IASB/FASB Meeting
Week commencing 18 July 2011

IASB Agenda reference	**5 App A**
FASB Agenda reference	**186 App A**

Staff Paper

Project	**Leases**
Topic	**Cover Memo – Appendix A**

Objective

1. The objective of this appendix is to assist the Boards by providing information about the decisions to date on accounting for leases by lessees.

LEASES PROJECT UPDATE – TOPICAL

CONTENTS

DEFINITION OF A LEASE (AP 1D/MEMO 158) – APRIL 12-13

In the *Leases* Exposure Draft, the Boards defined a lease as a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.

The Boards tentatively decided the following in relation to applying that definition, having considered feedback received from targeted outreach meetings held during March 2011 as well as feedback received in comment letters and through other outreach:

1. An entity would determine whether a contract contains a lease on the basis of the substance of the contract, by assessing whether:

    a. The fulfilment of the contract depends on the use of a specified asset; and

    b. The contract conveys the right to control the use of a specified asset for a period of time.

2. A contract would convey that right to control the use if the customer has the ability to direct the use, and receive the benefit from use, of a specified asset throughout the lease term. Guidance on separating the use of a specified asset from other services should be aligned with the Boards' tentative decisions in March 2011

relating to the separation of lease and non-lease components.

3. A “specified asset” refers to an asset that is explicitly or implicitly identifiable.

4. A physically distinct portion of a larger asset of which a customer has exclusive use is a specified asset. A capacity portion of a larger asset that is not physically distinct (for example, a capacity portion of a pipeline) is not a specified asset.

SEPARATING LEASE AND NON-LEASE COMPONENTS OF A CONTRACT (AP 11I/MEMO 153 AND AP1 11J/MEMO 154) – MARCH 22-23

The Boards tentatively decided that an entity should be required to identify and separately account for the lease and the non-lease components of a contract.

The Boards tentatively decided that in allocating payments in a contract between the lease and non-lease components of the contract:

1. The lessee should allocate payments as follows:

    a. If the purchase price of each component is observable, the lessee would allocate the payments on the basis of the relative purchase prices of individual components;

    b. If the purchase price of one or more, but not all, of the components is observable, the lessee would allocate the payments on the basis of a residual method; or

    c. If there are no observable purchase prices, the lessee would account for all the payments required by the contract as a lease.

SCOPE (AP 5B/MEMO 138) – MARCH 2

The Boards tentatively decided that leases of intangibles are not required to be accounted for in accordance with the leases standard.

The Boards affirmed the decision in the leases Exposure Draft that the following are within the scope of the leases standard:

1. Right-of-use assets in a sublease

2. Leases of non-core assets

3. Long-term leases of land.

The Boards affirmed the decision in the leases Exposure Draft that the following are not within the scope of the leases standard:

1. Leases for the right to explore for or use minerals, oil, natural gas and similar non-regenerative resources

2. Leases of biological assets, including (U.S. GAAP only) timber

3. (IFRSs only) Leases of service concession arrangements within the scope of IFRIC 12, *Service Concession Arrangements.*

The Boards directed the staff to perform additional research and present an analysis at a future meeting of whether the following are within the scope of the leases standard:

1. Leases of internal-use software in accordance with Subtopic 350-40, Intangibles–Goodwill and Other Internal-Use Software, of the *FASB Accounting Standards Codification*®

2. Leases of inventory.

CONFIRMATION OF THE RIGHT-OF-USE MODEL (AP 5A/MEMO 137) – MARCH 2

The Boards affirmed the decision in the leases Exposure Draft to apply a right-of-use model to all lease arrangements. Under that model, a lessee in an arrangement that is, or contains, a lease would recognize an asset representing its right to use an underlying asset during the lease term and a liability representing its obligation to make lease payments during the lease term.

LESSEE ACCOUNTING (AP 2D/MEMO 171 AND AP 2I/MEMO 176) – MAY 17-19

The Boards tentatively decided that lessees should apply a single accounting approach for all leases consistently with the approach proposed in the Leases Exposure Draft. This accounting approach would require a lessee to:

1. Initially recognize a liability to make lease payments and a right-of-use asset, both measured at the present value of the lease payments.

2. Subsequently measure the liability to make lease payments using the effective interest method.

3. Amortize the right-of-use asset on a systematic basis that reflects the pattern of consumption of the expected future economic benefits.

SUBLEASES (AP 2B/MEMO 182) – JUNE 13-15

The Boards discussed the accounting for subleases under the proposed leases requirements for lessees and lessors and tentatively decided the following:

1. A head lease and a sublease should be accounted for as separate transactions.

2. An intermediate lessor, as a lessee in a head lease arrangement, should account for its assets and liabilities arising from the head lease in accordance with the decisions-to-date for all lessees.
3. An intermediate lessor, as a lessor in a sublease arrangement, should account for its assets and liabilities arising from the sublease in accordance with the decisions-to-date for all lessors.
4. If the Boards decide that there should be more than one approach to lessor accounting, an intermediate lessor, as a lessor in a sublease, should evaluate its right-of-use asset, not the underlying asset, to determine the appropriate lessor accounting approach to apply to the sublease.

LEASE TERM (AP 5B/MEMO 130) – FEBRUARY 16-17

The FASB and the IASB tentatively decided that the lease term should be defined, for both lessees and lessors, as follows:

> The lease term is the non-cancellable 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.

The Boards tentatively decided that a lessee and a lessor should reassess the lease term only when there is a significant change in relevant factors such that the lessee would then either have, or no longer have, a significant economic incentive to exercise any options to extend or terminate the lease.

CONTRACT MODIFICATIONS OR CHANGES IN CIRCUMSTANCES AFTER THE DATE OF INCEPTION OF THE LEASE (AP 2B/MEMO 169) – MAY 17-19

The Boards tentatively decided to provide guidance on accounting for changes after the date of inception of the lease as follows:

1. A modification to the contractual terms of a contract that is a substantive change to the existing contract should result in the modified contract being accounted for as a new contract. The change is a substantive change if it results in a different determination of whether the contract is, or contains, a lease or, if applicable, whether the contract transfers substantially all of the risks and rewards incidental to ownership of the underlying asset.

2. A change in circumstances other than a modification to the contractual terms of the contract that would affect the assessment of whether a contract is, or contains, a lease should result in a reassessment as to whether the contract is, or contains, a lease.

3. A change in circumstances other than a modification to the contractual terms of the contract that would affect whether a lease transfers substantially all of the risks and

rewards incidental to ownership of the underlying asset should not result in a reassessment or a change in the accounting approach.

VARIABLE LEASE PAYMENTS AND OTHER LEASE PAYMENT CONSIDERATIONS (AP 1A/MEMO 156, AP 1B/MEMO 157, AND AP 5G/MEMO 135) – APRIL 12-13 AND FEBRURARY 16-17

At the February 2011 joint Board meeting, the FASB and the IASB tentatively decided that the lessee's liability and the lessor's receivable should include:

1. Lease payments that meet a high threshold

2. Lease payments for which the variability lacks economic substance

3. Lease payments that depend on an index or a rate.

Lease payments that meet a high threshold (AP 1B/Memo 157) – April 12-13

The Boards tentatively decided that the measurement of the lessee's liability and the lessor's receivable should not include variable lease payments that meet a high threshold.

Lease payments for which the variability lacks economic substance (AP 1A/Memo 156) – April 12-13

The Boards tentatively decided that the measurement of the lessee's liability and the lessor's receivable should include lease payments that are in-substance fixed lease payments but are structured as variable lease payments in form.

Lease payments that depend on an index or a rate

The Boards will discuss lease payments that depend on an index or a rate, including reassessment, at a future meeting.

In addition, the Boards directed the staff to consider appropriate disclosures for variable lease payments for future discussions.

Residual value guarantees (AP 5G/Memo 135) – February 16-17

The Boards tentatively decided to clarify that the lease payments should include amounts expected to be payable under residual value guarantees, except for amounts payable under guarantees provided by an unrelated third party.

Term option penalties (AP 5G/Memo 135) – February 16-17

The Boards tentatively decided that the accounting for term option penalties should be consistent with the accounting for options to extend or terminate a lease. That is, if a lessee would be required to pay a penalty if it does not renew the lease and the renewal period has not been included in the lease term, then that penalty should be included in the recognized lease payments.

LESSEE SUBSEQUENT MEASUREMENT (AP 2A/MEMO 178 AND AP 2B/MEMO 179) – JUNE 1

The IASB and the FASB continued their discussion on leases and discussed subsequent measurement issues relating to lessees, including foreign exchange differences, impairment, revaluation, and residual value guarantees.

Foreign exchange differences (AP 2A/Memo 178)

The Boards discussed the accounting by lessees for leases denominated in a foreign currency. The Boards tentatively decided that foreign exchange differences related to the liability to make lease payments should be recognized in profit or loss, consistently with foreign exchange guidance in existing IFRSs and U.S. GAAP.

Impairment (AP 2A/Memo 178)

The Boards discussed impairment of the lessee's right-of-use asset. The Boards tentatively decided to affirm the proposal in the *Leases* Exposure Draft to refer to existing guidance in IFRSs and U.S. GAAP for impairment of the right-of-use asset.

Revaluation (IASB only) (AP 2A/Memo 178)

The IASB discussed revaluation of the lessee's right-of-use asset. The IASB tentatively decided to affirm the proposals in the *Leases* Exposure Draft allowing revaluation of the right-of-use asset.

Residual value guarantees (AP 2B/Memo 179)

The Boards discussed the subsequent measurement of residual value guarantees by lessees (excluding guarantees provided by an unrelated third party) and tentatively decided that:

1. The amounts expected to be payable under residual value guarantees included in the measurement of the lessee's right-of-use asset should be amortized consistently with how other lease payments that are included in the measurement of a right-of-use asset are amortized. That is, amortization should be on a systematic basis from the date of commencement of the lease to the end of the lease term, or over the useful life of the underlying asset, if this is shorter. The method of amortization should reflect the pattern in which the economic benefits of the right-of-use asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method should be used.
2. The amounts expected to be payable under residual value guarantees that are included in the measurement of the lessee's liability to make lease payments should be reassessed when events or circumstances indicate that there has been a significant change in the amounts expected to be payable under residual value guarantees. An entity would be required to consider all relevant factors to determine whether events or circumstances indicate that there has been a significant change.
3. The amount of the change to the lessee's liability to make lease payments arising from changes in estimates of residual value guarantees should be recognized (a) in

net income to the extent that those changes relate to current or prior periods and (b) as an adjustment to the right-of-use asset to the extent those changes relate to future periods. The allocation for changes in estimates of residual value guarantees should reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or were consumed. If that pattern cannot be reliably determined, an entity should allocate changes in estimates of residual value guarantees to future periods.

DISTINGUISHING BETWEEN A LEASE AND A PURCHASE OR A SALE (AP 5C/MEMO 142) – MARCH 14

The Boards discussed whether the leases standard should provide guidance for distinguishing a lease from a purchase or a sale.

The Boards tentatively decided that guidance should not be provided in the leases standard for distinguishing a lease of an underlying asset from a purchase or a sale of an underlying asset. That is, if an arrangement does not contain a lease, it should be accounted for in accordance with other applicable standards (for example, property, plant, and equipment or revenue recognition).

ACCOUNTING FOR PURCHASE OPTIONS (AP 5D/MEMO 143) – MARCH 14

The Boards discussed how lessees and lessors should account for options to purchase the underlying assets that are included within an arrangement that contains a lease.

The Boards tentatively decided that lessees and lessors should include the exercise price of a purchase option (including bargain purchase options) in the measurement of the lessee's liability to make lease payments and the lessor's right to receive lease payments, if the lessee has a significant economic incentive to exercise the purchase option. If it is determined that the lessee has a significant economic incentive to exercise the purchase option, the right-of-use asset recognized by the lessee should be amortized over the economic life of the underlying asset, rather than over the lease term.

The Boards also discussed whether a lessee and a lessor should reassess how to account for a purchase option included within an arrangement that contains a lease in subsequent periods. The Boards tentatively indicated a preference for specifying the same reassessment guidance for purchase options as was tentatively decided for options to extend or terminate a lease.

REASSESSMENT OF OPTIONS IN A LEASE (2G/MEMO 174) – MAY 17-19

The Boards discussed how lessees and lessors should reassess whether a lessee has a significant economic incentive to exercise:

1. An option to extend or terminate a lease, and

2. An option to purchase the underlying asset.

The Boards tentatively decided that a lessee and a lessor should consider contract-based, asset-based, and entity-based factors in reassessing whether a lessee has a significant economic incentive to exercise an option. The boards noted that all these factors should be considered together and the existence of only one factor does not necessarily, by itself, signify a significant economic incentive to exercise the option.

The Boards tentatively decided that the thresholds for evaluating a lessee's economic incentive to exercise options to extend or terminate a lease and options to purchase the underlying asset should be the same for both initial and subsequent evaluation, except that a lessee and lessor should not consider changes in market rates after lease commencement when evaluating whether a lessee has a significant economic incentive to exercise an option.

The Boards tentatively decided that changes in lease payments that is due to a reassessment in the lease term should result in a lessee adjusting its obligation to make lease payments and its right-of-use asset

---

SHORT-TERM LEASES (AP 2C/MEMO 183 AND AP 5A/MEMO 140) – JUNE 13-15 AND MARCH 14

Short-Term Leases by Lessees (AP 2C/Memo 183 and AP 2D/Memo 184) – June 13-15

The Boards discussed the accounting for short-term leases by lessees. A short-term lease is defined as follows:

> A lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less.

The Boards tentatively decided that for short-term leases a lessee need not recognize lease assets or lease liabilities. For those leases, the lessee should recognize lease payments in profit or loss on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

The Boards also tentatively decided that a lessee may elect to apply the recognition and measurement requirements in the leases guidance to short-term leases.
The Boards expressed support for requiring disclosure of the rental expense recognized in the current period and a statement about the extent to which that expense is expected to be representative of rental expense in future periods.

The Boards will continue to discuss disclosures for short-term leases, as well as lessor accounting for short-term leases, at a future meeting.

INCEPTION VERSUS COMMENCEMENT (AP 11B/MEMO 146) – MARCH 22-23

The Boards discussed the accounting for elements of a lease contract at the date of inception versus the date of commencement from both the lessee's and lessor's perspective.

The Boards tentatively decided that the leases standard would:

1. Require a lessee and a lessor to recognize and initially measure lease assets and lease liabilities (and derecognize any corresponding assets and liabilities) at the date of commencement of the lease.

2. Require a lessee and a lessor to use a discount rate calculated at the date of commencement when initially measuring lease assets and lease liabilities.

3. Include application guidance on the accounting for costs incurred by the lessee before the date of commencement of a lease.

4. Include application guidance on the accounting for lease payments made by the lessee before the date of commencement of a lease.

5. Include application guidance on the accounting for incentives provided by the lessor to the lessee. This would clarify that a lessee will deduct all lease incentives from the initial measurement of the right-of-use asset.

The Boards also discussed the accounting for a lease contract between the date of inception and the date of commencement of a lease when the contract meets the definition of an onerous contract. The IASB affirmed the leases Exposure Draft proposal to exclude from the scope of the leases standard leases between the date of inception and the date of commencement if they meet the definition of an onerous contract. Such leases would be accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* until the date of commencement. The FASB also indicated support for applying Topic 450, Contingencies, to those contracts that meet the definition of an onerous contract before the date of commencement but noted that this issue would be reviewed when the Board considers impairment at a future meeting.

INITIAL DIRECT COSTS (AP 11A/MEMO 145) – MARCH 22-23

The Boards discussed the definition of initial direct costs and the accounting by lessees and lessors for initial direct costs.

The Boards tentatively defined initial direct costs as follows:

> Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

The Boards affirmed the decision in the leases Exposure Draft that lessees and lessors should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively.

DISCOUNT RATE (AP 11H/ MEMO 152) – MARCH 22-23

The Boards discussed how lessees and lessors would determine the discount rate to use to initially measure lease payments at present value.

The Boards tentatively affirmed the proposals in the leases Exposure Draft, but clarified the following:

1. The lessee would use the rate the lessor charges the lessee when that rate is available; otherwise, the lessee would use its incremental borrowing rate.

2. The rate the lessor charges the lessee could be the lessee's incremental borrowing rate, the rate implicit in the lease, or, for property leases, the yield on the property. When more than one indicator of the rate that the lessor charges the lessee is available, the rate implicit in the lease should be used.

The Boards also tentatively decided to provide application guidance for the determination of the discount rate when considering the use of a group discount rate and determining the yield on property.

REASSESSMENT OF THE DISCOUNT RATE (AP 2H/MEMO 175) – MAY 17-19

The Boards discussed whether there are circumstances that would require a lessee or a lessor to reassess the discount rate that is used to measure the present value of lease payments.

The Boards tentatively decided that the discount rate should not be reassessed if there is no change in the lease payments.

The Boards tentatively decided that the discount rate should be reassessed when the changes below are not reflected in the initial measurement of the discount rate:

1. When there is a change in lease payments that is 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.

2. When there is a change in lease payments that is due to the exercise of an option that the lessee did not have a significant economic incentive to exercise.

The Boards also decided that a lessee or lessor should determine a revised discount rate using the spot rate at the reassessment date and should then apply that rate to the remaining lease payments (i.e. to the remaining payments due in the initial lease plus the payments due during the extension period or upon exercise of a purchase option).

SALE AND LEASEBACK TRANSACTIONS (AP 11C/MEMO 147, AP 11D/MEMO 148, AP 11E/MEMO 149, AP 11F/MEMO 150, AND AP 11G/MEMO 151) – MARCH 22-23

The Boards affirmed the decision in the leases Exposure Draft that when a sale has occurred, the transaction would be accounted for as a sale and then a leaseback. If a sale has not occurred, the entire transaction would be accounted for as a financing.

The Boards tentatively decided that an entity should apply the control criteria described in the revenue recognition project to determine whether a sale has occurred.

The Boards affirmed the decision in the leases Exposure Draft that in a transaction accounted for as a sale and leaseback:

1. When the consideration is at fair value, the gains and losses arising from the transaction should be recognized when the sale occurs.

2. When the consideration is not established at fair value, the assets, liabilities, gains and losses recognized should be adjusted to reflect current market rentals.

The Boards affirmed the decision in the leases Exposure Draft that the seller/lessee would adopt the "whole asset" approach in a sale and leaseback transaction. The "whole asset" approach deems that in a sale and leaseback transaction, the seller/lessee sells the entire underlying asset and leases back a right-of-use asset relating to part of the underlying asset.

The Boards tentatively decided that the leases guidance would not prescribe a particular type of lessee accounting model for entities that are accounting for the leaseback part of a sale and leaseback transaction.