May 23, 2011

Commentary by Bill Bosco on the Latest Deliberations From a Joint-Meeting Held by the Boards of the IASB and FASB on May 19, 2011.

Topics Covered Include:

Short-Term Leases, Lease Term, Lessee Accounting Approach, Lessor Accounting Approach, Distinguishing Between Lease Types, Contract Modifications or Changes in Circumstances, Options in a Lease and Discount Rate in a Lease. (Editor's note: portions of commentary excerpted from Deloitte's IASPLUS "IFRS Project Insights")

Short-term Leases

The Boards discussed short-term leases and took an informal vote that would have eliminated the short-term lease exemption tentatively developed during the March 2011 Board meetings. However, the Boards decided to discuss short-term leases at a future meeting.

Lease Term

At a previous Board meeting, the Boards tentatively decided that "lease term" should be defined for the lessee and lessor as the non cancelable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.
In the May 2011 joint Board meeting, the Boards tentatively decided that in determining whether there is a significant economic incentive, lessees and lessors should consider contract-based factors, asset-based factors and entity-specific factors for both the initial and subsequent evaluation.

Contract-based factors are terms that are written into the lease contract that could create a significant economic incentive to exercise an option at the date of commencement, or subsequently if there is a change in the lease contract. Examples of contract-based factors include the requirement of the lessee to pay a substantial penalty for terminating the lease earlier than the contractual lease term, the obligation of the lessee to incur material costs to restore the asset prior to returning it to the lessor and the existence of a bargain renewal or purchase option.

Asset-based factors relate to the characteristics of the underlying leased asset that exist either at lease commencement or subsequently that could create a significant economic incentive to exercise an option. Examples of asset-based factors include the existence of significant leasehold improvements installed by the lessee during the lease term that will have significant value at the time when the option becomes exercisable and the importance of the geographic location of the asset.

Entity-specific factors would include historical practice of the entity, management intent and common industry practice. Market-based factors such as fluctuations in the market rental or asset values would not be considered by the lessee or lessor.

The Boards tentatively decided that a lessee would adjust its right-of-use asset when there are changes in lease payments due to a reassessment and a lessor that applies the de-recognition approach would adjust the lease receivable and the carrying amount of the residual asset.

Lessee Accounting Approach

The Boards re-deliberated on their April 2011 joint meeting tentative decision that there should be two accounting approaches by lessees (finance and other-than-finance, although all Board members requested that a new naming convention to other-than-finance leases).

The majority of both Boards expressed an interest in applying one lessee accounting model, as originally proposed in the Lease ED, as opposed to application of two lease accounting models, in commenting that all leases appear to have some financing element. Likewise, in application of two lease accounting models, these Board members expressed concern as to the ultimate application of presentation in an other-than-finance environment in considering accounting alternatives including use of other comprehensive income to achieve a straight-line profit or loss recognition pattern (assuming a constant pattern of consumption), an annuity approach which was rejected in an early Board meeting, undiscounted measurement approach or maintaining current operating lease accounting.

A minority of the Boards proposed to retain two lessee accounting models to distinguish the principle of the transfer of substantially all risks and rewards of ownership, with varying views on application of accounting approach. The majority of Board members who preferred a two lease accounting model for lessees preferred an annuity based approach assuming the Boards could resolve the different patterns of recognition of leased assets over the lease term.

With general discussion focused on application of one type of lease for lessee accounting, one Board member discussed potential disclosure requirements surrounding such a model. Specifically, this Board member cited targeted outreach, which noted that users were interested in understanding the straight-line recognition of lease charges for other-than-finance leases, and therefore, he requested that application of one type of lease require disclosure of interest, depreciation and cash commitments, as distinguished by the class of the underlying transaction (e.g., equipment and buildings). Multiple Board members supported this proposal.

As a result, the Boards tentatively decided there should be one type of lease for lessee accounting consistent with the Leases ED. The lessee would recognize a right-of-use asset and a liability to make lease payments at the present value of the lease payments. The right-of-use asset would be amortized/depreciated using a systematic and rational method and the liability to make lease payments would be amortized using the effective interest method. Therefore, the expense recognition pattern would be on an accelerated basis for all leases. The Boards asked the staffs to bring back analysis on relevant disclosures surrounding this tentative decision in a future meeting.

Given the Boards' tentative decision for one lessee accounting model, one Board member proposed that the Boards revisit the scope of practical expedients to using the right-of-use model for lease arrangements as proposed in the Leases ED. Specifically, this Board member, citing historic decisions that short-term leases (i.e., a lease that, at the date of commencement of the lease, has a maximum possible lease term, including any options to renew or extend, of 12 months or less) would not be recognized on a lessee's statement of financial position, requested that the Boards consider increasing the scope of items subject to the right-of-use model exception (e.g., applying current operating lease requirements for leases of up to 24 months or more). While some Board members supported this proposal as a practical expedient, other Board members expressed a desire to eliminate the exception for short-term leases completely as the underlying purpose of the leases project was to put risks and rewards on the statement of financial position. These Board members also expressed concern with a bright-line contract length as the basis for exemption in reporting.

The Boards took an informal vote on retaining the short-term leases exemption, with the majority of the Boards voting to eliminate the short-term lease exemption. However, the Boards decided to discuss short-term leases at a future meeting, including whether to include a short-term lease exemption or a discussion regarding materiality in the final standard; to require the right-of-use asset and liability to make lease payments be discounted for all leases; and to require the service component be separated from the lease component for all leases.

Lessor Accounting Approach

The Boards then discussed the lessor accounting model in other-than-finance leases in considering three potential approaches: (1) the performance obligation approach with net presentation, (2) current operating lease accounting and (3) the de-recognition approach.

Several IASB members, citing the most-recent deliberations on one lessee accounting model, outlined a preference to apply one model in lessor accounting for all leases, and therefore, preferred the de-recognition approach with consistent application in finance and other-than-finance leases.

Opposing views, primarily expressed by the FASB members, noted that targeted outreach expressed a desire for the lease project to be consistent in principle with the revenue recognition project, and such Board members felt that application of the de-recognition approach was inconsistent with the revenue recognition project, although one IASB member noted that the de-recognition approach was consistent with the revenue recognition project as recognition was determined in line with performance transfer.

Another FASB member noted that the lessor and lessee accounting approaches should not necessarily be aligned, as he expressed a view that the underlying business models for lessors and lessees were unique, and therefore, he preferred retention of two lessor accounting models with other-than-finance leases accounted for under current operating lease accounting.

When put to an informal vote, the IASB voted in favor of the de-recognition approach and the FASB voted in favor of operating lease accounting. Given the divergence on this issue, the Chairman of the IASB requested the Board advisors and project team meet to discuss a possible way forward.

Because of the disagreement on the accounting for "other than finance" leases, the chairman of the FASB decided it would be best to assume for purposes of further discussing lessor accounting that the lease would not transfer substantially all the risks and rewards of ownership. This line of inquiry served as a hypothetical series of questions taken by way of an informal vote to assist the staff in developing staff papers on lessor accounting for a future Board meeting (given that the Boards were divided on application of one lessor accounting model or two, as discussed above), as all staff papers developed in advance of this meeting presumed a two model approach.

In an environment in which the lease would not transfer substantially all the risk and rewards of ownership, both Boards supported:

- A partial de-recognition approach, consistent with the proposal in the Leases ED, as opposed to recognition of full de-recognition in all lessor accounting transactions, given that the partial de-recognition approach is viewed by many to be consistent with the right-of-use approach applied by lessees and any day-one gain recognized for the portion of the underlying asset transferred arguably more faithfully depicts the transfer of benefits from the lessor to the lessee (as a note, many Board members indicated that they would be supportive of a full de-recognition approach if a lease transfers substantially all risks and rewards of ownership);

- The use of an allocation methodology to measure the residual under a partial de-recognition approach given that it was considered to more faithfully depict the economics of the lease transaction (recognition of profit only on the portion of the underlying asset transferred to the lessee in the form of the right-of-use);

- Accretion of the residual value over the lease term to reflect the time value of money on the amount initially recognized for the residual asset (avoids delaying recognition of gains solely from the time value of money), and likewise, since such application is considered to be consistent with how the lease is typically priced and maintains a historical-cost basis for measurement of the residual asset; and

- Separate presentation for the lease receivable and residual asset in the statement of financial position.

The above informal votes were reached without significant debate, absent the presentation for the lease receivable and residual asset in the statement of financial position, in which several IASB members supported the combined presentation of the lease receivable and the residual asset. Board members supporting separate presentation noted that the lease receivable and the residual asset provide for different risks and variability, while other Board members believed that recognition of the receivable, residual and deferral of the day one gain (where applicable) could be recorded collectively on the face of the statement of financial position and disaggregated in the notes. The latter position was expressed out of concern that inclusion of residual assets in property, plant and equipment would yield unique presentation of revaluation adjustments when accreting the residual asset, yield less useful information about the amount of cash flows expected from the residual asset at the end of the lease term and cause confusion in separately presenting assets arising from one underlying asset.

In conjunction with the above discussion, the Boards discussed the initial measurement of lease receivables (e.g., measure all lease receivables at the present value of lease payments, discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor; or measure lease receivables at fair value). Many Board members questioned the basis for scoping lease receivables out of the financial instruments standard for measurement purposes. The Boards asked the staff to consider the implications of applying financial instruments standard to lease receivables, including implications surrounding embedded derivative exemptions, in bringing back this issue in a future meeting.

Distinguishing Between Lease Types

The Boards re-deliberated on how to distinguish between lease types if it is ultimately determined that the final standard will include two types of leases for lessees and/or lessors. The underlying principle continues to be based on whether substantially all the risks and rewards of the underlying asset have transferred from the lessor to the lessee, but the staffs presented potential indicators including fair value, variable rent and embedded / integral service indicators. The Boards did not want to establish a bright line for fair value indication, as outlined in US GAAP, but the Boards tentatively decided that fair value should be considered an indicator. Likewise, while Board members noted that significance should be considered, Board members felt that variable rent should be an indicator for consideration in distinguishing lease types. Board members were opposed to the inclusion of embedded or integral services as an indicator for consideration, however, as they felt it conflicted with revenue recognition guidance where the inability to distinctly identify components to a transaction led to the entire transaction being treated as a service.

Contract Modifications or Changes in Circumstances

The Boards then discussed how to account for changes after the date of inception of the lease. The staffs provided feedback from outreach activities, in conjunction with assessment of current guidance. Without much debate, absent one Board member questioning the threshold for determining contract modification or changes in circumstances, the Boards agreed that the modifications to contract terms after the date of inception should be reflected in the accounting for contracts to avoid structuring opportunities.

Thus, the Boards tentatively decided that the final leases standard would include guidance for accounting for modifications to the contractual terms of a contract or changes in circumstances after the date of inception of the lease, and the guidance would clarify that (1) a substantive change to the existing contract would result in the accounting for the modified lease as a new lease; (2) a change in circumstances that would affect the assessment of whether a contract is, or contains, a lease would result in a reassessment by the lessee and the lessor as to whether the contract is, or contains, a lease and may result in the lessee and lessor applying or ceasing to apply the leases standard; and (3) a change in circumstances that would affect the "classification" of the lease (if applicable) should not result in a reassessment by the lessee or lessor.

Options in a Lease

Historic Board meetings have defined the "lease term" for the lessee and lessor as the non-cancelable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. In this meeting, the Boards considered potential indicators for defining whether there is a significant economic incentive for an entity to exercise an option.

The staffs presented four specific potential factors for consideration as indicators in the assessment of a significant economic incentive; contract-based, asset-based, market-based and entity-specific. Contract-based factors are terms that are written into the lease contract that could create a significant economic incentive to exercise an option at the date of commencement, or subsequently if there is a change in the lease contract. Examples of contract-based factors include the requirement of the lessee to pay a substantial penalty for terminating the lease earlier than the contractual lease term, the obligation of the lessee to incur material costs to restore the asset prior to returning it to the lessor and the existence of a bargain renewal or purchase option.

Asset-based factors relate to the characteristics of the underlying leased asset that exist either at lease commencement or subsequently that could create a significant economic incentive to exercise an option. Examples of asset-based factors include the existence of significant leasehold improvements installed by the lessee during the lease term that will have significant value at the time when the option becomes exercisable and the importance of the location of the asset. Entity-specific factors would include historical practice of the entity, management intent and common industry practice.

While the Boards generally agreed that contract and asset-based indicators should be considered, many Board members expressed uncertainty regarding the inclusion of market-based or entity-specific factors. With the former, Board members noted that market-based factors may lend to significant variability, where market variances may lead to subsequent reversals from period-to-period. These Board members considered that the inclusion of this factor should be limited to only 'permanent' changes in market valuation, but the Boards expressed concern in practical application. Others expressed a view that assurance of permanent market price changes could only be obtained near the end of the lease term, and therefore, would allow for this indicator in the last months of a lease. Many felt this led to variability without significant benefit to users of the financial statements, and thus, the Board tentatively decided market-based factors such as fluctuations in the market rental or asset values would not be considered by the lessee or lessor.

In considering entity-specific factors, many Board members expressed concern over the inclusion of management intent and historic practice as possible indicators, as intent could be abused as past practice did not ensure comparability. Other Board members noted that this should be considered an indicator, although the assessment should not be exclusively based on management intent. Instead, they cited the importance of considering the needs of an entity. As a result, the Boards tentatively decided that in determining whether there is a significant economic incentive, lessees and lessors should consider entity-specific factors for both the initial and subsequent evaluation.

Discount Rate in a Lease

Following previous decisions by the Boards as to the determination of the discount rate in a lease, the Boards discussed whether there are circumstances that would require a lessee or a lessor to reassess the discount rate used to measure the present value of lease payments.

The staffs presented feedback under the Leases ED which did not permit a change in the discount rate after inception of a lease unless lease payments are contingent on variable reference interest rates. Without significant debate, the Boards tentatively decided that (1) the discount rate should not be reassessed on a periodic basis when there is no change in lease payments; (2) the discount rate would be reassessed when there is a change in lease payments due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease or to purchase the underlying asset; (3) the discount rate would also be reassessed when there is a change in lease payments due to the exercise of an option that the lessee did not have a significant economic incentive to exercise.

If reassessment is necessary, the discount rate would be revised using the spot rate at the reassessment date and applied to the remaining lease payments, including the remaining payments on the initial lease plus the payments due to the extension period or upon exercise of the purchase option, although the Boards noted an intention to discuss the rate at a future meeting.