Project	**Leases**
Topic	**Transition**

Objective

1. The purpose of this paper is to discuss transition requirements for lessees and lessors upon adoption of the proposed new leases guidance.[1]

2. This paper is organized as follows:

    (a) Summary of proposals

    (b) Approaches

    (c) Illustrative examples

    (d) Working group questions

    (e) Appendix 1: Transition matters

    (f) Appendix 2: Illustrative examples – supporting calculations.

[1] On October 19, 2010, the FASB issued a Discussion Paper, *Effective Dates and Transition Methods,* which asks stakeholders to explain what will be involved in learning about and adapting to the new requirements on an overall basis. Similarly, the IASB issued a Request for Views soliciting input on the same issues as the FASB DP. The comment letter deadline for both of these documents is January 31, 2011.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB's and the IASB's Lease Accounting Working Group.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Boards.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Summary of proposals

3. At the date of initial application, which is the beginning of the first comparative period presented in the first financial statements in which the entity applies the proposed new leases guidance, entities are required to recognize and measure all outstanding lease contracts within the scope of that guidance.

4. For example, suppose an entity is required to adopt the new leasing requirements as of January 1, 20X4, (beginning of the year) and presents income statements for the years ended December 31, 20X4, 20X3, and 20X2, in its annual financial statements. Under the proposals, the entity would use all outstanding leases as of January 1, 20X2, for the transition proposals; therefore, all information presented upon adoption of the new requirements would be on a comparable basis.

5. Lessees are required (unless the lease is a "simple" capital/finance lease prior to application of the proposals, as discussed in paragraph 6) to recognize the following at the date of initial application:

    (a) A liability to make lease payments for each outstanding lease, measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate *on the date of initial application*. For a short-term lease, (that is, a lease that, at the date of inception of the lease, has a maximum possible lease term, including options to renew or extend, of 12 months or less), the liability recorded would be undiscounted.

    (b) A right-to-use asset for each outstanding lease measured at the amount of the related liability to make lease payments, subject to impairment adjustments and adjusted for any prepaid/accrued rent previously recognized.

6. For leases that lessees previously classified as capital/finance leases that do not have options, contingent rentals, term options penalties, or residual value guarantees, the carrying amounts previously recorded are carried over at transition (and not remeasured subsequently).

7. Lessors should present a right to receive lease payments (lease receivable) measured at the present value of remaining lease payments, discounted using the rate charged in the lease determined *at the date of inception of the lease*, adjusted for any impairment, and either:

    (a) A lease liability for each outstanding lease, measured at the amount of the lease receivable and an underlying asset measured at depreciated cost, determined as if the asset had never been derecognized (subject to any adjustments required to reflect impairment) if the lessor applies the **performance obligation approach**, or

    (b) A residual asset measured at fair value determined at the date of initial application if the lessor applies the **derecognition approach**.

Approaches

8. The following chart summarizes the most common transition scenarios. The accounting for lessees/lessors under current guidance is displayed on the left (rows) that transition into the requirements under the leases Exposure Draft proposals across the top (columns).

As currently required:	As proposed in Exposure Draft: Lessee	Lessor - performance obligation	Lessor - derecognition
LESSEE			
Operating lease	A		
Capital lease - sales type	B		
Capital lease - direct finance	C		
LESSOR			
Operating lease		D	E
Capital lease - sales type		F	G
Capital lease - direct finance		H	I

** Illustrative graphs showing the income statement impacts of A, D, B, and F are presented below. All scenarios are included in Appendix 2.

9. For each of the above scenarios in the chart, the staff has considered the following approaches for the transition requirements:

   (a) Approach 1: Retain the Exposure Draft guidance (simplified retrospective approach).

   (b) Approach 2: Require full retrospective approach.

   (c) Approach 3: Optional full retrospective approach, otherwise Approach 1.

   (d) Approach 4: Modified retrospective approach.

Approach 1: Retain the Exposure Draft guidance

10. Approach 1 is the transition method proposed in the Exposure Draft and attempts to simplify the transition requirements by providing preparers with a practical expedient. The information gathered and calculations required are expected to be less burdensome under this method of transition as compared to a full retrospective approach. Additionally, all comparative periods presented would generally be on a similar basis.

11. However, under this method of transition, the asset and liability are linked at transition (rather than only at inception). As a result, the total aggregate expense (lessee) and income (lessor) recognized subsequent to transition is greater than if a full retrospective approach was applied. See illustrations in paragraphs 19–24 below.

Approach 2: Require full retrospective

12. Approach 2 would require entities to transition using a full retrospective approach.[2] That is, entities would be required to calculate the carrying amounts of

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[2] Codification Topic 250, Accounting Changes and Error Corrections (originally issued as Statement 154), and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, provide guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. When it is impracticable to determine, the guidance requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for that period rather than

all outstanding leases as if those leases had always been accounted for in accordance with the proposed requirements. That method would provide the best comparative information; however, it is most time consuming and burdensome for preparers. Additionally, some constituents think that the benefits provided by such information would not outweigh the costs.

13. Despite the difficulty, preliminary feedback from constituents is that this Approach may be preferred by some to the proposal requirements (Approach 1) primarily due to the income statement impacts (higher expense [lessees] and income [lessors]) subsequent to transition, which is illustrated in paragraphs 19–24.

Approach 3: Optional full retrospective; otherwise, Approach 1

14. Approach 3 allows preparers an option to choose either the simplified retrospective approach or a full retrospective approach. This approach would enable entities to avoid the income statement impacts criticized in Approach 1 or the cost burden of performing a full retrospective approach based on the preference of the preparer. While providing meaningful information, this approach may be challenged due to the inconsistency it creates across preparers.

Approach 4: Modified retrospective approach

15. Approach 4 is another simplified retrospective approach that allows preparers to approximate a full retrospective method without performing all of the costly calculations from the beginning of the lease term. This approach uses key inputs at the date of transition to approximate the transition impact and calculates a right-of-use asset (lessee) that approximates the right-of-use asset in a full retrospective approach. This approach minimizes the income statement impacts criticized in Approach 1 while proving comparable information on a retrospective basis.

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being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, guidance requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable.

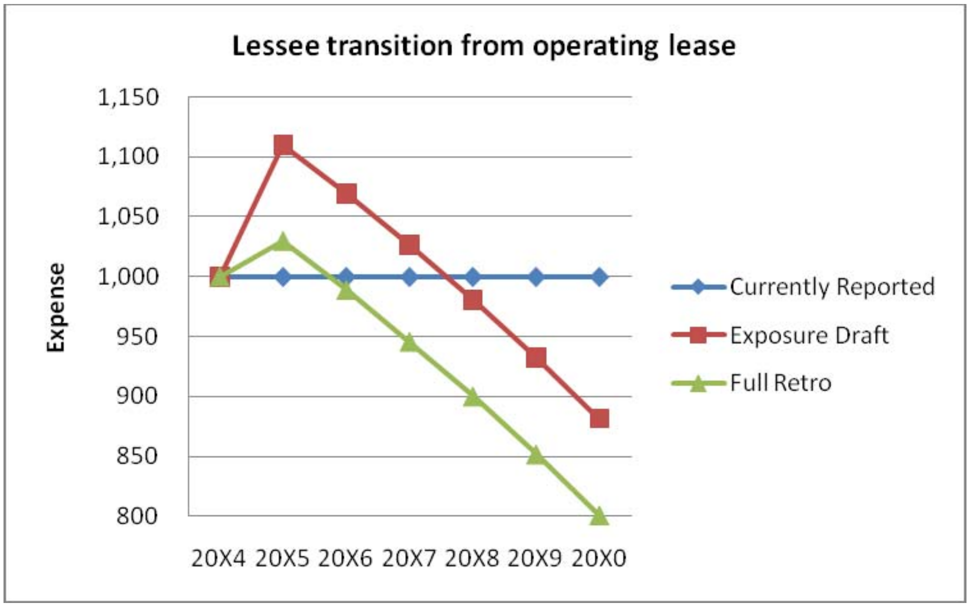
16. Approach 4, illustrated in Appendix 2 (Tab 8), calculates the lessee's liability in a manner consistent with Approach 1 (Exposure Draft). The right-of-use asset is calculated in a modified manner. The asset calculation uses the same information as required in the liability calculation (discount rate, lease term. and lease payments) and the liability calculated in Approach 1 (Exposure Draft) to approximate the right of use asset based on the proportion of the lease term remaining.

17. However, Approach 4 is challenged when there are rent escalators or other changes in payments during the lease term or the discount rate used at lease inception differs from the rate used at transition. See additional details in Appendix 2 (Tab 8 & Tab 9).

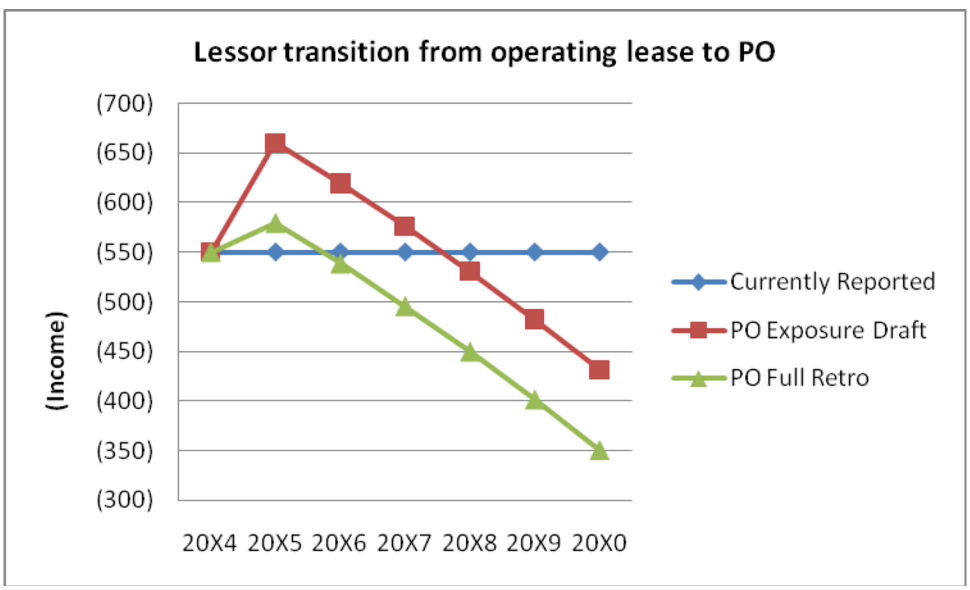
Illustrative examples

18. The staff prepared illustrative examples for the common scenarios outlined above in paragraph 8 and the approaches discussed in paragraphs 9–17. Appendix 2 contains the calculations and additional detail for all the scenarios. Below are four graphs that present the income statement impacts of transition for both a lessee and a lessor. Appendix 2 contains the calculations that support the charts presented below.

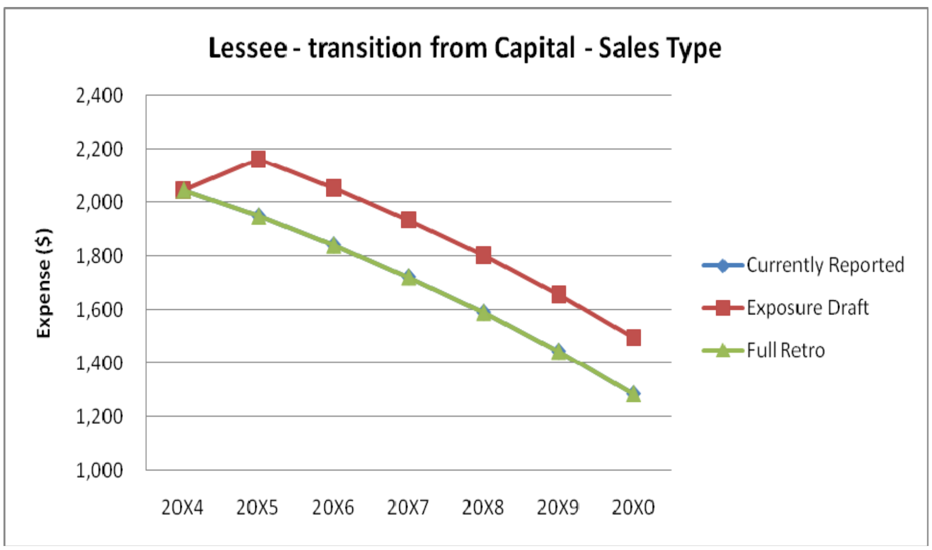
19. The first transition scenario (A) depicts the income statement impact of a lessee that previously reported an operating lease transitioning to the proposed guidance. This example demonstrates transition at the beginning of 20X5 (end of 20X4) and the resulting expenses recorded in subsequent years.



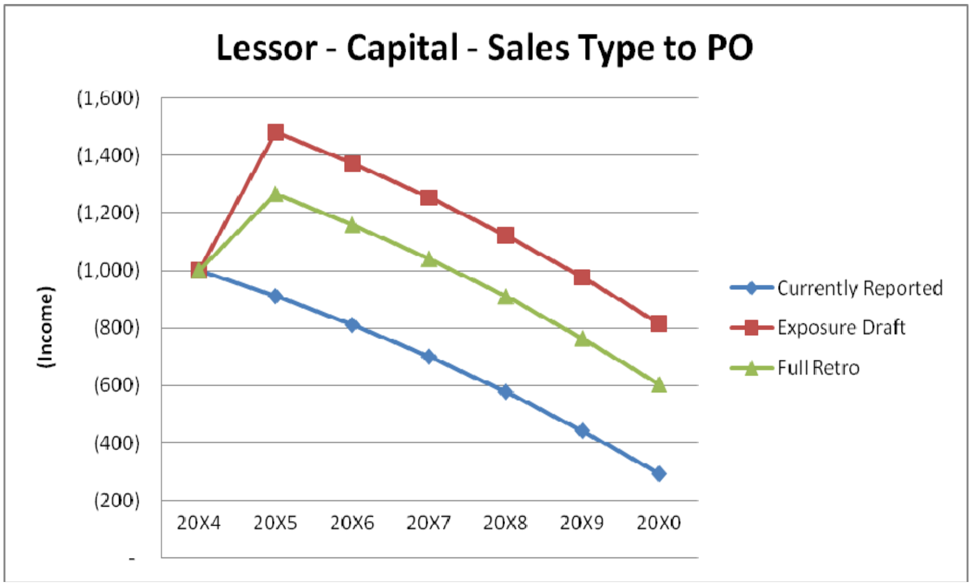
20. The second transition scenario (D) depicts the income statement impact of a lessor that previously reported an operating lease moving to the proposed guidance and applying the performance obligation approach. This example demonstrates transition at the beginning of 20X5 (end of 20X4) and the resulting income recorded in subsequent years.



21. The third transition scenario (B) depicts the income statement impact of a lessee that previously reported a capital lease (sales type) transitioning to the proposed guidance. This example demonstrates transition at the beginning of 20X5 (end of 20X4) and the resulting expense recorded in subsequent years. As the graph illustrates, the amounts under currently reported guidance are the same as full retrospective transition, which is why the Boards allowed for a scope exception for "simple" capital leases as outlined above in paragraph 6. The illustrative examples used in Appendix 2 do not include complex lease features (term options or contingent rentals) for simplicity; however, the staff did calculate and present both Approach 1 (Exposure Draft) and Approach 2 (full retrospective) to facilitate discussion.



22. The fourth transition scenario (F) depicts the income statement impact of a lessor that previously reported a capital lease (sales type) moving to the proposed guidance and applying the performance obligation approach. This example demonstrates transition at the beginning of 20X5 (end of 20X4) and the resulting income recorded in subsequent years.

23. 

24. The other transition scenarios (C, E, G, H, and I) are presented in Appendix 2. The staff notes the following regarding those transition scenarios:

(a) The derecognition approach (E, G, and I) produces the same income statement impact under both Approach 1 (Exposure Draft) and Approach 2 (full retrospective), except for the final year due to the accounting for the residual asset. Approach 2 (full retrospective) produces higher expense (lessee) and income (lessor) compared to Approach 1 due to the proposal requirements that the residual asset not be remeasured subsequent to initial measurement (i.e., no accretion).

(b) Lessee transition from a capital lease – direct finance (C) is similar to Scenario B presented above. Additionally, if original capital lease was a "simple" capital lease, it also would qualify for the transition exception because the current guidance would produce a similar result to that of retrospective application under the new proposals.

(c) Lessor transition from a capital lease – direct finance (H) is similar to Scenario F presented above.

Working group questions

Question 1
Does the working group support the Boards' Exposure Draft proposal regarding transition? If not, why not?

Question 2
If the working group does not support the Boards' Exposure Draft proposal, what approach to transition does the working group support?

Question 3
Appendix 1 provides a listing of various transition issues that the staff has identified during outreach that highlight missing, unclear, and/or inadequate guidance. Are there other topics you would highlight for the Boards' consideration?

Appendix 1 – Transition matters

This appendix lists some other transition matters identified by the staff during outreach.

1. Leveraged leases – For U.S. GAAP reporting entities, lack of guidance for entities that had previously reported leveraged leases in accordance with Topic 840, Leases.

2. Sale – Leaseback Transactions

   (a) Lack of guidance on how to account for these transactions including any previously reported deferred gains.

   (b) Lack of guidance for situations in which a successful sale-leaseback was recorded under existing guidance that would fail to achieve such accounting under the proposals.

3. Various grandfathering issues – There were various amendments to lease accounting (e.g., EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," (now included in Topic 840) and IFRIC 4, *Determining whether an Arrangement contains a Lease*) that used prospective transition. The Exposure Draft on leases does not allow for any grandfathering of lease contracts.

4. Lease vs. Purchase/Sale – If lease contracts contained a bargain purchase option or the asset transferred to the counterparty at the end of the lease, the lease contract would be accounted for as a capital/finance lease while the proposals would require treatment as a purchase/sale.

5. Residual asset recorded under lessor derecognition approach – Clarify guidance on measurement (fair value).

6. Lessor approach determination – at transition is hindsight and information at date of transition used to make determination of which approach is required under the proposals.

7. Subleases – Lack of guidance on accruals for unfavourable terms (losses).

Appendix 2 – Illustrative examples – supporting calculations

APPENDIX 2

OVERALL SUMMARY OF WORKBOOK

This workbook contains the calculations and details of several transition scenarios and should be read in connection with Working Group Memo 8. There are three prior reporting scenarios, (1) Operating lease, (2) Capital Lease - Sales Type and (3) Capital Lease - Direct Finance that are transitioned using the Exposure Draft's simplified retrospective transition approach (Approach 1) and a full retrospective transition approach (Approach 2). This workbook contains the detailed calculations for each scenario in Tabs 3, 5, and 7. A summary of the resulting income statement impacts is presented in Tabs 2, 4, and 6.

Additionally, Tab 8 presents Approach 4 - the Modified Retrospective Approach for a lessee transitioning from an operating lease to the proposed guidance. Finally, Tab 9 is also an illustration of Approach 4 (Modified Retrospective) for a lease that includes a rent escalator.

		Includes Scenarios		
		LESSEE	LESSOR	
Tab 1	Overall Summary of Workbook			
Tab 2	Summary of **Operating Lease** transition	**A**	**D**	**E**
Tab 3	Detailed Calculations of **Operating Lease** Transition			
Tab 4	Summary of **Capital - Sales Type** Lease transition	**B**	**F**	**G**
Tab 5	Detailed Calculations of **Capital - Sales Type** Lease Transition			
Tab 6	Summary of **Capital - Direct Finance** Lease transition	**C**	**H**	**I**
Tab 7	Detailed Calculations of **Capital - Direct Finance** Lease Transition			
Tab 8	Modified Retrospective Approach			
Tab 9	Modified Retrospective Approach with Rent Escalator			