Proposed New Lease Accounting: A Joint Project Between the FASB and the IASB

September 9, 2010

OBJECTIVE:

To establish consistent principles for lessees and lessors to use when reporting information to financial statement users about the cash flows from leasing transactions.

TIMELINE:

The Financial Accounting Standards Board (FASB) issued a discussion paper on preliminary views on March 19, 2009 with a comment period that ended July 19, 2009. The FASB and the International Accounting Standards Board (IASB) have been deliberating monthly since the FASB issued its discussion paper, and have published the minutes from their most recent meeting on April 22, 2010. An exposure draft was issued August 17, 2010 with comments due December 15, 2010. The IASB and FASB will hold roundtable discussions during the fourth quarter of 2010, and a Final Accounting Standards Update is expected during the second quarter of 2011. Estimates are that the new standard could be applicable as early as January 1, 2012.

SCOPE:

The guidance shall be applied by entities to all right-of-use asset leases and subleases, except:

1. Leases of intangible assets.
2. Leases to explore for or use natural resources (e.g., oil or natural gas).
3. Leases of biological assets.

The guidance shall not apply to contracts that represent a purchase or sale of an asset, such as:

1. A contract that results in the transfer of control of an asset and all but a trivial amount of the risks and benefits associated with the asset.
2. A lease after the lessee has exercised a purchase option.

Leases that are for fewer than 12 months (even those with renewal options) can be classified as short-term, and are subject to simplified rules.

SUMMARY:

The FASB's new exposure draft on leases proposes significant changes to how lessees and lessors would account for leases. Some of the more significant changes are as follows:

- Lessees will need to recognize a liability to make lease payments and an asset to represent their right to use the leased property.
- Lessors will need to recognize an asset to represent their right to receive lease payments. Also, depending on risk/benefit retention, lessors will also need to either derecognize the underlying asset or recognize a liability to represent their requirement to provide the underlying asset to the lessee.
- The liabilities and assets recognized by lessees and lessors will require calculations that include estimated lease terms and expected outcome analyses to reflect all possible lease payments. These calculations will require monitoring and potential adjustment during future reporting periods.
- Additional and extensive disclosures will be required.

DEFINITIONS:

Important terms used throughout the guidance will be as follows:

- Lease – A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.
- Lease liability – The lessor's obligation to permit the lessee to use the underlying asset over the lease term.
- Right-of-use asset – An asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.
- Underlying asset – The asset for which a right of use is conveyed in a lease.

LESSEE:

Statement of financial position – At the commencement of a lease, the lessee shall recognize a right-of-use asset and a liability to make lease payments in the statement of financial position.

Income statement – During the lease term, the lessee shall recognize: interest expense on the liability to make lease payments; amortization expense on the right-of-use asset; changes to the liability to make lease payments that result from reassessment of the expected lease payments for current or prior periods; and impairment losses on the right-of-use asset in the income statement.

Initial measurement of the liability to make lease payments shall be at the present value of the lease payments discounted using the lessee's incremental borrowing rate, or, if readily determinable, the rate the lessor charges the lessee. Initial measurement of the right-of-use asset shall be at the amount of the liability to make lease payments plus any initial direct costs incurred by the lessee.

In calculating the present value, a lessee shall calculate the probability-weighted average of cash flows for a reasonable number of possible outcomes, taking into consideration items such as:

- An estimated lease term that includes consideration of renewal or cancellation options and the probability of occurrence for each.
- An estimate of contingent rental payments over the estimated lease term.
- An estimate of amounts due to the lessor under residual value guarantees over the estimated lease term.
- An estimate of payments due to the lessor under term option penalties over the estimated lease term.

The guidance does not consider the exercise price for a purchase option to be a lease payment, and therefore the exercise price is not included in the present value calculation.

After the initial recognition, the liability to make lease payments shall be measured at amortized cost using the interest method. The right-to-use asset shall be measured at amortized cost.

For subsequent measurement, a lessee shall reassess the carrying amount of the liability to make lease payments if facts or circumstances indicate that the liability has changed significantly since the previous reporting period. If such facts exist, then the lessee shall use all of the same considerations involved in the initial measurement to calculate a new present value. If the present value of the liability to make lease payments is subsequently changed due to current or prior facts and circumstances, then the change is offset against income. However, the change is offset against the right-to-use asset if it is due to changes in future facts and circumstances.

For amortization of the right-to-use asset, the lessee shall use a systematic approach over the lease term or over the useful life of the asset if shorter.

For presentation purposes, the following guidance is applicable for the lessee:

- Liabilities to make lease payments shall be separately reported in the statement of financial position.
- Right-of-use assets shall be included in the statement of financial condition with property, plant and equipment, but separately from assets that are not leased.
- Amortization expense and interest expense shall be reported separately from other amortization and interest expense, either in the income statement or in the notes.
- Cash payments made under the lease agreement shall be reported separately in the cash flow statement as financing activities.

For leases that are considered short-term, under the simplified rules, lessees can elect to recognize the liability to make lease payments and the right-of-use asset at the undiscounted amount.

LESSOR:

At the inception of a lease, the lessor shall determine if the lease should be accounted for in accordance with the performance obligation approach or the derecognition approach. This determination is based on whether the lessor is subject to significant risks or benefits associated with the asset either during or after the expected term of the lease. The lessor shall use the performance obligation approach if significant risks or benefits are retained and the derecognition approach if significant risks or benefits are not retained. The lessor cannot change the approach after the initial determination.

Performance Obligation Approach:

Statement of financial position – Under this approach, the lessor shall recognize a right to receive lease payments and a lease liability in the statement of financial position. The lessor does not derecognize the underlying asset under this approach.

Income statement – During the lease term, the lessor shall recognize: interest income on the right to receive lease payments; lease income as the lease liability is satisfied; changes in the lease liability resulting from subsequent reassessments; and impairment losses on the right to receive lease payments in the income statement. Lease income shall be recognized as revenue only if it arises from the lessor's ongoing, major or central activities.

Initial measurement of the right to receive lease payments is measured at the sum of the present value of the lease payments discounted using the rate charged by the lessor, plus any initial direct costs incurred by the lessor. Initial measurement of the lease liability is measured at the present value of the lease payments discounted using the rate charged by the lessor.

In calculating the present value, a lessor shall calculate the probability-weighted average of cash flows for a reasonable number of possible outcomes, taking into consideration items such as:

- An estimated lease term that includes consideration of renewal or cancellation options and the probability of occurrence for each.
- An estimate of contingent rental receipts over the estimated lease term.
- An estimate of receipts from the lessee under residual value guarantees over the estimated lease term.
- An estimate of receipts from the lessee under term option penalties over the estimated lease term.

The guidance does not consider the exercise price for a purchase option to be a lease payment, and therefore the exercise price is not included in the present value calculation.

After the initial recognition, the right to receive lease payments asset shall be measured at amortized cost using the interest method. The lease liability shall be measured by taking into consideration the use pattern of the lessee or using the straight line method, whichever is more readily determinable.

For subsequent measurement, a lessor shall reassess the carrying amount of the right to receive lease payments if facts or circumstances indicate that the asset has changed significantly since the previous reporting period. If such facts exist, then the lessor shall use all of the same considerations involved with the initial measurement to calculate a new present value. Changes to the right to receive lease payments are recognized in the income statement to the extent that the lessor has satisfied the related lease liability. If the lessor has not satisfied the related lease liability, the change shall be an adjustment to the lease liability.

For presentation purposes, lessors and sublessors shall report: underlying assets, rights to receive lease payments; lease liabilities and the difference between underlying assets; and lease liabilities as a net lease asset or net lease liability in the statement of financial position. Interest income, lease income and depreciation expense shall be reported separately, totaling to a net lease income or net lease expense line on the income statement. For cash flow purposes, lease activity shall be included separately as a component of operating activities.

Derecognition Approach:

Statement of financial position – Under this approach, the lessor shall: recognize a right to receive lease payments; derecognize the lessee's portion of the carrying amount of the underlying asset during the term of the lease; and reclassify as a residual asset any portion of the underlying asset retained by the lessor.

Income statement – During the lease term, the lessor shall recognize: lease income representing the present value of the lease payments; lease expense representing the cost of the portion of the underlying asset that is derecognized; interest

income on the right to receive lease payments; lease income or expense upon and reassessment of the lease term or expected rental receipts; and any impairment losses on the right to receive lease payments or residual asset in the income statement.

Initial measurement of the right to receive lease payments is measured at the sum of the present value of the lease payments discounted using the rate charged by the lessor, plus any initial direct costs incurred by the lessor. Initial measurement of the residual asset is measured at the allocated amount of the underlying asset. The allocated amount is determined based on the fair value of the rights that have been transferred to the lessee and the fair value of the rights that have been retained by the lessor.

In calculating the present value, a lessor shall calculate the probability-weighted average of cash flows for a reasonable number of possible outcomes taking into consideration items such as:

- An estimated lease term that includes consideration of renewal or cancellation options and the probability of occurrence for each.
- An estimate of contingent rental receipts over the estimated lease term.
- An estimate of receipts from the lessee under residual value guarantees over the estimated lease term.
- An estimate of receipts from the lessee under term option penalties over the estimated lease term.

The guidance does not consider the exercise price for a purchase option to be a lease payment, and therefore the exercise price is not included in the present value calculation.

After the initial recognition, the right to receive lease payments asset shall be measured at amortized cost using the interest method. The lessor shall not remeasure or amortize the residual asset unless a subsequent reassessment of the right to receive lease payments is required.

For subsequent measurement, a lessor shall reassess the carrying amount of the right to receive lease payments if facts or circumstances indicate that the asset has changed significantly since the previous reporting period. If such facts exist, then the lessor shall use all of the same considerations involved with the initial measurement to calculate a new present value. Changes to the right to receive lease payments are recognized proportionally to the derecognized asset, the residual asset and the income statement.

For presentation purposes, the lessor shall include in the statement of financial position the right to receive asset separately from other financial assets and residual assets separately within property, plant and equipment. In the income statement, the lessor shall present lease income and lease expense either as separate line items or as a net line item to reflect the lessor's business model. Interest income shall be reported separately from other interest income on the income statement. For cash flow purposes, lease activity shall be included separately as a component of operating activities.

For leases that are considered short-term, under the simplified rules, lessors can elect to not recognize assets and liabilities associated with the lease and also not derecognize any portion of the underlying asset associated with the lease.

DISCLOSURES:

Lessors and lessees are subject to extensive qualitative and quantitative disclosure requirements under this guidance. Disclosures include:

- A detailed description of the nature of lease arrangements.
- Nature of significant subleases.
- Nature of leases accounted for under the simplified guidance for short-term leases.
- Reconciliations of opening and closing balances associated with the assets and liabilities for leasing activity.
- Information regarding the exposure to risks or benefits a lessor retains to justify using the performance obligation approach versus the derecognition approach.
- Details regarding impairment losses.
- Nature of residual assets.
- Information about the significant assumptions and judgments and any subsequent changes.
- A five-year maturity analysis of the liability to make lease payments or the right to receive lease payments.

TRANSITION:

At the date of initial application, an entity shall recognize and measure all outstanding contracts within the scope of this guidance using a simplified retrospective approach. This includes adjusting the opening statement of financial position balances of the earliest period presented.

For lessees with outstanding operating leases, the lessee shall recognize a liability to make lease payments and a right-of-use asset measured at the present value of the remaining lease payments using the lessee's incremental borrowing rate. For lessees with outstanding capital leases, there are no significant adjustments to make.

Lessors must consider their exposure to significant risks or benefits to assess whether to account for outstanding leases using the performance obligation approach or the derecognition approach. For lessors that determine that the performance obligation approach is appropriate for outstanding leases, the lessor shall recognize a right to receive lease payments and a lease liability at the present value of the remaining lease payments. The lessor shall also reinstate previously derecognized underlying assets to depreciated cost. For lessors that determine that the derecognition approach is appropriate for outstanding leases, the lessor shall recognize a right to receive lease payments measured at fair value and a residual asset at fair value.

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