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Proposed Changes to Lease Accounting

The FASB and the IASB (the Boards) recently issued a joint exposure draft on accounting for leases that, if finalized as proposed, would significantly change how lessees and lessors account for and report leasing arrangements in their financial statements.[1] The exposure draft is a key step in the Boards' efforts to develop comprehensive, converged guidance on lease accounting by mid-2011 and was developed after considering responses to their preliminary views discussion paper, which focused on lessee accounting.[2]

The proposed guidance would impact almost every organization. Lessees would account for all leases using a single right-of-use model that abandons the idea that the only asset to be accounted for in a lease is the underlying property.[3] The model would require lessees to recognize an asset representing the right to use the underlying property over the estimated lease term (the right-of-use asset) and a liability to make estimated future lease payments in their statements of financial position for each lease. Lessees would no longer classify each lease as either operating or capital, and the model would fundamentally change the accounting and reporting of leases currently classified as operating leases and substantially increase both assets and liabilities of lessees.

Two very different accounting models would apply to lessors: the performance obligation approach and the derecognition approach. Both models would require a lessor to recognize a lease receivable for estimated future lease payments. If the lessor retains significant risks or benefits associated with the underlying property it would also continue to recognize the underlying property and recognize a liability to deliver its use to the lessee over the estimated lease term (the performance obligation approach). Conversely, if the lessor does not retain significant risks or benefits associated with the underlying property, it would derecognize the portion of that property representing the cost of the right-of-use sold to the lessee, reclassify the remaining portion as a residual asset representing its rights to the underlying property at the end of the lease term, and recognize an immediate profit or loss on the transaction (the derecognition approach).

[1] Proposed Accounting Standards Update, Leases, August 17, 2010, available at www.fasb.org.

[2] FASB and IASB Discussion Paper, Leases: Preliminary Views, March 19, 2009, available at www.fasb.org or www.iasb.org.

[3] To avoid confusion with the right-of-use asset, this newsletter uses the term "underlying property" to refer to the property that is the subject of the lease.

Existing U.S. GAAP has been subject to longstanding criticisms that lease accounting is too permissive of off-balance-sheet treatment for lessees, overly complex, and dominated by arbitrary rules.[4] The exposure draft partly responds to these criticisms by proposing to require rights and obligations in lease arrangements that the Boards believe meet the definitions of assets and liabilities in their conceptual frameworks to be recognized in lessees' and lessors' statements of financial position and to increase comparability of financial statements by removing some of the arbitrary rules that are applied in practice under current standards.[5] Although many of the criticisms associated with the existing lease accounting standards relate to lessees' accounting for operating leases, the Boards also decided to address lessor accounting in an effort to avoid inconsistencies with their proposals on lessee accounting and revenue recognition.[6]

The guidance in the exposure draft would require significantly more judgment and estimation of uncertain future events and conditions by lessees and lessors than what is currently required, particularly in estimating the lease term, contingent rental amounts, and residual value guarantees. Lessees and lessors with large leasing portfolios may need to make significant information systems changes to comply with the proposed requirements. Many financial covenants, such as those associated with debt agreements, will need to be renegotiated if the proposed rules are finalized.

Comments on the exposure draft are due by December 15, 2010. The FASB will hold public roundtable meetings for interested parties during the comment period to obtain feedback about the proposed guidance. Organizations wishing to participate in a public roundtable meeting should contact the FASB.

Definition and Scope

The exposure draft defines a lease as "a contract in which the right to use a specified asset or assets (the underlying asset) is conveyed, for a period of time, in exchange for consideration." To conclude that an arrangement includes a lease, entities would need to determine whether:

- Fulfillment of the arrangement depends on a *specified asset or assets* and
- The arrangement conveys to the lessee the right to control the use of the specified asset for an agreed period of time.

The proposed guidance would apply to all leases, including subleases of right-of-use assets, except:

- Leases of intangible assets;
- Leases to explore for or use natural resources (e.g., minerals, oil, and similar non-regenerative resources);
- Leases of biological assets (such as crops and timber);
- Leases that represent an in-substance purchase or sale of underlying property; and

4 See Office of the Chief Accountant, Office of Economic Analysis, and Division of Corporation Finance, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, June 15, 2005, available at www.sec.gov/news/studies/soxoffbalancerpt.pdf..

5 FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, available at www.fasb.org, and IASB, Framework for the Preparation and Presentation of Financial Statements, January 1, 2009, available at www.iasb.org.

6 Proposed Accounting Standards Update, Revenue from Contracts with Customers, June 24, 2010, available at www.fasb.org, and Exposure Draft ED/2010/6, Revenue from Contracts with Customers, June 2010, available at www.iasb.org.

- For lessors applying IFRS, leases of investment property measured at fair value under IAS 40.[7]

Except for the exclusion of leases that are in-substance purchases or sales of an underlying property, this scope is consistent with current U.S. GAAP for leases.[8]

A lease would be considered an in-substance purchase or sale of an underlying property if control of the property, and all but a trivial amount of the risks and benefits associated with it, are transferred to the lessee at the end of the arrangement. This determination would be made at the inception of the lease and not subsequently reassessed. All facts and circumstances would be considered in making this determination. However, leases that automatically transfer title to an underlying property to the lessee by the end of the lease term and leases that include a bargain purchase option generally would be considered in-substance purchases or sales of the underlying property and would not be within the scope of the proposed guidance. Although the Boards did not identify the accounting requirements that would apply to these transactions, for lessors, the revenue recognition and financial instruments accounting requirements likely would apply.[9] It is not clear what accounting literature lessees would apply to these transactions.

For entities applying IFRS, leases that meet the definition of an onerous contract would be excluded from the scope of the standard between lease inception (i.e., "the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement") and lease commencement (i.e., "the date on which the lessor makes the underlying asset available for use by the lessee"). During that period, these leases would be accounted for under the IFRS requirements for contingent liabilities.[10]

Lessors of investment property applying IFRS would apply the IAS 40 requirements rather than the proposed leases standard to account for investment property that the lessor has elected to measure at fair value. Lessors of investment property measured at cost would apply the proposed leases standard. Lessees of investment property applying IFRS would be subject to the proposed leases standard for recognition purposes but would be permitted to measure their investment property right-of-use assets at fair value under IAS 40. U.S. GAAP currently does not permit entities to measure investment property at fair value. However, this scope difference may be eliminated by the FASB's recent tentative decision to issue a proposed Accounting Standards Update that would require investment property as defined in IAS 40 to be measured at fair value.[11]

Short-term leases, defined as leases that have a maximum possible lease term, including options to renew or extend, of 12 months or less would be within the scope of the proposed standard but a simplified form of accounting would be allowed. Lessees would be permitted to elect, on an individual lease basis, to measure the right-of-use asset and the liability to make lease payments for short-term leases on an

[7] International Accounting Standard No. 40, Investment Property

[8] FASB ASC Topic 840, Leases, available at www.fasb.org.

[9] FASB ASC Topic 605, Revenue Recognition, and FASB ASC Topic 825, Financial Instruments, both available at www.fasb.org.

[10] International Accounting Standard No. 37, Provisions, Contingent Liabilities, and Contingent Assets.

[11] See Defining Issues No. 10-28, FASB to Issue a Proposed Accounting Standards Update on Investment Properties, available at www.us.kpmg.com/definingissues.

undiscounted basis. Lessors would be permitted to elect, on an individual lease basis, to not recognize assets or liabilities arising from short-term leases nor derecognize any portion of the underlying property.

Many arrangements include lease components and service components (e.g., a lease of office space with common area maintenance provided by the lessor). Under the proposed guidance, lessees and lessors would separately account for service components that are considered distinct by allocating payments under the arrangement between the lease and service components unless it is impracticable to do so. Lessors would account for separated service components using the Boards' proposed guidance on revenue recognition. Arrangements that contain service and lease components that are not accounted for separately would be accounted for under the proposed leases standard in their entirety. Consistent with the Boards' proposed guidance on revenue recognition, the proposed guidance defines a good or service as distinct if either is sold separately (by the entity or another entity) or the entity could sell the good or service separately because it has a distinct function and profit margin.[12] This definition may affect the measurement of lease assets and liabilities depending on whether the lease requires the lessee or the lessor to pay for items such as insurance, property taxes, and maintenance.

The accounting for executory contracts would be unchanged by the proposed standard. Assets and liabilities generally are not recognized at the commencement of an executory arrangement, similar to the accounting for operating leases under existing U.S. GAAP. Because the accounting for lease and service components under the proposed standard would no longer be similar, the identification of arrangements containing lease and service components, and the allocation of payments to each component, would be more consequential. Entities would need to analyze all concurrently negotiated contracts with other parties to identify arrangements containing both components.

Lessee Accounting

Recognition. The right-of-use model would require the lessee to recognize a right-of-use asset and a liability to make estimated future lease payments for each lease. The asset and liability would be recognized in essentially the same way that capital leases are currently recognized under U.S. GAAP. However, the measurement of the asset and liability would differ from current U.S. GAAP. Lessees would not separately account for renewal options, contingent rentals, and residual value guarantees except as already required by other authoritative literature.[13] They would recognize a single right-of-use asset and a single liability to make estimated future lease payments for each lease contract and reflect the various features or components of the arrangement in the measurement of the asset and liability.

Because of the recognition and measurement requirements of the proposed guidance, lessees' assets and liabilities would increase and the expenses they recognize over the lease term would be accelerated (due to interest expense on the lease liability) as compared to expenses recognized for operating leases under current accounting standards.

[12] See Defining Issues No. 10-25, Proposed Changes to Accounting for Revenue Recognition, available at www.us.kpmg.com/definingissues.

[13] FASB ASC Topic 815, Derivatives and Hedging, available at www.fasb.org.

Initial Measurement. At lease inception, a lessee would measure the liability to make lease payments over the estimated lease term at the present value of the estimated future lease payments, discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee. A right-of-use asset would be recognized at lease commencement for an amount equal to the liability (also initially recognized at lease commencement) plus any rent that the lessee has prepaid and any recoverable initial direct costs incurred by the lessee. The Boards concluded that this measurement approach would be more practicable than a strict fair value measurement and would reasonably approximate fair value.

Under the proposed right-of-use model, lessees would be required to estimate the lease term and periodically reassess that estimate. The estimated lease term would be defined as "the longest possible term that is more likely than not to occur." The lessee would consider all facts and circumstances in making this assessment, including but not limited to:

- The terms of the contract and the resulting amount of lease payments in any renewal period (e.g., bargain, discounted, market, fixed-rate, etc.);
- The existence and amount of any contingent rentals, residual value guarantees or termination penalties;
- Any financial consequences of extending or terminating the lease caused by factors other than the contract such as significant leasehold improvements that would be surrendered to the lessor if the lease was terminated or not extended;
- Local regulations that affect the lease term, relocation costs and other costs of obtaining an alternative item for use by the lessee;
- The leased property's location and nature (e.g., whether it is specialized or crucial to the lessee's business operations); and
- The lessee's intentions and past practice.

The lessee's liability would be determined as the present value of the estimated future lease payments over the estimated lease term. Undiscounted estimated future lease payments would include:

- Fixed payments owed to the lessor during the estimated lease term. Fixed payments would include noncontingent rentals and any applicable termination penalties.
- Estimated variable payments due to the lessor during the estimated lease term determined using a probability-weighted expected outcomes approach. Variable payments would include contingent rentals and amounts payable under residual value guarantees provided to the lessor. If contingent rentals depend on an index or rate, readily available forward rates or indices would be used to estimate future lease payments. If these are not available, the lessee would use the prevailing spot rates or indices.

The exercise price of a purchase option included in a lease would not be considered a lease payment and would be excluded from the present value of estimated future lease payments. As a result, a lease designed to give the lessee optional access to the economic utility of an asset likely would be reflected as a smaller amount on the lessee's statement of financial position if that optionality comes from a purchase option (even if exercise of the option is more likely than not) instead of term renewal options.

Determining the amount to include in estimated lease payments for contingent rentals and other variable lease payments may prove challenging, especially for long-term leases such as a 10- or 20-year lease of retail space with contingent rentals based on a percentage of sales.

Subsequent Accounting. After initial recognition and measurement, the right-of-use asset would be amortized on a systematic basis (generally straight-line) based on the pattern of the lessee's consumption of the right-of-use asset's economic benefits from lease commencement over the shorter of the lease term or the useful life of the underlying property. The expense would be characterized in the lessee's income statement as amortization rather than rent expense. The right-of-use asset also would be subject to impairment testing under existing standards.[14]

The liability to make estimated future lease payments would be measured at amortized cost using the interest method under which lease payments would be apportioned between interest expense and a reduction of the remaining lease liability. Each reporting period the liability would be reassessed and the amount of the liability would be revised for changes in estimated future lease payments if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period. Changes in estimated lease payments could relate to the estimated lease term, contingent rentals, or expected payments under termination options or residual value guarantees. Changes in the liability to make estimated future lease payments due to a change in the estimated lease term or other estimated payments that relate to future periods would result in an equal adjustment to the right-of-use asset. Changes in the liability due to changes in estimated contingent rentals, expected payments under termination options, and residual value guarantees would be recognized immediately in the income statement to the extent they relate to current or prior periods. For example, when lease payments are contingent on the lessee's sales, changes in estimated contingent rentals relating to sales of current or prior periods would be recognized immediately in the income statement, while changes relating to estimated future sales would result in an adjustment of the right-of-use asset. The discount rate would remain unchanged except to reflect changes in reference interest rates when contingent rentals are based on an interest rate index. Changes in estimated contingent rentals arising from reference interest rates would be recognized in the income statement.

Under the proposed guidance, the timing of expense recognition would differ significantly from operating leases under current U.S. GAAP. Expenses would be accelerated or front-loaded because interest expense on the liability to make lease payments would be recognized by applying the interest method rather than the straight-line expense recognition currently associated with most operating leases. Additionally, the expenses related to the lease would be characterized as amortization and interest expense rather than rent expense, which could affect non-GAAP performance measures such as EBITDA used by some entities.

The accompanying appendix summarizes some of the major provisions of the proposed standard for lessees.

[14] FASB ASC Topic 350, Intangibles—Goodwill and Other, available at www.fasb.org.

Lessor Accounting

The proposed guidance would require that lessors also recognize assets and liabilities arising from a lease. The details of the accounting by lessors would depend on whether the lessor retains exposure to significant risks or benefits associated with the underlying property during or after the estimated lease term (e.g., by having the expectation or ability to generate significant returns by re-leasing the property or by selling it). The FASB decided to propose eliminating leveraged lease accounting to promote further convergence with IFRS. The Board also concluded that a difference in the method of financing or the timing of cash flows under the lease are not valid reasons for application of a different accounting methodology by the lessor.

If a lessor retains exposure to significant risks or benefits associated with the underlying property, the lessor would be required to apply the performance obligation approach to account for the lease. Otherwise, a lessor would be required to apply the derecognition approach. A lessor would not be allowed to change the accounting approach after lease inception. The following factors would be considered in determining whether a lessor retains exposure to significant risks or benefits associated with the underlying property, although the existence of one or more factors would not be determinative:

- During the estimated term of the lease:
  - Significant contingent rentals based on use or performance of the underlying property;
  - Options to extend or terminate the lease; and
  - Material non-distinct services provided under the lease.
- After the estimated term of the lease:
  - The estimated lease term is not significant in relation to the remaining useful life of the underlying property; and
  - A significant change in the value of the underlying property at the end of the estimated lease term is expected. The effect of any residual value guarantees (including those provided by parties other than the lessee) would also need to be considered. In general, a residual value guarantee would reduce a lessor's exposure to risk without affecting its right to benefits.

Counterparty credit risk of the lessee would not impact the lessor's analysis.

Under both the performance obligation and derecognition approaches, the lessor would recognize a lease receivable for its right to receive estimated future lease payments from the lessee over the estimated lease term. The lease receivable would be measured at the present value of the estimated future lease payments discounted using the rate the lessor charges the lessee. The amount of this receivable may differ from the amount of the lessee's liability to make future estimated lease payments for the following reasons. First, the lessor would be required to discount the estimated future lease payments at the rate the lessor charges the lessee whereas the lessee could use its incremental borrowing rate or the rate the lessor charges the lessee, if known. Second, the lessor would not include in estimated future lease payments amounts due under contingent rentals and residual value guarantees that it cannot reliably measure. Third, the lessor's receivable would include any recoverable initial direct costs it incurred to enter into the lease. Finally, it is likely that the lessor may have different information about the likelihood that the lessee will exercise a renewal or termination option (e.g., the lessor may be unable to assess the lessee intentions and past practice) and, therefore, the lessor's determination of the longest possible lease term that is more likely than not to occur may differ from the lessee's.

Consistent with the proposed guidance for lessee accounting, residual value guarantees from third parties would not be included in the lessor's lease receivable. This would differ from current U.S. GAAP, which requires residual value guarantees from third parties to be included in minimum lease payments by the lessor to the extent the third party is financially capable of discharging its obligations.

Performance Obligation Approach. The performance obligation approach takes the perspective that the lessor delivers the right to use the underlying property to the lessee over the lease term rather than at lease commencement. In addition to recognizing a lease receivable, lessors applying the performance obligation approach would continue to recognize the underlying property and recognize a new liability to permit the lessee to use the underlying property during the estimated lease term (a performance obligation) in the statement of financial position. The performance obligation liability would be initially measured at the present value of the estimated lease payments, including any prepaid rentals.

After initial recognition and measurement, the lessor's receivable would be measured at amortized cost using the interest method, subject to any impairment loss.[15] The carrying amount of the lease receivable would be reassessed each reporting period if facts or circumstances indicate that there is a significant change in the right to receive estimated future lease payments since the previous reporting period relating to the same factors that would cause a change in the lessee's liability for estimated future lease payments. Changes in the lease receivable due to a change in the estimated lease term or other estimated payments that do not relate to a satisfied performance obligation (as discussed below) would result in an equal adjustment to the performance obligation liability. Changes in the lease receivable due to changes in estimated contingent rentals, amounts receivable under termination options, and residual value guarantees would be recognized immediately in the income statement to the extent that they relate to a satisfied performance obligation. The lessor also would recognize in the income statement any change that would reduce the performance obligation liability below zero. The discount rate would remain unchanged except to reflect changes in reference interest rates when contingent rentals are based on an interest rate index. Changes arising from reference interest rates would be recognized in the income statement.

In addition to any adjustments from reassessment of the lease receivable, the performance obligation liability would be amortized after initial recognition based on the pattern of use of the underlying property by the lessee over the estimated lease term. (The amortization represents the lessor's satisfaction of the performance obligation.) If the lessor cannot reliably determine the pattern of use of the underlying

[15] FASB ASC Topic 310, Receivables, available at www.fasb.org.

property by the lessee (e.g., based on the number of units produced by the lessee, machine hours used as a percentage of total expected machine hours, etc.), it would use the straight-line method. Amortization of the performance obligation would result in revenue being recognized by the lessor over the estimated lease term. Therefore, this approach would preclude any up-front profit recognition from the lease consistent with the accounting for operating leases under current U.S. GAAP.

Derecognition Approach. The derecognition approach takes the perspective that the lessor has delivered the right to use the underlying property to the lessee at lease commencement. In addition to recognizing a lease receivable, a lessor applying the derecognition approach would derecognize the portion of the carrying amount of the underlying property that represents the cost of the right-of-use sold to the lessee. The remaining portion of the carrying amount of the underlying property representing the economic benefits that the lessor is entitled to at the end of the estimated lease term would be reclassified as a residual asset in the lessor's statement of financial position. The Boards rejected a full derecognition approach under which the lessor would recognize up-front profit equal to the difference between the carrying amount of the underlying property and its fair value because not all of the economic benefits of the underlying property are transferred to the lessee.

The portion of the underlying property to be derecognized by the lessor would be determined based on the relative fair values of the right-of-use and the underlying property (expressed as [fair value of right to receive lease payments ÷ fair value of underlying property × carrying amount of underlying property]). This is the only aspect of the proposed standard that would require the lessor to determine the fair value of the right to receive lease payments. The difference between the lease receivable plus any prepaid rent received by the lessor and the portion of the underlying property that is derecognized would be recognized as up-front profit in the lessor's income statement. As a result, the pattern of income recognition under the derecognition approach would be similar to revenue recognition under current U.S. GAAP for sales-type leases. However, the measurement of the lease receivable and residual assets would differ from leases classified as sales-type leases under current U.S. GAAP.

After initial recognition and measurement, the lessor's receivable would be measured in the same manner as under the performance obligation approach. Changes in the lease receivable due to a change in the estimated lease term would result in an adjustment of the carrying amount of the residual asset using the same methodology as that used to initially measure the residual asset. Any remaining difference would be recognized in the income statement. Changes in the lease receivable due to changes in estimated contingent rentals, amounts receivable under termination options, and residual value guarantees would be recognized immediately in the income statement. The discount rate would remain unchanged except to reflect changes in reference interest rates when contingent rentals are based on an interest rate index. Changes arising from changes in reference interest rates would be recognized immediately in the income statement. A lessor would apply existing U.S. GAAP at each reporting date to determine if the residual asset is impaired.[16] Unlike current U.S. GAAP, the residual asset would not be accreted to its estimated future value at the end of the estimated lease term.

[16] FASB ASC Topic 350, Intangibles-Goodwill and Other, and FASB ASC Topic 360, Property, Plant, and Equipment, both available at www.fasb.org.

The accompanying appendix summarizes some of the major provisions of the proposed standard for lessors.

Sale and Leaseback Transactions. Under existing U.S. GAAP, sale-leaseback transactions result in off-balance-sheet accounting for the seller-lessee when a sale is recognized and the lease is classified as an operating lease. The exposure draft proposes that sale-leaseback transactions would no longer be off-balance sheet as all leases would be required to be recognized in the statement of financial position.

Under the proposed guidance, to qualify for sale-leaseback accounting, the transfer and lease contracts must be (a) entered into at or near the same time, (b) negotiated as a package with a single commercial objective, and (c) performed either concurrently or consecutively, and the transfer must meet the conditions for a purchase and sale (i.e., control of the underlying property and all but a trivial amount of the risks and benefits associated with the underlying property must be transferred at the end of the arrangement). The criteria to determine whether all but a trivial amount of the risks and benefits associated with the underlying property are transferred at the end of the arrangement are essentially the same as the criteria for determining whether a sale-leaseback of real estate qualifies as a sale under current U.S. GAAP.[17] Therefore, it is likely that most sale-leaseback transactions (including those involving only equipment) would not qualify for sale-leaseback accounting. A transaction that does not meet the criteria for sale-leaseback accounting would be accounted for as a financing (i.e., the transferred asset would not be derecognized and amounts received would be recognized as a financial liability) by the transferor/lessee and as a loan receivable for the amount paid (rather than a purchase of the underlying property) by the transferee/lessor.

If the transfer and lease contracts qualify for sale-leaseback accounting, the seller-lessee would derecognize the underlying property from its statement of financial position, recognize a gain or loss on the sale, and recognize a right-of-use asset and liability to make estimated future lease payments under the requirements applicable to lessees under the proposed guidance. The buyer-lessor would recognize the underlying property in its statement of financial position and apply the performance obligation approach to account for the lease. If the consideration for the sale-leaseback transaction is not at fair value, both parties would record adjustments (i.e., to the underlying property and/or to lease assets and liabilities) to reflect current market rates, which would affect the amount of the gain or loss recognized by the seller-lessee.

Subleases. A sublease would be accounted for by sublessees using the right-of-use model and by sublessors under the performance obligation approach.

Presentation

Lessees would present liabilities to make estimated future lease payments separately from other financial liabilities within the statement of financial position. Right-of-use assets would be classified within property, plant, and equipment but shown separately from owned assets. Amortization of right-of-use assets and interest expense on liabilities to make estimated future lease payments would be shown separately from other amortization and interest expense in the income statement

[17] FASB ASC paragraphs 840-40-25-13, 25-14, and 25-17, available at www.fasb.org.

or disclosed in the notes to the financial statements. Lease payments would be classified as financing activities in the statement of cash flows and be presented separately from other financing cash flows.

Performance Obligation Approach. A lessor would present the underlying property, the lease receivable, and the performance obligation liability together in the statement of financial position, totaling to either a net lease asset or a net lease liability. Interest income on lease receivables, income resulting from satisfaction of performance obligation liabilities, and depreciation expense on the underlying property would be presented separately in the income statement. The FASB has proposed that these amounts be totaled to a net lease income or net lease expense. Cash receipts from leases would be classified as an operating activity in the lessor's statement of cash flows and would be presented separately from other cash flows from operating activities (under the direct method, or changes in lease receivables would be presented separately from changes in other operating receivables under the indirect method).

Derecognition Approach. A lessor would present lease receivables separately from other financial assets (distinguishing those that arise under subleases), and residual assets separately within property, plant, and equipment (distinguishing those that arise under subleases). If the lessor's business model uses leases to provide financing, the lessor would present net income or expense in a single line item in the income statement. Conversely, if the lessor's business model uses leases as an alternative means of realizing the benefit of goods it would otherwise sell (such as many manufacturer or dealer lessors), the lessor would present income and expense in separate line items in the income statement. Interest income from lease receivables would be classified separately from other interest income. Cash receipts from leases would be classified as an operating activity in the lessor's statement of cash flows and would be presented separately from other cash flows from operating activities (under the direct method, or changes in lease receivables would be presented separately from changes in other operating receivables under the indirect method).

Sublessors. A sublessor would present the liability to make estimated future lease payments (as lessee) separately from other financial liabilities in the statement of financial position. These items would be presented separately totaling to a net lease asset or net lease liability: the right-of-use asset (e.g., the underlying property in a sublease); the lease receivable under the sublease; and the performance obligation liability under the sublease. There are no unique income statement or cash flow statement presentation considerations that would apply to sublessors.

Disclosures

Both lessees and lessors would be required to disclose more information about their leasing arrangements than currently required. The proposed guidance would require disclosure of quantitative and qualitative financial information that:

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

Information would be aggregated or disaggregated to ensure it is useful to financial statement users. The disclosures would include, but not be limited to:

- The nature of lease arrangements, including descriptions of general terms, options to renew or terminate, terms of contingent rentals and residual value guarantees, purchase options, amortization methods, and initial direct costs;
- Key assumptions and judgments;
- Restrictions imposed by lease arrangements (e.g., restrictions on dividends, additional debt, and further leasing);
- Nature and amount of significant subleases;
- Terms of sale-leaseback transactions;
- For lessors, information about exposures to significant risks or benefits associated with the underlying property used in determining whether to apply the performance obligation or derecognition approach;
- Information about the nature and amount of each class of residual asset;
- Information about the nature of significant service obligations;
- For lessees, a reconciliation between opening and closing balances of right-of-use assets and liabilities to make estimated future lease payments, disaggregated by class of underlying property;
- For lessors, a reconciliation between opening and closing balances of lease receivables, performance obligation liabilities, and residual assets;
- For lessees, a maturity analysis of the liability to make estimated future lease payments showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years (the analysis would separately disclose the minimum obligations specified in the lease); and
- For lessors, a maturity analysis of the right to receive lease payments showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years (the analysis would separately disclose the minimum amounts receivable specified in the lease).

Effective Date and Transition

The proposed standard does not specify an effective date. The Boards are working on various joint projects, including this one, under their Memorandum of Understanding.[18] The Boards plan to issue a separate consultation document later this year seeking input about effective dates and transition methods.

The Boards have proposed that lessees and lessors would recognize and measure all leases outstanding as of the date of initial application (i.e., the beginning of the first comparative period presented in the first financial statements in which the proposed guidance would be applied) using a simplified retrospective approach. The Boards have not proposed any transition provisions for leases that would meet the definition of an in-substance purchase or sale of the underlying property.

[18] Joint IASB and FASB Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards, June 24, 2010, available at www.fasb.org.

The simplified retrospective approach would require, at the date of initial application, lessees to recognize a liability to make lease payments for each outstanding lease, measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application, and a corresponding right-of-use asset, adjusted to reflect any impairment charges. There would be no adjustments to lessee asset and liability amounts for leases previously classified as capital leases that do not have any renewal options, contingent rents, or residual value guarantees. The guidance also proposes simplified transition requirements for short-term leases and would require additional adjustments to the right-of-use assets for prepaid or accrued rent when lease payments are uneven over the lease term. Opening balances of affected equity components also would be adjusted as of the beginning of the earliest period presented.

The proposed standard also would require simplified transition requirements for lessors. For leases accounted for under the performance obligation approach, lessors would recognize a lease receivable for each lease outstanding at the date of initial application, measured at the present value of the remaining estimated future lease payments, discounted using the rate the lessor charged the lessee as determined at lease inception, adjusted to reflect any impairment charges. Lessors would recognize a corresponding lease liability equal to the amount of the lease receivable and would reinstate previously derecognized underlying properties at depreciated cost, adjusted to reflect any impairment charges. For leases accounted for under the derecognition approach, lessors would recognize a lease receivable measured in the same manner as under the performance obligation approach and would derecognize the underlying asset (if it is on the statement of financial position) and recognize a residual asset measured at fair value at the date of initial application.

Appendix

The following tables summarize some of the major provisions of the proposed leases standard for lessees and lessors.

Proposed Guidance for Lessees
Recognition
• A right-of-use asset and a liability to make estimated future lease payments would be recognized for every lease in the statement of financial position beginning at lease commencement.
Initial Measurement
• The liability to make estimated future lease payments would be measured at the present value of the estimated future lease payments over the longest possible lease term that is more likely than not to occur (estimated lease term) considering all contractual, noncontractual, and business factors as well as the lessee's intentions and past practice. • Estimated future lease payments would be determined using a probability-weighted expected outcomes approach and would include estimates for contingent rentals, residual value guarantees, and termination option penalties. • The right-of-use asset would be measured as the present value of the liability to make estimated future lease payments plus any prepaid rent plus recoverable initial direct costs.

Proposed Guidance for Lessees
Subsequent Accounting
• The right-of-use asset would be amortized over the shorter of the estimated lease term or estimated useful life of the underlying property subject to adjustment for any impairment. Remeasurement of the liability to make estimated future lease payments would result in remeasurement of the right-of-use asset in some circumstances. • The liability to make estimated future lease payments would be measured at amortized cost using the interest method. • The liability would be reassessed each reporting period and remeasured if circumstances indicate a significant change since the previous reporting period. Remeasurement of the liability would be recognized immediately in the income statement to the extent the changes relate to current or prior periods.

Proposed Guidance for Lessors
Classification
• Lessors would account for leases under either: (1) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying property or, if not, (2) the derecognition approach.
Recognition
Performance Obligation Approach • Lessors would continue to recognize the underlying property and recognize a receivable for the present value of estimated future lease payments and a performance obligation liability to permit the lessee to use the underlying property during the estimated lease term. **Derecognition Approach** • Lessors would derecognize the portion of the underlying property representing the cost of the right-of-use asset sold to the lessee, reclassify the remaining portion as a residual asset, and recognize a receivable for the present value of estimated future lease payments.
Initial Measurement
Performance Obligation Approach • The underlying property would remain on the lessor's statement of financial position at its carrying amount. • The lease receivable would be measured at the present value of estimated future lease payments over the longest possible lease term that is more likely than not to occur (estimated lease term) plus recoverable initial direct costs. It would be discounted using the rate the lessor charges the lessee. • Estimated future lease payments would be determined using a probability-weighted expected outcomes approach and would include estimates for contingent rentals and residual value guarantees (to the extent they are reliably measurable) and termination option penalties. • The performance obligation liability would equal the present value of the estimated lease payments, including any prepaid rent.

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Proposed Guidance for Lessors

Derecognition Approach

- The portion of the underlying property representing the cost of the right-of-use sold to the lessee would be derecognized from the lessor's statement of financial position and the remaining portion reclassified as a residual asset.
- The lease receivable would be measured in the same manner as under the performance obligation approach.
- The residual asset would be measured as the difference between the carrying amount of the underlying property and the ratio of the fair value of the right to receive lease payments over the fair value of the underlying property multiplied by the carrying amount of the underlying property.
- Profit would be recognized on lease commencement for the difference between the portion of the underlying property that is derecognized and the lease receivable plus any prepaid rent.

Subsequent Accounting

Performance Obligation Approach

- The underlying property would continue to be depreciated over its estimated useful life and adjusted for any impairment.
- The lease receivable would be measured at amortized cost using the interest method.
- The lease receivable would be reassessed each reporting period and remeasured if circumstances indicate a significant change since the previous reporting period.
- The performance obligation liability would be amortized based on the pattern of use of the underlying property or on a straight-line basis if the lessor cannot reliably determine a different pattern of use. Remeasurement of the lease receivable would result in remeasurement of the performance obligation liability in some circumstances.

Derecognition Approach

- The lease receivable would be measured at amortized cost using the interest method.
- The lease receivable would be reassessed each reporting period and remeasured if circumstances indicate a significant change since the previous reporting period.
- The residual asset would not be remeasured except for any impairment or when the estimated lease term is revised.

This edition of *Defining Issues* identifies some of the potential changes in practice. A more comprehensive analysis of the provisions and potential impact of the proposed guidance will be provided in a future *Issues In-Depth* publication. In addition, we encourage readers to participate in our upcoming CFO Financial Forum Webcast on the proposed guidance on October 19, 2010.