Project **Leases**

Topic **Lessor Accounting—Transition**

Objective

1. The objective of this paper is to address transition requirements for the proposed new leases requirements for lessors.

2. At this meeting, some staff members recommend that an entity should apply the proposed new requirements retrospectively in accordance with the guidance on accounting changes and error corrections in Topic 250 of the *FASB Accounting Standards Codification*™ and in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, but not to those lease contracts that have been completed before the effective date of those requirements.

3. Other staff members recommend a simplified retrospective approach for lessor transition. Although the lessor is required to recognize and measure a lease receivable and a performance obligation for all outstanding leases as of the effective date, the measurement of these assets and liabilities would be simplified.

4. In addition, transition disclosures should be required in accordance with Topic 250 and IAS 8.

5. The staff also recommends that the previously derecognized asset associated with outstanding capital (finance) leases (that is, sales-type leases, direct financing leases, and leveraged leases under current U.S. generally accepted accounting principles [GAAP]) be reinstated for all periods presented. Some

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staff members recommend that the reinstated leased asset be measured at depreciated cost. Other staff members recommend measuring the reinstated leased asset in accordance with respective standards on property, plant and equipment. That is, U.S. GAAP preparers would measure the reinstated leased asset under guidance on property, plant, and equipment in Topic 360 and International Financial Reporting Standards (IFRS) preparers would measure the reinstated leased asset under guidance in IAS 16, *Property, Plant and Equipment*.

6. This paper only applies to the transition requirements for the lease portion of arrangements that contain both lease and non-lease elements. This paper does not discuss transition requirements for non-lease (service) elements because they will be discussed in a future memo.

7. The IASB will address whether an exemption should be made to the transition requirements of IFRS 1, *First Time Adoptions of International Financial Reporting Standards*, for first-time adopters after the transition issues addressed in this paper are discussed.

8. This paper also does not discuss the proposed effective date or whether early adoption should be permitted as these issues will be addressed in a separate memo for all current projects in April 2010.

9. This paper is structured as follows:

   (a) Background

   (b) Comment Letter Feedback Received

   (c) Staff Analysis and Staff Recommendations.

Background

10. In June 2009, the boards tentatively decided that a lessee should recognize and measure all existing lease contracts on the effective date of the proposed new leases requirements as follows:

(a) The obligation to pay rentals should be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate.

(b) The right-of-use asset should be measured on the same basis as the obligation to pay rentals, subject to any adjustments required to reflect impairment.

11. In October 2009, the boards reconfirmed their support for the performance obligation approach for lessors. Under this approach, the lessor would:

(a) Recognize an asset representing its right to receive rental payments (a lease receivable), and

(b) Recognize a liability representing its performance obligation under the lease – that is, its obligation to permit the lessee to use one of its assets (the leased item). The lessor would recognize revenue as that performance obligation is satisfied over the lease term.

12. In November 2009, the boards tentatively decided to specify the required accounting for a lessor's receivable and performance obligation as follows:

(a) Initial measurement of the lessor's receivable would be at the present value of the lease payments discounted using the interest rate implicit in the lease plus any initial direct costs incurred by the lessor, and

(b) Initial measurement of the lessor's performance obligation would be at the transaction price. That is, the customer consideration, which would be measured at the present value of the lease payments, would be discounted using the interest rate implicit in the lease (on the same basis as the receivable).

13. However, in February 2010, the boards tentatively decided that the rates used in the initial measurement of the lessor's receivable and performance obligation should be the rate that the lessor is charging the lessee rather than, specifically, the interest rate implicit in the lease.

Comment Letter Feedback Received

14. The Discussion Paper, *Leases: Preliminary Views* (DP), was published without any preliminary views on transition issues. Although the DP mainly addressed lessee accounting, the staff noted the following general comments made by respondents regarding transition:

> In moving forward to the Exposure Draft stage, we believe the Board should examine closely the impact of the proposals on the current carrying values of leasing assets and liabilities: our impression is that, in the absence of any transitional relief, all of these would have to be re-assessed – a considerable task. (CL #117)

> We support relief on transition from full retrospective application which would have practical difficulties and prove to be an onerous exercise if retrospective restatement back to the lease inception date was required. However, to aid comparability, we believe that comparatives should be restated, although a pragmatic approach to this should be adopted. (CL #167)

> As currently required under U.S. GAAP, we support the retrospective application of the proposed new standard to previously issued financial statements upon adoption in order to allow practical comparability of the financial statements, particularly of the balance sheet, and do not believe it would be impractical to apply this proposed new standard retrospectively. (CL #180)

Staff Analysis

Lease Guidance

15. Under existing requirements, lessees/lessors are required to classify their lease contracts as either capital (finance) leases or operating leases.

16. Under guidance in IAS 17, *Leases*, if the lease is classified as a finance lease, the lessor derecognizes the leased asset and recognizes a receivable for an amount equal to the net investment in the lease.

17. Under the guidance on leases in Topic 840, lessors are required to classify leases as sales-type leases, direct financing leases, leveraged leases or operating leases. If the lease is classified as a sales-type lease or a direct financing lease, the lessor recognizes an asset representing its gross investment in the lease and

unearned income. For leveraged leases, the lessor recognizes its investment net of the non-recourse debt.

18. However, under the proposed new leases requirements, all lessors would retain the leased asset on its statement of financial position for all leases, and would continue to depreciate that leased asset without recognition of any selling profit or loss. The leased asset also would be subject to impairment assessment and could be subject to revaluation for IFRS preparers.

19. Currently, if the lease is classified as an operating lease, the leased item is included in the statement of financial position with or near property, plant and equipment (based on the nature of the asset under the guidance in IAS 17) and is depreciated in accordance with the lessor's normal depreciation policy. The leased asset also is evaluated for impairment and could be subject to revaluation for certain IFRS preparers. Lease income is normally recognized on a straight-line basis over the term.

20. Although, under the proposed new requirements, former operating leases would be treated similarly and, leases that presented rental income also would have an interest income component.

21. The following table represents changes from the current leases guidance to the proposed new leases requirements:

Operating Leases		
	Current Guidance	**Proposed Guidance**
Statement of Financial Position	Leased Asset	Leased Asset Receivable Liability
Profit/Loss	Depreciation Expense Rental Income	Depreciation Expense Lease Income Interest Income

Capital/Finance Leases		
	Current Guidance	**Proposed Guidance**
Statement of Financial Position	Lease Receivable Unearned Income OR Net Investment	Leased Asset Receivable Liability
Profit/Loss	Profit (potentially, if sales-type) Earned Income	Depreciation Expense Lease Income Interest Income

22. Additionally, under existing guidance, contingent rentals and options are not accounted for until they occur. However, under the proposed new requirements, those contingent rentals and options would be included in the asset and the liability.

Transition Approaches

23. The staff considered the following approaches:

    (a) Retrospective application.

    (b) Modified retrospective application.

    (c) Simplified retrospective application.

    (d) Prospective application.

Approach A – Retrospective application

24. The guidance in Topic 250 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. IAS 8 has similar requirements for a change in accounting principle.

25. Under Approach A, the lessor would apply the proposed new leases requirements to all leases as if the proposed new lessor accounting requirements had always been applied. This means:

    (a) For leases currently classified as operating leases, in addition to the leased asset, the lessor would recognize a receivable for all remaining lease payments and a liability for the obligation to permit the lessee to use the underlying asset. Additionally, lease income would include an interest income component for the receivable recognized.

    (b) For leases currently classified as capital (finance) leases, the leased asset would be reinstated on the lessor's statement of financial position. Additionally, the lessor would continue to recognize a receivable for all remaining lease payments and a liability for the obligation to permit the

lessee to use the underlying asset. Sales would no longer be recognized because the lessor would retain the underlying asset on its statement of financial position. The lessor would recognize depreciation expense on the underlying asset, lease income as the performance obligation would be satisfied, and interest income as the lease receivable would be satisfied.

26. The staff notes that Approach A would result in the most useful information for users of financial statements. An entity would be required to present its financial statements as if the proposed new leases requirements had always been in place. Thus, the information presented for all periods would be fully comparable.

27. However, Approach A would be costly and may be difficult to apply. Approach A would require an entity to apply the proposed new lessor accounting model to all leases. For example, lessors with leases currently accounted for as capital leases would be required to reverse derecognition of the underlying asset.

28. Additionally, due to the proposed accounting for term options and contingent rentals, recognizing and measuring the performance obligation may be complex and costly for preparers to apply. Some may argue that Approach A may be impossible because it would require the determination of past management intent. Specifically, the guidance in Topic 250 and IAS 8 states that it shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively if retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated.

29. Others may argue that using known facts at the effective date and applying those to previous periods would be sufficient for retrospective application (i.e., assumptions on the effective date would be applied to assumptions at inception of the lease). This would eliminate changes in the entity's estimates and judgements throughout the lease period prior to the effective date. It would also allow the retrospective application to reflect reality.

30. The staff notes that under Approach A, a retrospective application with an impracticability exception is allowed by the guidance in Topic 250 and IAS 8 if,

in some cases, retrospective application is impracticable. The guidance in Topic 250 (similar guidance is included in IAS 8) states that, an entity shall report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, *unless it is impracticable to do so*. If it is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period, the new accounting principle shall be applied as if the change was made prospectively as of the earliest date practicable.

31. The guidance in Topic 250 also states that it shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:

    (a) After making every reasonable effort to do so, the entity is unable to apply the requirement.

    (b) Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated (as discussed above).

    (c) Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:

        (i) Provides evidence of circumstance that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application

        (ii) Would have been available when the financial statements for that prior period were issued.

32. The staff notes that Approach A was the tentative decision of the boards in February 2010 on the revenue recognition project (that is, full retrospective application as of the effective date).

Approach B – Modified retrospective application

33. Approach B would require a reporting entity to apply the proposed new requirements to:

(a) All arrangements outstanding as of the effective date, and

(b) All arrangements entered into after the effective date.

34. This approach is similar to Approach A, except that an entity would only restate the accounting for arrangements that are outstanding as of the effective date.

35. Under Approach A, an entity would be required to make fewer estimates than under full retrospective application (Approach A) because the number of leases requiring analysis is less.

36. This approach results in leases that are not outstanding as of the effective date but are outstanding during prior reporting periods to be accounted for under current leases requirements.

37. This approach provides more comparable information than a limited retrospective application (Approach C) and a prospective application (Approach D) but less comparable information than full retrospective application (Approach A).

38. Approach B would also apply the current impracticability guidance under Topic 250 and IAS 8.

Approach C – Simplified Retrospective Application

39. Under Approach C, the lessor is required to recognize and measure a lease receivable and a performance obligation for all outstanding leases as of the effective date of the proposed new leases requirements. However, the measurement of these assets and liabilities would be simplified:

    (a) The lessor's receivable would be measured at the present value of the remaining lease payments, discounted using the rate the lessor is charging the lessee in the lease (as of the date the lease arrangement was entered into), and

    (b) The lessor's performance obligation shall be measured on the same basis as the lessor's receivable.

40. The staff notes that the interest rate used on the date the lease arrangement was entered into may not be available. Therefore, the lessor should use its best

estimate of that rate as of the effective date. The staff notes that in some circumstances the lessee's incremental borrowing rate as of the effective date may be more obtainable and easier to apply to the lessor's receivable and performance obligation.

41. In addition, the staff notes that in the case of uneven lease payments, measuring the lessor's performance obligation at the present value of the remaining expected lease payments could cause either an understatement of revenue (for large upfront payments) or an overstatement of revenue (for back-ended lease payments). Consequently, the performance obligation will need to be adjusted to reflect deferred/accrued income balances on the effective date.

42. Approach C may be simpler to apply than a full retrospective (Approach A) or modified retrospective (Approach B) approach. Determining what the performance obligation would have been had the new standard always been in place (as required by retrospective applications) may be difficult for very long-term leases or leases that include option and/or contingent rental arrangements.

43. This approach is also consistent with the approach proposed for lessees which will ensure that the assets and liabilities arising in subleasing transactions are accounted for consistently on transition.

Approach D – Prospective application

44. Approach D would require a reporting entity to prospectively apply the proposed new leases requirements as of the effective date. As such, entities would continue to apply the current guidance to existing leases while applying the proposed new leases requirements to any leases entered into after the effective date.

45. The advantages of this approach are as follows:

    (a) It is simple to apply because an entity does not need to restate the accounting on any previous lease arrangements.

    (b) It does not require an entity to make estimates as of earlier dates because all information required is readily available at the time.

(c) It would be less costly for preparers than retrospective application (Approaches A, B and C).

46. However, the staff notes that Approach D would reduce comparability because similar leases would be accounted for differently. Arrangements entered into before the effective date would be accounted for in accordance with existing requirements while arrangements entered into after the effective date would be accounted for in accordance to the proposed new leases requirements.

47. In addition, the boards need to decide if the proposed new leases requirements should apply to situations involving a lease modification.

Staff Recommendation

48. Some staff members recommend Approach B. That is, an entity should apply the proposed new leases requirements under the requirements of Topic 250 and IAS 8, but not to those lease contracts that have been completed prior to the effective date. This approach would be applied to all outstanding leases as of the effective date. Under Approach B, if it is determined to be impracticable to apply the proposed new leases requirements retrospectively, then the impracticability guidance in Topic 250 and IAS 8 would be applied.

49. Other staff members recommend Approach C because they think that retrospective applications (Approach A and B) would be impracticable for many leases. They also note that Approach C is consistent with the tentative decisions for the lessee’s transition which will ensure that the assets and liabilities arising from subleases are measured on a consistent basis on effective date.

Retrospective Implications

50. If the boards adopt a retrospective approach (Approaches A, B or C), the staff notes that there will be implications for accounting for the previously derecognized asset.

Accounting for the Previously Derecognized Asset

51. For leases currently classified as capital (finance) leases, retrospective approaches would require the leased asset to be reinstated on the lessor's statement of financial position. This would require guidance to be developed on measuring the asset. Impairment and revaluations of leased assets will be discussed in a future memo.

52. That staff notes the following approaches to valuing the previously derecognized leased asset:

    (a) Depreciated cost

    (b) Fair value

    (c) In accordance with respective standards on property, plant and equipment. That is, U.S. GAAP preparers would measure the reinstated leased asset under requirements in Topic 360 and IFRS preparers would measure the reinstated leased asset under guidance in IAS 16.

Approach A: Depreciated Cost

53. This approach would measure the reinstated asset at a depreciated cost.

54. Under the guidance in IAS 16, an item of property, plant, and equipment that qualifies for recognition as an asset shall be measured at cost.

55. After recognition, an entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant, and equipment.

56. IAS 16 describes the cost model as follows:

    > After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

57. Similarly, under the guidance in Topic 360, initial measurement of property, plant, and equipment is at historical cost including interest. Subsequently, property, plant, and equipment are depreciated.

58. Under this approach, the reinstated asset would be measured similarly to property, plant, and equipment as described in paragraph 57 as if it had not been derecognized. This approach is familiar to entities and the recognized asset would be measured comparatively to other property, plant, and equipment.

59. The staff notes that there is a possibility that an entity may not have the information to determine what the depreciated cost would have been. However, the staff thinks that the entity should have adequate information to estimate the depreciated cost based on the original cost of the asset and when the asset was bought.

Approach B: Fair value

60. Under Approach B, the reinstated asset would be measured at fair value.

61. As discussed in paragraph 55, under IAS 16, after recognition, an entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant, and equipment.

62. IAS 16 describes the revaluation model as follows:

> After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

63. U.S. GAAP does not contain similar guidance.

64. The staff notes that Approach B also is consistent with paragraph D5 in IFRS 1, which states:

> An entity may elect to measure an item of property, plant and equipment at the date of transition to IFRSs at its fair value and use that fair value as it deemed cost at that date.

65. The staff notes that this approach would reflect current market conditions and may be simpler to apply. However, allowing this option would create inconsistencies on the treatment of property, plant, and equipment under U.S. GAAP.

Approach C – Follow respective GAAP

66. Under Approach C, U.S. GAAP lessors would measure the reinstated leased asset under the requirements in Topic 360 and IFRS lessors would measure the reinstated leased asset under guidance in IAS 16.

67. U.S. GAAP and IFRS preparers would be able to reinstate the leased asset on a cost-basis. IFRS preparers would have an option to fair value the leased asset upon reinstatement.

Staff recommendation

68. Some staff members recommend measuring the reinstated leased asset at depreciated cost.

69. Other staff members recommend measuring the reinstated leased asset in accordance with respective requirements on property, plant, and equipment. That is, U.S. GAAP preparers would measure the reinstated leased asset under guidance in Topic 360 and IFRS preparers would measure the reinstated leased asset under guidance in IAS 16.

Question 1
Question 1 – Some staff members recommend a modified retrospective approach (Approach B) for lessor transition. Other staff members recommend a simplified retrospective approach (Approach C). Which approach do the boards prefer?

Question 2
Question 2 – What amendments or alternatives (if any) do you suggest, and why?

Question 3
Question 3 – Some staff members recommend that the reinstated leased asset be presented at depreciated cost, adjusted for impairment and revaluation (IFRS only). Other staff members recommend valuing the reinstated leased asset based on respective guidance. Which approach do the boards prefer?

Transition Disclosures

70. If the boards support the staff recommendations to apply the proposed new leases requirements on a modified retrospective approach (Approach B) or a simplified retrospective approach (Approach C), lease arrangements that have expired before the effective date will not be restated on an entity's financial statements.

71. The staff thinks that the effect of the initial application of the proposed new leases requirements must be made clear in the financial statements.

72. Existing disclosure requirements in the guidance of Topic 250 and IAS 8 (see Appendix A) allow users to adequately compare the current reporting period with prior periods and to evaluate the effect of the proposed new leases requirements on each respective reporting period.

Staff Recommendation

73. The staff does not recommend any additional disclosure requirements other than those in the guidance of Topic 250 and IAS 8.

Question 4
Question 4– The staff recommends that transition disclosures should be required in accordance with the guidance in Topic 250 and IAS 8. Do the boards agree? If not, why not?

Appendix A: Disclosure Requirements of Topic 250 and IAS 8

IAS 8, paragraphs 28-31

28. When initial application of an IFRS has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

    (a) the title of the IFRS;

    (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;

    (c) the nature of the change in accounting policy;

    (d) when applicable, a description of the transitional provisions;

    (e) when applicable, the transitional provisions that might have an effect on future periods;

    (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

    (i) for each financial statement line item affected; and

    (ii) if IAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;

    (g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

    (h) if retrospective application required by paragraph 19(a) or (b) is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.

29. When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

    (a) the nature of the change in accounting policy;

    (b) the reasons why applying the new accounting policy provides reliable and more relevant information;

    (c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

        (i) for each financial statement line item affected; and

        (ii) if IAS 33 applies to the entity, for basic and diluted earnings per share;

    (d) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

    (e) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.

30. When an entity has not applied a new IFRS that has been issued but is not yet effective, the entity shall disclose:

    (a) this fact; and

    (b) known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application.

31. In complying with paragraph 30, an entity considers disclosing:

    (a) the title of the new IFRS;

    (b) the nature of the impending change or changes in accounting policy;

    (c) the date by which application of the IFRS is required;

(d) the date as at which it plans to apply the IFRS initially; and either:

(i) a discussion of the impact that initial application of the IFRS is expected to have on the entity's financial statements; or

(ii) if that impact is not known or reasonably estimable, a statement to that effect.

Section 250-10-50

[General Note: Section 250-10-50 provides guidance on the disclosure in the notes to financial statements. In some cases, disclosure may relate to disclosure on the face of the financial statements.]

> Accounting Changes

> > Change in Accounting Principle

250-10-50-1 An entity shall disclose all of the following in the fiscal period in which a **change in accounting principle** is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

1. A description of the prior-period information that has been retrospectively adjusted, if any.

2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

4. If **retrospective application** to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:

1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable

2. Unless impracticable, the amount of the total recognized indirect effects of the **accounting change** and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

250-10-50-2 An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

250-10-50-3 In the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption shall disclose the effect of the change on income from continuing operations, net income (or other

appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for those post-change interim periods.