Project	**Leases**
Topic	**Accounting for short-term leases**

Objective

1. The purpose of this paper is to discuss the accounting for short-term leases and the tentative decisions made by the Boards at the March 15, 2011 joint meeting. In the May 2011 joint meetings, the Boards decided to continue with a single approach, consistent with the proposals in the *Leases* Exposure Draft (ED), for all leases entered into by lessees. Because of that decision, the Boards asked the staff to reconsider the short-term leases decisions relating to lessees, as they were originally made in consideration of a second lease approach with a straight-line profit or loss recognition pattern. Since the Boards revised their decision to have two lease approaches, the short-term lease accounting for lessees now has a more significant, cost/benefit implication as a practical expedient to the single lessee approach.

2. At the March 15 joint meeting, the Boards also tentatively decided to allow operating lease treatment for short-term leases by lessors. That tentative decision reaffirmed the proposals for lessors in the ED, with some differences in the definition of short-term leases and how the accounting may be elected. Based on the discussions that the Boards are having on the lessor accounting approach at the June 2011 joint meeting, this paper also asks the Boards to confirm the short-term lease exception for lessors.

3. Based on the tentative decisions in the May 2011 joint meeting, the staff has mixed views in its recommendations for short-term lease accounting by lessees and for the definition of short-term leases.

4. Contingent upon the decisions reached by the Boards on the lessor accounting approach in the June 2011 joint meetings, the staff also recommends that the Boards confirm the March 15 decision on accounting by lessors for short-term leases, which is to allow lessors to elect operating lease treatment for short-term leases.

5. This paper is structured as follows:
   (a) Background and feedback
   (b) Lessee: Accounting for short-term leases
   (c) Lessee: Definition of short-term leases
   (d) Lessor: Accounting for short-term leases.

Background and feedback

Summary of ED proposals

6. The ED proposes the following for short-term leases:
   (a) Appendix A defines a short-term lease as:

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

   (b) Paragraph 64 proposes the following accounting for short-term leases for lessees:

   > At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (a) the liability for lease payments at the undiscounted amount of the lease payments and (b) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees shall recognize lease payments in the income statement over the lease term.

(c) Paragraph 65 proposes the following accounting for short-term leases for lessors:

> At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets or liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors shall continue to recognize the underlying asset in accordance with other Topics and shall recognize lease payments in the income statement over the lease term.

Summary of tentative decisions

7. Agenda Paper 5A/FASB Memo 140 previously addressed the issues related to accounting by lessees and lessors for short-term leases in redeliberations. That paper was discussed at the March 15 meeting in which the Boards tentatively decided that:

(a) A short-term lease is defined as:

> 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 staff analysis on the definition of short-term leases can be found in paragraphs 35-46 of AP 5A/Memo 140.

(b) Lessees and lessors may elect, as an accounting policy for a class of underlying asset(s), to account for all short-term leases by not recognizing lease assets or lease liabilities and by recognizing 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 staff analysis on the accounting policy election and the profit or loss recognition can be found in paragraphs 41-61 of AP 5A/Memo 140.

Summary of feedback

8. A comprehensive summary of the feedback received on the ED proposals can be found in paragraphs 7-17 of AP 5A/Memo 140. The majority of respondents requested more cost relief from short-term leases by lessees than proposed in the ED.

9. The following summarizes comments that have been made by a number of interested parties on the accounting by lessees for short-term leases in both formal and informal leases outreach activities performed after the March 15 meeting:

   (a) Many preparer participants commenting on short-term leases supported the Boards' tentative decisions for a short-term lease practical expedient and the cost/benefit rationale identified by the Boards. Some of those preparers noted that structuring around the short-term practical expedient is not a concern because lessors require a premium from the lease payments and would not risk forfeiting a contractual right to lease payments to help a lessee avoid capitalization of a lease.

   (b) Some accounting firm participants supported the Boards' tentative decisions for the practical expedient as a sensible cost/benefit consideration, noting the challenges of applying materiality guidance to determine whether a lease for a short term, without such a practical expedient, should be accounted for under the final leases guidance. However, other accounting firm participants explicitly rejected the need for the practical expedient for short-term leases because the definition of a lease was appropriately narrowed and clarified in redeliberations, the distinction between services and leases was clarified in redeliberations, and because the expedient provides structuring opportunities.

   (c) Private company participants supported keeping a practical expedient and requested an expansion to the definition to allow leases of longer than 12 months to be accounted for as short-term leases. Private company participants also expressed concerns about having to capitalize month-to-month, at-will leases and supported capturing month-to-month leases in the short-term leases definition. However, the staff notes that month-to-month leases will be discussed in a future paper.

(d) Private construction company participants supported defining short-term leases by using an operating cycle instead of a bright line at 12 months. Many private construction companies lease equipment by the job and include the lease costs in the job cost; having to track and capitalize those leases separately from normal job costs would have a substantial impact for those companies. The operating cycles for those companies are based on the length of the construction projects and range from 6 to 24 months.

(e) Standard-setter participants supported the Boards' tentative decisions for short-term leases and, like some preparers, argued that structuring around the short-term leases practical expedient is not a concern because lessors will not want to take the risk that a lessee will walk away.

(f) Users continue to express concerns relating to the usefulness of information that will be provided to them on short-term leases if the Boards provide a practical expedient for lessees.

Lessee: Accounting for short-term leases

10. The staff thinks that the basic options to consider for lessee accounting for short-term leases under one lessee approach remain similar to the options presented in paragraph 18 of AP 5A/Memo 140:

(a) Approach A: Return to the proposal in the ED, which is to record short-term lease assets and liabilities at undiscounted amounts.

(b) Approach B: Affirm the Boards' tentative decisions in the March 15 meeting to allow operating lease treatment for short-term leases.

(c) Approach C: Eliminate the practical expedient for short-term leases.

11. The staff does not intend for the Boards to consider the accounting by lessees separately from the definition of short-term leases. The staff notes that Board

members' preferences for Approach A, Approach B, or Approach C may change depending on how narrow or expansive the definition is. Analysis of the definition is provided in the next section of this paper. For example, some Board members may be comfortable with Approach B and operating lease treatment for leases less than 12 months, but not for those less than 24 months. The staff thinks it is appropriate to consider the accounting and the definition together when developing preferences for lessee accounting for short-term leases.

Approach A

12. Approach A is the approach in the ED to record short-term lease assets and liabilities at undiscounted amounts. This approach was discussed in paragraphs 19-20, 22-23, and 34 of AP 5A/Memo 140. The staff notes that any cost relief to lessees comes from not having to discount the right-of-use (ROU) assets and liabilities to make lease payments for short-term leases.

13. The main advantages of Approach A are the following:

    (a) Provides *some* relief to lessees of short-term leases from the cost burdens of the lessee ROU model proposed in the ED (and tentatively decided upon as the single lessee approach by the Boards in the May 2011 joint meeting).

    (b) Requires ROU assets and liabilities to make lease payments for short-term leases (and overall, for *all* leases) to be recognized on the SFP of lessees. This meets the objective of the Leases project and provides decision-useful information to users of financial statements about lessees' potential future cash flows from short-term leases.

14. The main disadvantages of Approach A are the following:

    (a) Does not provide *significant* relief to lessees of short-term leases from the cost burdens of the lessee model as supported in ED feedback.

    (b) Requires differential accounting for specific leases based on an arbitrary, bright-line cut-off.

    (c) Creates, in substance, an additional accounting approach for leases. Some may argue that multiple approaches add complexity to the final leases guidance, while others may argue instead that Approach A follows the single lessee approach, but uses a discount rate of 0.

Approach B

15. Approach B, which is currently the Boards' tentative decision in redeliberations, allows operating lease treatment for short-term leases. It was discussed in paragraphs 24-27 and 31-33 of AP 5A/Memo 140. The staff notes that the majority of the cost relief to lessees in this approach comes from not having to track and identify contracts to determine (a) whether or not the contracts are, or contain, a lease and (b) if bundled services need to be bifurcated. That is because lessees would not have to recognize ROU assets and liabilities to make lease payments for short-term leases. Leases meeting the definition of short-term leases would instead receive operating lease treatment.

16. The main advantages of Approach B are the following:

    (a) Provides *significant* cost relief to lessees of short-term leases from the cost burdens of the lessee model, responding to preparer and auditor feedback, both before and after the March 15 tentative decision, to provide a practical expedient in the final leases guidance for short-term leases.

    (b) Simplifies the accounting for short-term leases compared to what was proposed in the ED.

17. The main disadvantages of Approach B are the following:

    (a) Requires differential accounting for specific leases, which may create a means to structure lease contracts so that lessees may avoid recognizing material lease assets and liabilities on their SFP.

    (b) Does not provide decision-useful information to users about lessees' potential future cash flows from short-term leases.

    (c) Creates, in substance, an additional accounting approach for leases. Some may argue that multiple approaches add complexity to the final leases guidance.

Approach C

18. Approach C eliminates any short-term lease practical expedient. It was discussed in paragraphs 28-29(a) and 29(c)-30 of AP 5A/Memo 140.

19. The main advantages of Approach C are the following:

    (a) Requires lessees to recognize lease assets and liabilities on their SFP for all leases, subject to materiality and capitalization thresholds, including leases of a short-term nature. That provides the most decision-useful information to users of lessees' financial statements and meets the objective of the Leases project.

    (b) Requires lessees to account for all leases under one approach, which is consistent with Boards' decision in the May 2011 joint meeting. That avoids the need for any arbitrary bright lines to cut off and define a short-term lease.

    (c) Decreases some of the complexity of the final leases guidance by having only one accounting approach for all leases by lessees. Leases that are short-term in nature will be covered under companies' normal materiality and capitalization thresholds if immaterial to the financial statements and there will be no need for lessees to separately determine whether or not a lease meets the definition of a short-term lease (and thus its subsequent accounting).

20. The main disadvantages of Approach C are the following:

    (a) Provides little to no cost relief to lessees from the cost burdens of the single lessee approach and is not responsive to preparer and auditor feedback that supported decreasing the costs of the lessee model with a practical expedient for short-term leases.

    (b) Introduces uncertainty about how immaterial leases would be reflected in the financial statements. Applying materiality may be more difficult now that the Boards have decided to reject two lease approaches and have returned to a single lessee approach; profit or loss materiality must also be considered in addition to SFP materiality. Also, it is unclear whether tracking those leases to ultimately determine that they are immaterial and do not need to be accounted for under the single lessee approach would be more costly than differential accounting, such as in Approaches A and B.

21. The staff thinks that as a result of eliminating the short-term lease practical expedient, the following might occur in practice:

    (a) Short-term leases that are immaterial to the financial statements will not be accounted for under the final leases guidance.

    (b) Short-term leases that are material will be recognized on the SFP in accordance with the final leases guidance, but at undiscounted amounts. That is consistent with how other transactions of a short-term nature are treated under Codification paragraph 835-30-15-3(a) and paragraph 45 of IAS 37.

Staff recommendation

22. The staff has mixed views between Approach B and Approach C in its recommendation for lessee accounting of short-term leases based on the different advantages presented in this paper for each approach.

Question 1
The staff has mixed views in its recommendation on lessee accounting of short-term leases. Which approach do the Boards prefer?

Lessee: Definition of short-term leases

23. If the Boards agree with Approaches A or Approach B above (that is, if they agree to a short-term lease practical expedient for lessees), then the staff will ask the Boards if they would like to confirm, expand, or narrow the definition of short-term leases from the March 15, 2011 tentative decision. See paragraph 7(a) of this paper for that definition.

24. The staff thinks that the following are approaches for the short-term lease definition from the Boards' tentative decision made at the March 15 joint meeting:

(a) Confirm the definition of short-term leases (only those leases with a maximum possible term, including any options to renew, of 12 months or less).

(b) Expand the definition of short-term leases.

(c) Narrow the definition of short-term leases.

Confirm the definition

25. If the Boards decide to confirm the definition of short-term leases from the tentative decisions made at the March 15 joint meeting, it will be included in the final leases guidance 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.

26. The staff notes that the ED proposals defined short-term leases using a cut-off of 12 months and that the Boards tentatively decided to continue with a 12-month cut-off in the definition at the March 15 joint meeting. However, in light of the decisions made in May 2011 to return to a single lessee approach, there has been discussion and constituent feedback to expand or narrow the definition of short-term leases from 12 months. The staff thinks that any cut-off in the definition will be an arbitrary bright line, but analysis on expanding and narrowing the definition is provided below.

Expand the definition

27. If the Boards decide to expand the definition of short-term leases, leases of a longer term, more leases, or both will be accounted for as short-term leases and either be recognized at undiscounted amounts on the SFP (Approach A) or receive operating lease treatment (Approach B), depending on the Boards' decision on the accounting by the lessee.

28. The staff thinks that the most likely means to expand the definition in paragraph 25 of this paper would be to allow the practical expedient for leases with terms less than one operating cycle, less than three years, or less than five years. However, the definition may also be expanded by removing renewal options

from consideration in the definition or by making the short-term lease definition consistent with *lease term* as defined by the Boards in February 2011.

29. The main advantage of expanding the definition of short-term leases is an increased amount of cost relief to lessees from a short-term lease practical expedient. That is responsive to preparer feedback on the ED proposals and from private companies on the tentative decisions, as outlined in paragraph 9 of this paper.

30. In addition, expanding the definition of short-term leases may seem more appealing now that the Boards have decided that there is only one approach for lessee accounting. That would expand the number of leases accounted for either under Approach A (undiscounted lease assets and liabilities) or Approach B (operating lease treatment), depending on the Boards' decision, and would provide straight-line profit or loss recognition, which many preparer constituents supported.

31. The disadvantages of expanding the definition of short-term leases are the following:

    (a) Increases the ability of lessees to structure lease contracts to avoid accounting for leases under the single lessee approach, especially if renewal options are not considered in the definition; lessees could more easily enter into a series of repeating short-term lease contracts when they would have otherwise had a single, long-term contract.

    (b) Does not provide the most decision-useful information to users about a *larger* amount of lessees' potential cash flows from short-term leases as compared to the definition from the Boards' tentative decision.

Narrow the definition

32. If the Boards decide to narrow the definition of short-term leases, leases of a shorter term, fewer leases, or both will be accounted for as short-term leases and either be recognized at undiscounted amounts on the SFP (Approach A) or receive operating lease treatment (Approach B).

33. The following are approaches identified by the staff to narrow the definition of short-term leases in paragraph 25 of this paper:
    (a) Lower the cut-off in the definition below 12 months (to 6 months, 9 months, etc.) or to an 'insignificant' or 'trivial' term;
    (b) Restrict application of the practical expedient so that it may not be applied to specific situations, such as when the lease contract:
        (i) includes RVGs or purchase options, and/or
        (ii) is part of a sale/leaseback transaction;
    (c) Define the practical expedient in a principles-based manner, clarifying that it can be applied only when a single contract, or multiple contracts that may be viewed, in-substance, as one contract (for example, 10 sequential leases of office space, each for 364 days) meets the substance of a transaction for a lease of less than 12 months (or 9 months, etc.) such that the nature of the lease is short-term.
34. The advantages of narrowing the definition of short-term leases are the following:
    (a) Reduces the ability of lessees to structure lease contracts to avoid accounting for leases under the single lessee approach. Only leases that are in-substance short-term would receive short-term lease accounting.
    (b) Fewer leases would be eligible for short-term lease accounting, which means more lease assets and liabilities would be recognized and measured on the SFP of lessees as intended in the single lessee approach.
    (c) Provides decision-useful information to users about a *larger* amount of lessees' potential cash flows from leases as compared to the definition from the Boards' tentative decision.
35. The disadvantages of narrowing the definition of short-term leases are the following:
    (a) Decreases the amount of cost relief to lessees from a short-term lease practical expedient.

(b) Adds complexity to the final leases guidance and makes the definition of short-term leases from the tentative decision *too* narrow. Lessees would have to track all of those leases for additional exclusions besides the length of the term and renewal options to see if they meet the short-term lease definition, and the costs to do this may outweigh the benefit provided to lessees by what should be a practical expedient.

36. The staff thinks that as a result of the more principles-based expansion outlined in paragraph 33(c) above all of the considerations discussed in paragraphs 33(a) and 33(b), as well as the existence of any renewal options, would be considered in practice to determine whether a lease is truly of a short-term nature.

Staff recommendation

37. The staff has mixed views in its recommendation to define short-term leases. Some staff members think that the definition of short-term leases taken from the tentative decisions in the March 15 joint meeting is appropriate and should be confirmed. Some staff members think that the advantages of narrowing the definition from the tentative decisions, as outlined in paragraph 34 of this paper, are the most compelling. Those staff members also agree with the results in practice discussed in paragraph 36. Others staff members are persuaded by the arguments and feedback received from nonpublic entities to provide additional cost relief from the single lessee approach. Those staff members think that the Boards should expand the definition of short-term leases from the tentative decisions. The FASB staff notes that if the Boards do not decide to expand the definition, it may bring a future paper to a FASB-only meeting to allow an expanded practical expedient for short-term leases for nonpublic entities.

Question 2
The staff has mixed views in its recommendation on the definition of a short-term lease. How do the Boards prefer to define a short-term lease?

Lessor: Accounting for short-term leases

38. At the March 15, 2011 joint meeting, the Boards tentatively decided to also allow operating lease treatment for short-term leases by lessors. Paragraph 7(b) of this paper outlines that tentative decision.

39. The staff notes that the March 15 tentative decision confirms the ED proposals for lessors. Paragraph 9 in AP 5A/Memo 140 notes that the feedback on the ED proposals for lessor accounting is supportive and that the staff has received little to no other feedback on lessor accounting for short-term leases in targeted outreach, other outreach, or other informal meetings since the March 15 tentative decisions. The staff does not think there are any arguments that are new or significantly different from those presented in AP 5A/Memo 140 and therefore does not think it is appropriate to change the tentative decision from the March 15 joint meeting for lessors.

40. However, the staff notes that the lessor approach under the ROU model is yet to be decided on by the Boards. Therefore, if the Boards decide on one lessor accounting approach in the June 2011 meeting, the staff recommends that the Boards confirm the tentative decisions from the March 15 meeting for short-term leases by lessors. Otherwise, if the Boards decide on two lessor accounting approaches that are similar or close to current lessor accounting, the staff does not think a short-term lease practical expedient is necessary for lessors.

Question 3
If the Boards decide on a single lessor accounting approach, do they also agree to confirm the tentative decision on lessor accounting for short-term leases, which would allow a lessor that has leases with a maximum possible term, including any options to renew, of 12 months or less to elect operating lease accounting for a class of underlying assets?