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Heads Up

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FASB and IASB Issue Preliminary Views on Lease Accounting

Boards Propose to Eliminate Operating Leases

by Randall Sogoloff and Stephen McKinney, Deloitte & Touche LLP

Introduction

On March 19, 2009, the FASB and IASB took a significant step toward revamping existing lease accounting rules by issuing a Discussion Paper (DP) outlining the boards' preliminary views on a new accounting model. Lease accounting under U.S. GAAP and IFRSs is often criticized as being too reliant on bright lines and subjective judgments. Many believe that such reliance has resulted in economically similar transactions being accounted for differently and has presented opportunities for entities to structure transactions to achieve a desired accounting effect. The criticism prompted the SEC in its 2005 report on off-balance-sheet arrangements to recommend that the FASB undertake a project on lease accounting. The FASB and IASB added lease accounting to their agendas in 2006 as part of their Memorandum of Understanding between the boards to work toward convergence.

The scope of the leasing project has been the subject of much debate by both boards. Initially, the boards agreed that the scope should include both lessee and lessor accounting, but they later decided to limit the scope to lessee accounting. The DP discusses various issues associated with lessor accounting, but the boards had no preliminary views on them. Timing for the resolution of those issues will be determined over the next several months.

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Comments on the DP are due on July 17, 2009, and it is expected that both boards will issue an exposure draft in the first half of 2010 and a final standard in 2011. The method of transition and the effective date will be discussed by the boards after comments are received and will be included in a future exposure draft of the proposed standard. The DP is available on the FASB's Web site and the IASB's Web site.

The following table summarizes the preliminary views of each board as presented in the DP. A more detailed discussion of each subject follows the table.

Subject	FASB's Preliminary View	IASB's Preliminary View
Scope	Based on the scope covered in the existing leasing standards. Limited to lessee accounting.	Same as FASB view.
Overall model	Recognize a right-of-use asset and a liability for the obligation to pay rentals.	Same as FASB view.
Measurement — right-of-use asset	Initially measure at cost, which would equal "the present value of the lease payments discounted using the lessee's incremental borrowing rate." Subsequently measure the asset on an amortized cost basis over (1) the shorter of the lease term or the economic life or (2) the economic life if the lessee is expected to obtain title.	Same as FASB view.
Measurement — obligation to pay rentals	Initially measure at "the present value of the lease payments, discounted using the lessee's incremental borrowing rate." Subsequently measure by using a "cost-based approach in which interest is accrued on the outstanding obligation to pay rentals."	Same as FASB view.
Measurement — reassessment of the incremental borrowing rate	Rate **is not reassessed** to reflect current market conditions.	Rate **is reassessed** to reflect current market conditions.
Measurement — changes in estimated cash flows	Adjust carrying amount of the "liability to the present value of the revised estimated cash flows" by using the **original** incremental borrowing rate.	Adjust carrying amount of the "liability to the present value of the revised estimated cash flows" by using a **revised** incremental borrowing rate.
Determining lease term	Lessee's lease term is based on the most likely lease term that may include renewal and purchase options.	Same as FASB view.
Reassessment of lease term	Reassessment of lease term required as of each reporting date on the basis of any new facts and circumstances. Change in obligation to pay rentals is an adjustment to the carrying amount of the right-of-use asset.	Same as FASB view.
Contingent rentals and residual value guarantees — initial measurement	Lessee's obligation to pay rentals is based on the **most likely rental payment**. However, if "rentals are contingent on changes in an index or rate, the lessee would initially measure the obligation to pay rentals by using the index or rate existing at . . . inception of the lease."	Lessee's obligation to pay rentals is based on a **probability-weighted estimate of amounts payable.**
Contingent rentals and residual value guarantees — reassessment	Change in obligation to pay rentals is recognized in **profit or loss**.	Change in obligation to pay rentals is an "**adjustment to the carrying amount of the right-of-use asset."**
Presentation — statement of financial position	Presentation of right-of-use asset depends on nature of leased item and is separate from owned assets. Obligation to pay rentals is presented **separately** from other financial liabilities.	Presentation of right-of-use asset depends on nature of leased item and is separate from owned assets. Obligation to pay rentals is **not required to be separately presented.**
Presentation — income statement	Based on asset and liability classification.	Same as FASB view.
Presentation — statement of cash flows	No preliminary views expressed.	No preliminary views expressed.

Scope

The DP states that the scope of the proposed model should be based on the scope of existing leasing standards because those standards are familiar to constituents. The boards noted that their time would be better spent focusing on other aspects of a new model before they addressed any potential changes to the scope. Therefore, contracts currently accounted for as leases would continue to be accounted for as leases under the DP's proposed model.

The boards discussed whether non-core-asset leases (i.e., leases of assets not essential to an entity's operations) and short-term leases (i.e., leases typically of less than one year) should be excluded from the DP's scope, but they did not have preliminary views on either of those issues.

> **Editor's Note:** The boards acknowledge that further consideration should be given to scope differences that exist in current standards. For example, the scope of Statement 13[1] only applies to leases involving property, plant, and equipment, while the scope of IAS 17[2] applies broadly to assets (with certain exceptions).

Overall Model

In a lease contract, the lessee obtains a right to use a leased asset for a specified period. A lessee currently accounts for this right either as an asset and liability (i.e., capital/finance lease) or as an executory contract (i.e., operating lease) depending on the terms of the lease. According to the boards, these accounting differences have led to inconsistent treatment for what is essentially the same transaction: the right to use a leased asset for a specified period.

Because the boards believe that the current accounting model is inconsistent with the current definitions of an asset and liability, they have proposed a model that will require the lessee to recognize an asset and liability arising in all lease contracts. The asset represents the lessee's right to use the leased item for the lease term ("right-of-use asset") and the liability represents its obligation to pay rentals.

Because the boards believe that the current accounting model is inconsistent with the current definitions of an asset and liability, they have proposed a model that will require the lessee to recognize an asset and liability arising in all lease contracts.

> **Editor's Note:** The proposed model eliminates for lessees the operating lease classification. This is the most significant change to the existing lessee accounting model, which is aimed at ensuring that accounting is consistent in arrangements throughout industries. Therefore, if this view is adopted in a final standard (subject to possible scope exceptions), operating leases will no longer be "off-balance sheet" and rental expense will no longer be straight-lined over the lease term. Rather, an asset and liability will be recognized in the statement of financial position and amortization and interest expense will be recognized in profit or loss. See the Measurement section below for further discussion.

The DP also discusses the accounting for other "complex" leases that include options, guarantees, and contingent rentals. Specifically, the boards discussed whether these items should be recognized separately from the right-of-use asset. While the boards acknowledge that these items may individually meet the definition of an asset or liability, under the proposed model they are not separately recognized. Rather, the proposed model requires the lessee to recognize a single right-of-use asset and obligation that considers these items.

Measurement

As noted above, under the DP's overall model, the lessee reflects its right to use a leased asset by recording a right-of-use asset and an obligation to pay rentals. The following discussion summarizes the DP's model for initial and subsequent measurement of this right and obligation.

[1] FASB Statement No. 13, *Accounting for Leases.*

[2] IAS 17, *Leases.*

Right-of-Use Asset

The proposed model requires the lessee to initially measure the right-of-use asset at cost. Cost is defined as "the present value of the lease payments discounted using the lessee's incremental borrowing rate." The right-of-use asset is subsequently amortized over (1) the shorter of the lease term or the economic life of the asset or (2) the economic life of the asset if the lessee is expected to obtain title at the end of the lease term. In addition, although the boards believe that the right-of-use asset should be reviewed for impairment, they have yet to reach a preliminary view on how to perform that determination.

Obligation to Pay Rentals

The lessee initially measures the liability for its "obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate." The lessee subsequently amortizes the liability by using an amortized cost-based approach in which interest is accrued on the outstanding obligation to pay rentals.

The boards evaluated whether it would be appropriate for lessees to discount lease payments using the rate implicit in the lease, but they ultimately excluded it as an option. The boards believe that (1) the implicit interest rate may be difficult to determine and complex for preparers to apply and (2) its use reduces comparability for users.

Reassessment of the Incremental Borrowing Rate

The FASB and the IASB do not agree on reassessment of the incremental borrowing rate.

The DP discusses whether the incremental borrowing rate used to discount lease payments should be reassessed to reflect current market conditions. Such a reassessment may provide more relevant information about the lessee's obligation to pay rentals and would be consistent with the approach in IAS 37.[3] The FASB and the IASB do not agree on reassessment of the incremental borrowing rate. The FASB believes that the rate should not be reassessed, while the IASB believes it should be reassessed because it may affect the lessee's obligation to pay rentals. However, the IASB did not reach a conclusion on the timing or frequency of the reassessment.

Changes in Estimated Cash Flows

Some lease contracts may contain rental payments that are not fixed because of the existence of items such as extension or termination options, obligations to pay variable or contingent rentals, or residual value guarantees. Because these items may affect the lessee's obligation to pay rentals, the boards believe that the lessee should adjust the obligation to reflect the revised estimated cash flows by using a catch-up approach. Under this approach, the lessee adjusts the carrying amount of the liability to the present value of the revised estimated cash flows, discounted by an appropriate rate.

As previously stated, the FASB and the IASB did not reach an agreement on the reassessment of the incremental borrowing rate. Consequently, they differ on what discount rate a lessee should apply when adjusting the carrying amount of the liability. The FASB believes the lessee should apply the catch-up approach by using the original incremental borrowing rate, while the IASB believes the lessee should use a revised incremental borrowing rate.

Other Complex Lease Items

The DP requires the lessee to recognize a single right-of-use asset and obligation to pay rentals that takes into account renewal and purchase options, contingent rentals, and residual value guarantees. The following discussion summarizes the boards' tentative views on each of these items.

[3] IAS 37, *Provisions, Contingent Liabilities and Contingent Assets.*

Term and Purchase Options

Lease contracts often include renewal options that allow the lessee to extend the lease term beyond the initial lease period. Alternatively, lease contracts may contain an option to allow the lessee to terminate the lease after a period. In either case, the DP requires the lessee to recognize its obligation to pay rentals by using the "most likely lease term" that would be based on reasonable and supportable assumptions. In addition, the DP provides contractual, noncontractual, business, and lessee-specific factors for lessees to use when making this assessment and also indicates that past practice and a lessee's intentions should not be considered.

The following example, adapted from Example 5 in paragraph 6.35 of the DP, illustrates how a lessee would determine the "most likely lease term."

A lessee enters into a five-year lease of real estate. At the end of the first five years, the lessee has an option to renew the lease at the market rental rate (at the time of renewal) for another five years (the lessee then has the same option at the end of year 10). The lessee constructs significant leasehold improvements on the real estate that have a 10-year life.

Lease Term	5 years	10 years	15 years
Probability	25%	45%	30%

The probabilities reflect the fact that the lessee generally will need more than five years to recover its investment in the location; however, there is a chance that it would be willing to bear the costs of nonrenewal.

Because of the existence of the leasehold improvements, management concluded that the most likely lease term is 10 years (i.e., the lease term with the highest probability). Consequently, under this approach, the lessee would determine that the lease term is 10 years.

The DP requires the lessee to recognize its obligation to pay rentals by using the "most likely lease term" that would be based on reasonable and supportable assumptions.

Purchase options are treated in the same manner as renewal and termination options. If a lease contract contains a purchase option, the lessee must evaluate this option when determining the most likely lease term.

The boards believe that, like changes in estimated cash flows, the lease term should be reassessed as of each reporting date if new facts and circumstances warrant reassessment. If the reassessment of the lease term results in a change in the obligation to pay rentals, the change should also be recognized as an adjustment to the carrying amount of the right-of-use asset.

Contingent Rentals and Residual Value Guarantees

Because contingent rentals and residual value guarantees have similar characteristics (e.g., both result in variable lease payments), the DP requires them to be accounted for similarly. The boards believe that the lessee's obligation to make rental payments should include effects of contingent rentals and that residual value guarantees and reassessment of those obligations should be performed as facts and circumstances warrant reassessment.

However, the boards differ on how a lessee should consider these effects. The FASB believes that like the measurement of renewal and purchase options, the measurement of the lessee's obligation to pay rentals should be based on the **most likely rental payment**, which may include amounts payable under contingent rentals and residual value guarantees. It believes this approach is easier for users of financial statements to understand and is less complex for preparers. In addition, the FASB believes that changes to the obligation to pay rentals due to changes in estimated contingent rentals and payments under residual value guarantees should be recognized in profit or loss.

The IASB believes that the measurement of the lessee's obligation to pay rentals should include a **probability-weighted estimate** of amounts payable under contingent rentals and residual value guarantees. This approach is consistent with the IASB's position on the changes in the lessee's obligation as a result of lease term changes. In addition, the IASB believes that changes to the obligation to pay rentals due to changes in estimated contingent rentals and payments under residual value guarantees should be recognized as an adjustment to the carrying amount of the right-to-use asset.

The following example, adapted from Example 9 in paragraph 7.14 of the DP, illustrates the measurement of a lessee's obligation to pay rentals under the boards' different approaches.

A lessee enters into a five-year lease of a retail store. The lease is noncancellable and the lessee has no option to extend the lease. The lessee is required to make fixed annual payments of CU100. In addition, the lessee is required to make payments equal to 1 percent of sales from the leased store. The lessee forecasts the following sales for the store and assigns each outcome a probability:

Total forecasted sales, years 1–5 (CU)	10,000	20,000	35,000
Probability that forecasted sales will occur	10%	60%	30%
Total fixed rentals, years 1–5 (CU)	500	500	500
Total contingent rentals 1% of forecast sales (CU)	100	200	350
Total estimated rentals, years 1–5 (CU)	600	700	850

The obligation to pay rentals using the FASB's "most likely rental payment" approach equals CU700 (i.e., the rental payment with highest probability).

The obligation to pay rentals using the IASB's probability-weighted estimate approach, ignoring the effects of discounting, is CU735 ((600 × 10%) + (700 × 60%) + (850 × 30%)).

Presentation

The DP requires that the presentation of the right-of-use asset in the statement of financial position be based on the nature of the leased items. However, the boards acknowledge that because leased assets are different from owned assets, leased assets should be presented separately from owned assets.

The DP requires that the presentation of the right-of-use asset in the statement of financial position be based on the nature of the leased items.

The boards disagree on the presentation of the obligation to pay rentals. The FASB believes that the obligation should be presented separately from the other financial liabilities. It therefore believes that separate presentation of the obligation is appropriate. In contrast, the IASB believes that the obligation to pay rentals is no different from that of a secured borrowing that does not require separate presentation. The IASB thus believes that separate presentation of the obligation to pay rentals is not required.

The DP further states that the income statement classification is governed by the asset and liability classification in the statement of financial position. For example, if a right-of-use asset is recorded as property, plant, and equipment, any reduction in the carrying amount of the asset should be recorded as depreciation expense in the income statement. Similarly, if the obligation to pay rentals is separately presented in the statement of financial position, any interest expense on that obligation should be separately presented in the income statement. The boards have not discussed the presentation of lease contracts in the statement of cash flows.

Next Steps

The DP indicates certain items on which the boards have not stated their preliminary views. The boards plan to address the following areas before they publish an Exposure Draft.

- Timing of initial recognition.
- Sale and leaseback transactions.
- Initial direct costs.
- Leases that include service arrangements.
- Disclosures.

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