that current operating lease accounting provides users of financial statements with inadequate information regarding the obligations of lessees. With the expected issuance of the exposure draft later this summer, the time is right for companies to begin to evaluate the potential effects of this proposed leases guidance on their financial statements and their business operations.

Will the leases project affect my lease arrangements?

If you are a lessee or a lessor, you will likely be impacted by this joint project. However, the companies most affected will be those that lease material assets or have a large number of leases. The proposed model will be applied to leases in place at the time of adoption and the time and effort to adopt the proposed model will depend on the volume and complexity of those leases.

Generally, arrangements that are considered leases under existing accounting standards will be in the scope of the new leases standard. The proposed guidance would apply only to leases of property, plant and equipment and not the following types of arrangements:

- Leases of intangible assets
- Leases to explore for or use natural resources (such as minerals, oil and natural gas)
- Leases of biological assets
- Contracts that represent the purchase or sale of the underlying asset

Quality In Everything We Do

The proposed model also addresses the accounting for arrangements containing service components and lease components. Both lessors and lessees would use revenue recognition principles to identify the separate components of such arrangements and allocate payments between the service and lease components. The current accounting for operating leases and service contracts is similar. That is, assets and liabilities generally are not recorded for either operating leases or service contracts. Because the proposed model will require leases to be recorded on the balance sheet, the accounting for leases and service contracts will no longer be similar. 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.

Short-term leases (i.e., leases with a maximum possible lease term of less than 12 months) will be in the scope of the proposed guidance, but a simplified form of lease accounting for these types of arrangements will be permitted. Additionally, the proposed guidance does not distinguish between leased assets that are incidental versus those considered essential to the operations of the entity. In other words, the proposed model will be applied to leases of a corporate airplane or photocopiers as well as leased buildings and equipment. The proposed model will affect most lease arrangements and because there will be no grandfathering of in-place leases, companies should not delay their analysis of their current lease arrangements to understand the effects of the proposed model.

Companies also should consider the potential business implications of this new model, such as:

- Effects on certain loan covenants and financial statement ratios
- Impact on operational decisions to buy or lease assets
- Modifications to standard lease terms and lease structures
- Changes to processes, controls and necessary IT support

How will the proposed model affect lessees?

The proposed model will require all leases to find a home on the balance sheet. Lessees will be required to record an asset representing the right to use the leased item for the lease term (the right-of-use asset) and a liability for the obligation to pay rentals. Under the proposed model, the recorded asset and liability incorporate the rights (including renewal options) and obligations (including contingent payments) arising under the lease and are based on the lessee's assessment of the expected payments to be made over the lease term. Determining the amounts to record will require estimates and judgments about uncertain future events and conditions. The more complex a lease is (e.g., variability in term length or payment amounts), the more complicated the accounting will be.

In order to record the right-of-use asset and related liability based on the expected payments over the lease term, lessees will need to determine the lease term. The lease term under the proposed model will consider options to renew or terminate the lease and will be the longest possible lease term that is more likely than not to occur. All factors should be considered in making this determination, including a lessee's intentions and past practice as well as other contractual, non-contractual and business factors.

Identifying the possible lease terms should be relatively simple. For example, a lease with a five-year non-cancelable lease term and a two-year renewal option has possible lease terms of five or seven years. A seven-year lease with an option to terminate the lease after five years also would have possible lease terms of five or seven years. Considering the factors that influence whether a specific lease term is more likely to occur may be more challenging as lessees evaluate, among other things, expectations regarding future business operations, residual value guarantees, termination penalties, existence of significant leasehold improvements, tax consequences and the lessee's intentions and past practices.

Options to purchase the underlying asset would only be recorded upon exercise and would not be considered in the determination of the lease term. Note that if a purchase option were considered a bargain purchase option, the arrangement would be considered an in-substance purchase of the underlying asset and therefore excluded from the proposed guidance.

Lessees initially will measure the lease liability at the present value of expected payments to be made over the lease term discounted using the lessee's incremental borrowing rate at the inception of the lease. The incremental borrowing rate is the rate the lessee would have incurred to borrow funds for a similar term.

Lessees will be required to make a number of 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)
- Other factors (e.g., indexed for inflation)

Residual value guarantees also will need to be considered in the determination of the expected payments.

These contingent amounts will be measured using an expected outcomes technique (i.e., probability-weighted estimate). 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.

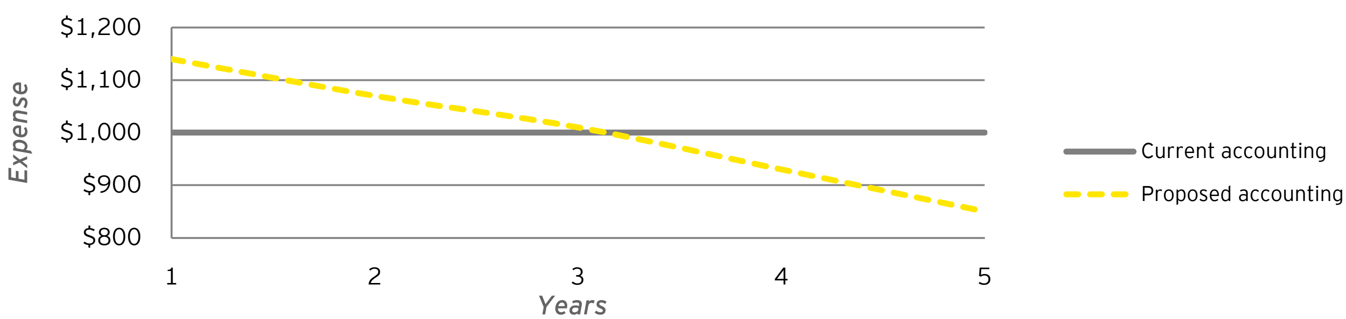
The right-of-use asset would be measured initially at cost and would include the amount of the liability as well as any initial direct costs incurred by the lessee.

Both the obligation to pay rentals and the right-of-use asset would be subsequently measured on an amortized-cost basis. Lease payments would be allocated between a reduction in the lease obligation and interest expense. The right-of-use asset would be amortized over the shorter of the lease term or the economic life of the leased asset. The following example illustrates the application of the proposed model to a simple lease, comparing the current accounting model and the right-of-use model.

Simple lease example

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. That is, under the proposed model, total expense (the sum of amortization and interest) is greater in the earlier periods of a lease and less in later periods. This occurs because interest expense is calculated on a liability balance that declines over the lease term.



The previous example shows how even a simple lease can result in significantly different accounting under the proposed model. The following example illustrates the application of the proposed model to a more complex lease.

Complex lease example

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)

Under the proposed model, lessees will be required to reassess the estimates and judgments used in determining the obligation to pay rentals each reporting period and make adjustments to reflect changes in the obligation due to changes in facts and circumstances. Companies 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 changes 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). Note that in situations in which changes in the lease obligation occur, the carrying amount of the right-of-use asset and the timing of expense recognition will not be equivalent to what they would have been had the original estimates reflected the revisions.

When reassessing the obligation for changes in facts and circumstances, one input that typically will remain constant is the discount rate. The discount rate used initially (i.e., the lessee's incremental borrowing rate at lease inception) generally would not change. The discount rate used should not be revised unless a change in the obligation is due to a change in rentals contingent on a variable reference interest rate.

The continuation of the complex lease example below illustrates the reassessment of the lease obligation.

Complex lease example continued

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 record 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.

Impairment

The assets recorded related to leases could become impaired. The right-of-use assets recorded under the proposed model would be subject to the impairment guidance for intangible assets subject to amortization. As such, the proposed model could result in different timing and amounts of charges for impairments of right-of-use assets in comparison to operating lease exit costs currently recognized under ASC 420, *Exit or Disposal Cost Obligations*.

Transition

As noted above, the proposed model will apply to existing leases as well as any new leases entered into after the model is adopted. Lessees would recognize an obligation to pay rentals and a right-of-use asset for outstanding leases as of the date of initial application. The obligation to pay rentals would be measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of transition. The right-of-use asset would be measured on the same basis as the liability, subject to any adjustments for impairment. Additional adjustments for prepaid or accrued rentals would be made when lease payments are uneven over the lease term. Lessees with simple capital leases (i.e., leases without options, contingent rents or residual value guarantees) would continue to account for those leases under the current model (i.e., the accounting for simple capital leases will not change on transition).

How will the proposed model affect lessors?

Lessors also will be required to recognize leases on their balance sheets. A major tenet of the proposed model for lease accounting is symmetry between lessor and lessee accounting. That is, the Boards have decided that the accounting for the lessor should be broadly consistent with the accounting proposed for the lessee. For example, where the lessee accounting model requires that a lessee record a liability for its obligation to pay rentals, the lessor accounting model would require a lessor to record an asset for its right to receive payments under the lease. The estimates and judgments used in determining the amount of the receivable to recognize also are broadly similar to those required by a lessee in determining the amount of the liability. While the Boards have agreed that a lessor should record a receivable and that the receivable should be determined in a manner consistent with the obligation recorded by the lessee, they continue to work through many lessor accounting issues. The Boards made a tentative decision earlier in the project to adopt a performance obligation approach to lessor accounting under which the underlying leased asset remains on the balance sheet of the lessor and a separate liability for the performance obligation of the lessor is recorded. The Boards have investigated an alternative approach, the derecognition approach, under which the underlying leased asset is partially derecognized to reflect the portion of the asset that is sold (i.e., the right to use the asset during the lease). More recently, the Boards have discussed using a hybrid model under which a lessor would use the performance obligation approach in some situations and the derecognition approach in other situations. In the upcoming exposure draft, the Boards likely will seek comments from constituents as to their views and preferences related to both approaches and the use of a hybrid model.

Under either approach, a lessor would recognize an asset (lease receivable) for its right to receive rental payments from the lessee and the asset will be measured in a manner similar to the lessee's obligation to pay rentals. The receivable should be recognized based on the lease payments expected to be received over the lease term. The recognized lease term would 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 outcomes technique. The lessor will discount the estimated payments over the lease term using the interest rate implicit in the lease (i.e., the rate the lessor is charging the lessee).The lessor's receivable would be subsequently measured at amortized cost using the effective interest method.

The accounting for residual value guarantees from third parties would be different from current accounting practice. Current accounting standards require that the residual value guarantees from third parties be included in the lease receivables to the extent the third party is capable of discharging its obligation under the lease. Under the proposed model, the residual value guarantees from an unrelated third party would not be included in the lessor's receivable, but rather will be accounted for separately under the guidance for accounting for other guarantees.

Although the lessor's receivable would be determined on a basis similar to that used by the lessee to determine the obligation to pay rentals, certain factors may result in a lessor's receivable differing from a lessee's liability. These factors include:

- Determination of the most likely lease term
- Determination of payments for contingent rentals and residual value guarantees
- Discount rate used to determine the present value of the expected lease payments

As such, the lessor's asset will not necessarily mirror the lessee's obligation. Because the estimates and judgments used to determine the lease assets and liabilities are based on different perspectives, a lessor and a lessee may reach different conclusions. 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.

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 obligation to pay rentals. For example, a lessor's receivable would be reassessed if any new facts or circumstances indicate that there is a material change in estimates and judgments regarding contingent rents or residual value guarantees or adjustments to the lease term.

Performance obligation approach

Under the performance obligation approach, the leased asset would remain on the balance sheet of the lessor and the lessor would record a liability for the obligation to permit the lessee to use the leased asset. The performance obligation would initially equal the lease receivable (less any initial direct costs incurred by the lessor) and the lessor would recognize revenue as the obligation is reduced over the term of the lease. The performance obligation would be amortized 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 would not recognize any revenue at the commencement of the lease (i.e., upon delivery of the leased asset). Interest income also would be recognized over the lease term using the effective interest method.

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. If a change were allocated to a satisfied performance obligation, the change would be recognized in revenue. If a change were allocated to an unsatisfied performance obligation, the carrying amount of the performance obligation would be adjusted.

Lessors would continue to depreciate the leased asset and the asset would be subject to impairment. Guidance on how lessors would perform impairment assessments under the performance obligation approach is expected to be included in the exposure draft.

Derecognition approach

The Boards are also considering a derecognition approach to lessor accounting under which a lessor would partially derecognize the underlying leased asset. The residual asset (i.e., the portion of the underlying asset not derecognized) would be an allocation of the previous carrying amount of the underlying asset. The residual asset would not be subsequently remeasured except for impairment. For lease arrangements that contain renewal options, the residual asset recognized by the lessor would be based on the assessed lease term (i.e., the longest possible lease term that is more likely than not to occur). That is, the lease term would be determined as described above and the residual asset would relate to the asset at the end of the lease term. Similar to current sales-type lease accounting, under the derecognition approach the lessor could recognize some measure of income (or loss) as of the commencement of the lease and would recognize only interest income over the term of the lease.

Under the derecognition approach, accounting for a reassessment of the expected lease term would be treated as a new derecognition/re-recognition event. That is, the lessor would derecognize/reinstate a portion of its residual asset. Changes in amounts receivable under all types of contingent rentals and residual value guarantees would be recognized in profit or loss.

What other aspects of lease accounting are changing?

Sale-leasebacks

Sale-leaseback transactions are an important source of financing for many companies. Under current lease accounting, sale-leaseback transactions can provide a source of off-balance sheet financing when the lease in the sale-leaseback is classified as an operating lease; however, the recognition of gains in these transactions is limited. Under the proposed leases guidance, sale-leaseback transactions would no longer provide off-balance sheet financing as all leases would be recorded on the balance sheet.

Under the proposed model, to qualify for sale-leaseback accounting (i.e., remove the asset from the balance sheet, record a gain or loss on sale and recognize a right-of-use asset and obligation to pay rentals), the underlying asset must be deemed to have been sold based on an assessment that at the end of the contract control of the asset has been transferred and all but a trivial amount of the risks and benefits associated with the asset have been transferred to the buyer-lessor. A transaction that does not meet the criteria to apply the sale-leaseback accounting would be accounted for as a financing transaction. Under the proposed model, gains or losses on the sales in transactions that qualify as sale-leasebacks would be recognized.

Subleases

In a sublease arrangement one party 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 they will act as the lessor in the sublease whereby they convey the right to use the underlying asset to a different party for the same or a shorter term. The proposed model will 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.

What's next?

At their upcoming meetings the Boards will continue to discuss lease accounting issues, in particular lessor accounting models. The Boards are expected to issue the exposure draft during the third quarter of 2010 and a final standard in 2011. The Boards recently issued a joint statement on 2 June 2010, announcing that they plan to modify their strategy for completing the major joint projects, which could affect the timing of the leases project. Despite the uncertainty as to the issuance date, companies should not wait to begin assessing the impact that these changes would have on them. The proposed model represents a significant change from current practice and determining the effects of these changes on a company that leases assets may involve a considerable undertaking. We encourage companies to watch closely for the exposure draft and submit comment letters to the Boards expressing their views on the model and any concerns identified or recommendations developed in assessing the proposed model and its effect on their business.

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