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To the Point

FASB — proposed guidance

Lease term simplified — other lease accounting changes are on the horizon

The changes reflect criticism that aspects of the Boards' initial proposal would have been too complex and costly to implement.

What you need to know

- The FASB and the IASB agreed to change their proposed definition of the lease term to include only optional periods for which there is a significant economic incentive for the lessee to extend (or not terminate) the lease.
- In many cases, this would result in shorter lease terms than the initial proposal and smaller lease-related assets and liabilities that would have to be recognized on the balance sheet.
- The Boards agreed that certain variable lease payments would be included in recognized lease-related assets and liabilities using a higher threshold (such as reasonably certain) than had been originally proposed.
- The Boards discussed other potentially significant changes to their proposal but decided to perform additional outreach.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) began changing their proposed model for lease accounting in response to criticism that it was overly complex and potentially costly to implement.

The Boards tentatively agreed to revise the proposed definition of the lease term and the treatment of variable lease payments, but remain committed to requiring that all leases be recognized on balance sheet.

In coming months, the Boards plan to seek feedback from selected constituents on changes to the proposal. The Boards have not announced changes in their plan to issue a final standard by 30 June 2011. However, that timing could change given the significance of the changes the Boards are contemplating.

Background

The Boards have been jointly developing a new approach to lease accounting that would require all leases to be recognized on the balance sheet of lessees and lessors. Last year, they proposed a right-of-use model under which assets and liabilities arising from leases would be recognized for all leases.[1]

Based on feedback they received in nearly 800 comment letters, workshops and roundtable discussions, the Boards identified issues for redeliberation, including:

- Lease term
- Variable lease payments
- Income and expense recognition pattern
- The definition of a lease
- Lessor accounting model

Many respondents were especially critical of the lease term and variable lease payment provisions in the proposal noting they would be too costly and complex to apply and would not provide the most relevant financial information. Some respondents raised questions about whether requiring lessees to recognize liabilities and lessors to recognize assets that include payments that could be avoided would meet the definitions of assets and liabilities under the conceptual framework.

Lease term

The Boards initially proposed defining the lease term for accounting purposes as the longest possible lease term that is more likely than not to occur (i.e., a greater than 50% probability). Lessees and lessors would have been required to assess the likelihood of occurrence of each of the possible lease terms based on a variety of factors.

In a major change, the Boards have tentatively decided to define the lease term as the non-cancellable period, plus any options where there is a significant economic incentive to extend or not terminate the lease. Factors that might create an economic incentive for the lessee include renewal rates priced at a bargain, penalty payments for cancellation or non-renewal and economic penalties such as significant customization or installment costs.

In many cases, the new definition would result in shorter lease terms for accounting purposes than the Boards' initial proposal. For example, assume a retailer has a lease that includes a non-cancellable term of 10 years and four five-year renewal options. Based on its experience and expectations, the retailer may determine that the longest possible lease term that is more likely than not to occur is 20 years. However, if there is no significant economic incentive for the retailer to exercise the renewal options, the lease term for accounting purposes, under the revised definition, would be 10 years.

The Boards tentatively agreed that companies would be required to reassess the lease term only when there is a significant change in factors relevant to determining if a significant economic incentive exists to exercise an option to extend or terminate a lease. The Boards believe that changing the definition of lease term will address some constituents' concerns about the cost of ongoing reassessment.

How we see it

The new definition of lease term more closely aligns the measurement of lease-related assets and liabilities with concepts used in current accounting and would make the new model less burdensome. However, many of the challenges that exist under current accounting around these judgments would persist.

Assessing whether an economic incentive is significant is a subjective determination. In addition, companies would need to consider how changes in facts and circumstances affect their assessment of economic incentives. This reassessment criterion is not present in today's lease accounting model.

Variable lease payments

The Boards initially proposed that companies estimate variable lease payments (e.g., contingent rent, residual value guarantees and termination penalties) using a probability-weighted expected outcome approach. Under this approach, contingent rent, including amounts based on performance (e.g., sales in a leased store) or usage (e.g., miles flown on a leased airplane), would be estimated under multiple scenarios and included in the assets and liabilities recognized on the balance sheet.

The Boards plan to deliberate additional details and selectively solicit feedback on changes to the proposal.

The Boards have tentatively decided that the lessee's liability and lessor's receivable should include:

- Lease payments that depend on an index or rate
- Lease payments for which the variability lacks commercial substance
- Lease payments that meet a high recognition threshold (such as reasonably certain)

Variable lease payments that depend on an index or a rate would be measured initially based on the spot or prevailing rate. The high recognition threshold would result in some performance- and usage-based contingent rents being excluded from lease-related assets and liabilities.

The Boards will continue to discuss the recognition threshold for and measurement of variable lease payments.

How we see it

While this change may result in lower lease-related assets and liabilities than the initial proposal, we do not believe it would fully address the significant cost and complexity concerns that many respondents expressed. The Boards did not address subsequent measurement of variable lease payments; however, based on their tentative decisions, we believe some reassessment on a periodic basis will likely be part of their model.

Other possible changes

The Boards discussed other possible changes but did not reach any conclusions.

To address concerns that the proposed recognition of lease income and expense does not correspond with the underlying economics of many lease transactions, the Boards discussed allowing for straight-line recognition of lease income and expense for leases that do not have a significant financing element. The Boards agreed to investigate how to distinguish between leases that contain a significant financing element and those that do not. Leases that contain a significant financing element would be recognized in a way that would result in front-end loaded income or expense consistent with the initial proposal.

The Boards are likely to refine the definition of a lease and clarify the distinction between leases and service arrangements. The Boards discussed clarifying the principles related to the definition of a specified asset and the assessment of whether a contract conveys the right to control the use of a specified asset. The Boards are also considering excluding from lease accounting contracts that involve the use of assets that are incidental to the delivery of a service. An example of such an arrangement discussed was a cable set-top box provided when a customer contracts to have viewing rights to particular television channels. The Boards will continue to deliberate these issues.

The Boards plan to wait for more developments in their joint revenue recognition project and the FASB's investment property project before deciding whether changes to lessor accounting should be made as part of the leases project. Some respondents said the initial proposal did not represent an improvement over existing guidance for lessors.

We will continue to update you on significant developments.

Endnotes:

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[1] FASB Proposed Accounting Standards Update, *Leases*. For additional detail about the exposure draft, refer to Financial Reporting Developments, *Proposed accounting for leases* (SCORE No. BB1992) or Technical Line, *Proposed leases guidance exposed* (SCORE No. BB1990)