IASB/FASB Meeting Week commencing October 17, 2011	IASB Agenda reference	2J
Staff Paper — FASB ED Session October 14, 2011	FASB Agenda reference	214

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Project **Leases**

Topic **Transition – other considerations**

Objective

1. The purpose of this paper is to address the following transition considerations:
   - (a) Determining the discount rate for measuring the lessee's liabilities to make lease payments and the lessor's rights to receive lease payments
   - (b) Whether to continue providing the transition exception in EITF 01-8, *Determining Whether an Arrangement Contains a Lease* (FASB only)
   - (c) Other considerations the staff do not think warrant guidance, including short-term leases, investment property measured at fair value, subleases, useful lives of leasehold improvements, secured borrowings, build-to-suit leases, and in-substance purchases and sales
2. The staff analysis and recommendations in this memo assume some form of retrospective transition generally will be required in the new leases standard.
3. This paper does not address transition considerations related to sale and leaseback transactions, first time adoption of IFRSs (IFRS 1, *First-time Adoption of International Financial Reporting Standards*), and impairment because they are addressed in other papers.

Summary of staff recommendations

4. The staff recommend that:

   (a) The discount rate for measuring liabilities to make lease payments and rights to receive lease payments should be as follows:

      (i) For a lessee, the discount rate at transition should be the incremental borrowing rate on the lessee's entire portfolio of leases.

      (ii) For a lessor, the discount rate at transition should be the discount rate charged in the lease determined at the date of commencement of the lease.

   (b) The transition exception in EITF 01-8 should not be retained.

   (c) No transition guidance is necessary for short-term leases, investment property measured at fair value, subleases, useful lives of leasehold improvements, secured borrowings, build-to-suit leases, and in-substance purchases and sales.

Staff analysis and recommendations

Discount rate for measuring liabilities to make lease payments and rights to receive lease payments

5. The proposed discount rate in the 2010 ED for transition is as follows:

> 90.(a) recognize 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**. [emphasis added]
>
> 95.(a) recognize a right to receive lease payments for each outstanding lease, measured at the present value of the remaining lease payments, **discounted using the rate charged in the lease determined at the date of inception of the lease**, subject to any adjustments required to reflect impairment. [emphasis added]

6. Some respondents identified concerns with determining a lessee's incremental borrowing rate (IBR) at transition. These respondents questioned whether the lessee should determine the IBR on an individual lease basis or on their entire

portfolio of leases basis. This question is important because an entity's IBR increases as its leverage increases, all else equal.

7. The staff identified three approaches for determining a *lessee's* IBR at transition. These IBR approaches are applicable to all of the general lessee transition approaches discussed in the staff's separate lessee transition paper, except for a full retrospective approach.

   (a) **Approach A**: Determine the IBR on the entire portfolio of leases. A lessee would determine its IBR for one obligation equal to the aggregate remaining payments for all leases.

      (i) Transition costs and complexity would be less than the other approaches because a lessee would determine the IBR once and apply that rate to all leases.

      (ii) The IBR likely would be higher than the other approaches because a lessee would be required to determine the IBR on its portfolio of leases, rather than on an individual lease basis as suggested in approaches B and C.

   (b) **Approach B**: Determine the IBR of each lease individually considering the lessee's leverage, including the cumulative effective of all leases previously commenced. The IBR would be determined from oldest lease to newest lease.

      (i) Transition costs and complexity would be more than the other approaches because a lessee would be required to determine the IBR for each lease individually taking into consideration its leverage.

      (ii) The IBR would be more accurate conceptually than the other approaches. The weighted-average IBR likely would be lower than approach A and higher than approach C.

   (c) **Approach C**: Determine the IBR of each lease individually without considering the lessee's leverage from leases previously commenced. A lessee would determine the IBR for each lease as though it were the only lease subject to transition.

(i) Transition costs and complexity would be more than approach A, but less than approach B. A lessee would be required to determine the IBR for each lease, but would not be required to determine the IBR considering its leverage from other leases.

(ii) The weighted-average IBR likely would be lower than the other approaches because a lessee is required to determine the rate without taking into account leverage from other leases.

8. The staff recommend approach A because the transition costs and complexity would be less than the other approaches. Although the IBR under approach B may be the most accurate conceptually, the benefits would not outweigh the costs, particularly for entities that have a significant number of leases (may be in the tens of thousands for some entities). Further, the IBR under approach A may not be significantly different than the weighted–average IBR under approaches B and C.

Question 1 – Lessee discount rate at transition
Do the Boards agree with the staff recommendation that a lessee's discount rate at transition should be the IBR on the lessee's entire portfolio of leases at the effective date (Approach A)?

9. The staff did not receive significant feedback regarding the discount rate to be used by *lessors* per the 2010 ED, and the staff continue to support the approach in paragraph 95(a) of the 2010 ED (refer to paragraph 5 above for the text). However, the text of the paragraph should be updated to reflect that the rate should be determined at the *date of commencement* of the lease so that it is consistent with the Boards' tentative decisions regarding lease inception versus commencement. In the March 2011 meeting (refer FASB Memo 146 / IASB Agenda paper 11B), the Boards tentatively decided to:

> 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.

Question 2 – Lessor discount rate at transition
Do the Boards agree with the staff recommendation that a lessor's discount rate at transition should be the discount rate charged in the lease determined at the date of commencement of the lease?

Transition exception in EITF 01-8 (FASB only)

10. The transition exception in EITF 01-8 is as follows:

> 16. The consensus in this Issue should be applied to (a) arrangements agreed to or committed to, if earlier, after the beginning of an entity's next reporting period beginning after May 28, 2003, (b) arrangements modified after the beginning of an entity's next reporting period beginning after May 28, 2003. ... Arrangements that are determined to be leases based on the application of this Issue are not subject to Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction," if the construction project was *committed to* prior to May 28, 2003, provided that construction has commenced by December 31, 2004.

11. Respondents requested clarification on whether or not the transition exception in EITF 01-8 would be retained in the new leases standard. One respondent wrote:

> We also note that the proposed scope includes what some believe is an important change from existing scope of current US GAAP. The transition guidance in paragraph 16 of EITF 01-8 allowed for certain transactions to be grandfathered and not evaluated under the EITF 01-8 framework unless they were subsequently modified. The transition and scope provisions of the ED appear to eliminate these grandfathering provisions. If this was the Boards' intention, we recommend that this decision is explicitly stated in the Basis for Conclusions of the final IFRS. [CL #364]

12. If the transition exception in EITF 01-8 was not retained in the new leases standard, then an entity with an arrangement that contains a lease (that was in effect before May 2003 and continued to be in effect as of the effective date) would be required to account for the lease even though it previously was not accounting for the lease due to the transition exception in EITF 01-8.

13. The staff identified two alternatives for addressing this transition issue:

    (a) **Alternative A**: Retain the aforementioned transition exception in EITF 01-8. Under this alternative, an entity would not be required to account for a lease in an arrangement within the scope of EITF 01-8 if it previously applied the transition exception in EITF 01-8.

(b) **Alternative B**: Retain the scope and transition approach in the ED (and the Boards' tentative decisions since the ED) for leases that were accounted for under EITF 01-8. Under this alternative, the transition exception in EITF 01-8 would no longer be available. Consequently, an entity would be required to account for a lease in an arrangement that contains a lease based on the facts and circumstances existing at the effective date of the new lease standard, even when it previously applied the transition exception in EITF 01-8.

14. Alternative A would reduce transition costs and complexity for an entity that has an applicable arrangement. However, the number of transactions expected to benefit from this is exception is limited because it would apply only to arrangements that existed prior to May 2003 and continued to be in effect as of the effective date of the new lease standard. In addition, the exception may add some complexity to the new leases standard because the guidance in EITF 01-8 would need to be retained in the standard indefinitely.

15. Alternative B would increase comparability because arrangements that contain leases would be accounted for in a consistent matter. The staff acknowledge that evaluating an arrangement where an entity previously applied the EITF 01-8 transition exception would require some effort. However, evaluation is consistent with a modified retrospective application approach that is applied to many other leases upon implementation of the new leases standard. For example, a lease currently accounted for as an operating lease is required to be evaluated under the leases standard and lease assets and liabilities are required to be measured and recognized on the statement of financial position.

16. This transition issue is not applicable to entities that report under IFRSs because IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, includes the following transition guidance:

> IAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying this Interpretation. If an entity uses this exemption, it shall apply paragraphs 6-9 of the Interpretation to arrangements existing at the start of the earliest period for which comparative information under IFRSs is presented on the basis of facts and circumstances existing at the start of that period.

Question 3 – Transition exception in EITF 01-8 (FASB only)
Does the Board agree with the staff recommendation that the transition exception in EITF 01-8 should not be retained (Alternative B)?

Other considerations the staff do not think warrant guidance

17. The staff considered whether transition guidance was necessary for the following considerations: short-term leases, investment property measured at fair value, subleases, useful lives of leasehold improvements, secured borrowings, build-to-suit leases, and in-substance purchases and sales. The staff concluded that guidance was not necessary because the accounting should be apparent based on the new leases standard, the accounting is addressed in other IFRSs or U.S. GAAP, and other reasons. A summary of the staff's analysis follows.

Short-term leases

18. The 2010 ED proposed the following accounting for short-term leases:

> 93. For each short-term lease that the lessee accounts for in accordance with paragraph 64, at the date of initial application a lessee shall recognize a liability to make lease payment measured at the undiscounted amount of the remaining lease payments and a right-of-use asset at the amount of the liability recognized.

19. The Boards' tentative decisions regarding short-term leases since the 2010 ED are as follows:

> 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.

20. Most short-term leases currently are accounted for as operating leases. If an entity elects the short-term lease accounting policy under the new leases standard, then the accounting treatment would be consistent with existing IFRSs and U.S. GAAP because no lease assets or liabilities would be recognized on the statement of financial position. If an entity does not elect the short-term lease accounting policy, then the entity would apply the transition guidance in

the new leases standard to recognize and measure the lease assets and liabilities. Consequently, the staff do not recommend transition guidance for short-term leases.

Investment property measured at fair value

21. In the 2010 ED, the IASB proposed a scope exception for investment property measured at fair value. In addition, the FASB added a project to its technical agenda to address the accounting requirements for investment property. In their redeliberations, the Boards tentatively decided investment properties measured at fair value would not be within the scope of the leases standard for lessor accounting.

22. The staff expect the FASB's separate project on investment property will contain transition guidance. As a result, the staff do not consider transition guidance in the new leases standard necessary for entities reporting under U.S. GAAP. The staff do not consider transition guidance in the new leases standard necessary for entities reporting under IFRSs because an entity currently following IAS 40 *Investment Properties*, would continue to apply such guidance.

23. The staff will consider consequential amendments regarding investment property and present any amendments separately to the Boards.

Subleases

24. The staff considered whether transition guidance on accounting for subleases was necessary. The staff concluded that no guidance was necessary because it should be apparent that the head lease and the sublease would be accounted for as separate transactions in accordance with transition guidance in the new leases standard. No significant feedback was received on the topic from respondents.

Useful lives of leasehold improvements

25. The staff considered whether or not transition guidance regarding the useful lives of leasehold improvements was necessary. The staff concluded that no guidance was necessary because other IFRSs and U.S. GAAP include guidance on useful lives of assets.

26. The current leases guidance in U.S. GAAP includes guidance originally published in EITF 05-6, *Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination*. EITF 05-6 addresses useful lives of leasehold improvements acquired significantly after lease commencement. The guidance is relevant under current U.S. GAAP because the lease term generally is not reassessed unless the lease terms are modified. Therefore, there potentially could be a significant difference between the remaining lease term for accounting purposes and the expected useful life of a leasehold improvement acquired significantly after lease commencement (that is, the life that management contemplated when making the leasehold improvement investment). In the new leases standard, the lease term is reassessed when measuring the lease assets and liabilities upon transition. Consequently, the staff do not think there is a transition issue associated with a potential difference between the lease term for accounting purposes and the useful lives of leasehold improvements.

Secured borrowings

27. Under current accounting in both IFRSs and U.S. GAAP, the factoring of a lease receivable can be treated as a sales transaction if the receivable is recognized by the lessor. Because a lessor does not recognize a lease receivable for operating leases under current guidance, the lessor cannot account for the sale or assignment of the lease receivable as a sale. The transaction is instead accounted for as a secured borrowing; the borrowing is secured by the assignment of future lease rentals.

28. If the Boards decide upon a retrospective approach for lessor accounting, under the ‘receivable and residual’ approach, a lessor would recognize a lease receivable for operating leases for which there previously was no recognized receivable. Thus, secured borrowings for previous operating leases would qualify for sale treatment upon transition.

29. The staff do not think transition guidance for such a transaction is needed because it should be apparent under a retrospective approach.

Build-to-suit leases

30. The staff previously concluded that the new leases standard should not have guidance related to build-to-suit leases because other IFRSs and U.S. GAAP address accounting for costs incurred before lease commencement.

31. The staff considered whether or not transition guidance is necessary for build-to-suit leases where costs were incurred, but the lease had not commenced, before the effective date of the new leases standard. The staff concluded that transition guidance is not necessary because an entity can continue to apply exiting IFRSs and U.S. GAAP until the lease commences and apply the new leases standard when the lease commences.

In-substance purchases and sales

32. The Boards' tentative decisions regarding distinguishing between a lease and a purchase or a sale are as follows:

> Guidance should not be provided in the leases standard for distinguishing a lease of an underlying asset from a purchase or 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).

33. Some respondents requested transition guidance for certain fact patterns where a determination would be required as to whether or not a transaction is within the scope of the leases standard. The staff do not think transition guidance is necessary given the Boards' tentative decisions since the ED.

Question 4 – Considerations not requiring transition guidance
Do the Boards agree with the staff recommendation that no transition guidance is necessary for short-term leases, investment property measured at fair value, subleases, useful lives of leasehold improvements, secured borrowings, build-to-suit leases, and in-substance purchases and sales?