IFRS
FASB

IASB/FASB Meeting —week commencing October 17, 2011

IASB Agenda reference: **2H**

FASB ED Session — October 14, 2011

FASB Agenda reference: **212**

Staff Paper

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Project **Leases**

Topic **Lessor Transition**

Objective

1. The purpose of this paper is to discuss the general transition requirements for lessors when implementing the proposed leases requirements. There are some transition issues that will need to be addressed for specified transactions. For example, this paper does not discuss transition requirements for sale and leaseback transactions, discount rate, etc. Those issues will be discussed in a separate memo.
2. This paper is organized as follows:
    (a) Summary of staff recommendations
    (b) Background
    (c) Summary of feedback received
    (d) Staff analysis of transition requirements for current capital/finance leases
    (e) Staff analysis of transition requirements for current operating leases
    (f) Staff analysis of uneven lease payments.
3. This paper does not discuss or intend to discuss effective dates, and any reference to effective dates is for illustrative purposes.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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.

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Summary of staff recommendations

4. The staff recommends that lessors that currently have leases classified as capital/finance leases under Topic 840, Leases, and IAS 17, *Leases*, be permitted to apply the new lease requirements on a prospective basis (applying the standard only to leases entered into after the effective date).

5. If the Boards agree with the staff recommendation that lessors that currently have leases classified as capital/finance leases under Topic 840 and IAS 17 be permitted to apply the new lease requirements on a prospective basis, some staff members recommend that lessors with existing operating leases should apply a simplified retrospective approach for transition of the new lease requirements. That would be similar to a full retrospective approach but would provide transitional reliefs. The transitional reliefs, which are discussed in a separate memo, would ease the burden of applying the proposed standard in the first year of application. However, other staff members recommend a modified approach to transition for existing operating leases in which the lessor would determine the lease receivable and residual asset on the date of initial application as opposed to lease commencement.

6. Lastly, the staff recommends that a lessor adjust the cost basis in the underlying asset derecognized at the date of initial application by the amount of any recognized prepaid or accrued lease payments.

Background

Summary of proposals in the 2010 ED

7. For lessors that applied the derecognition approach, the 2010 *Leases* Exposure Draft (ED) proposes the following in paragraph 95:

> At the date of initial application, a lessor shall:
>
> (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.

(b) recognize a residual asset at fair value determined at the date of initial application.

Interaction with other projects

Revenue recognition

8. The staff notes that in the revenue recognition project, the Boards have tentatively decided to affirm their decision in the 2010 Exposure Draft on revenue recognition that an entity should apply that proposed standard on a retrospective basis. However, to ease the burden of applying that proposed standard in the first year of application, the Boards tentatively decided to provide reliefs.

9. Additionally, an entity should apply any relief elected consistently to all transactions throughout the comparative periods.

Effective dates and transition

10. The staff has summarized the project on effective dates and transition in the lessee transition memo.

Summary of feedback received on the 2010 ED

11. Some respondents who commented specifically on lessor transition noted the interaction with revenue recognition.

> We suggest that the proposed guidance be applied prospectively for lease contracts entered into with customers on or after the effective date of the standard. Historically, other major revenue recognition standards have been applied on a prospective basis, including most recently Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements, and Update No. 2009-14, Software (Topic 985): Certain Revenue Arrangements that Include Software Elements. To address the Boards' concern regarding the preservation of trend information about leasing transactions, we suggest that entities be required to disclose information, where practicable, that enables financial statement users to understand the effects of the change in accounting principles, in the spirit of ASC 250. (CL #175)

Staff analysis of transition requirements for current capital/finance leases

12. The staff notes that paragraph 92 of the 2010 ED states the following:

> For leases that were classified in accordance with Topic 840/IAS 17 as capital leases and do not have options, contingent rentals, term option penalties or residual value guarantees, the carrying amount at the date of initial application of the right-of-use asset and the liability to make lease payments shall be the carrying amount of the lease asset and liability under that guidance.

13. The staff has recommended in the lessee transition memo that this requirement should be extended to all leases currently classified as capital/finance leases (for example, those including variable lease payments, options to extend or terminate, etc.) because the current accounting model is very similar to the proposed requirements.

14. For those lease contracts, the staff thinks that it may be appropriate for a similar relief to be permitted for lessors because they have already recorded a net lease asset on the statement of financial position that is likely to be similar to the net lease asset that would be recorded under the current proposals. Additionally, the pattern of income recognition under current guidance is similar to the proposed accounting considering the fact that full profit was only recognized when substantially all of the risks and rewards of the asset were transferred. Therefore, requiring entities to restate those lease contracts may be burdensome without providing substantially better information to users.

15. A prospective approach would allow companies to avoid the costs associated with retrospective application.

16. However, a prospective approach would create a lack of comparability both within and across companies. It also would prolong accounting treatment for leases under Topic 840/IAS 17.

17. The staff notes that current capital/finance leases are treated like a receivable, while the proposed guidance will have a total lease asset composed of a lease receivable and residual asset. The lease receivable under current guidance likely has either a small embedded residual asset or a bigger residual asset with a residual asset guarantee. Therefore, the receivable under current guidance will likely not equal the receivable under the proposed guidance because the

Boards have decided not to include residual value guarantees in the lease receivable. The staff notes this difference, but do not think that the costs of retrospective application are outweighed by the benefits of consistent treatment (presenting and disclosing the lease receivable and residual asset separately) of the less substantial residuals currently embedded in existing capital/finance leases.

Staff recommendation

18. The staff recommends that for all leases currently classified as capital/finance leases, lessors would (a) not need to restate the accounting at the date of initial application and (b) apply the proposed standard prospectively. That is because balance sheet and income statement treatment under the proposed standard is similar to that in current guidance for capital/finance leases and the staff does not think that requiring entities to restate those contracts would provide substantially better information to users and could be costly for preparers.

Question 1 – Capital/finance leases
The staff recommends that all leases currently classified as capital/finance leases should be prospectively transitioned. Do the Boards agree? If not, what approach do the Boards prefer?

Staff analysis of transition requirements for current operating leases

19. The staff has considered the following approaches for the general transition requirements for current operating leases:

    (a) Approach A: Simplified retrospective approach

    (b) Approach B: Modified retrospective approach

    (c) Approach C: Optional full retrospective approach, otherwise Approach B.

20. The staff has rejected the approach proposed in the 2010 ED for the transition of lessors because of the Boards’ decisions on measurement of the residual asset. Under the approach proposed in the 2010 ED, the lessor would recognize a residual asset at fair value determined at the date of initial application.

Recognizing the residual asset at fair value would be inconsistent with the receivable and residual model because it would result in the recognition of margin on both the lease payments and the residual asset; the Boards have decided not to recognize margin that is related to the residual asset at any point during the lease term.

21. Additionally, the staff has rejected a prospective approach (applying the standard only to leases entered into after the effective date) for the transition requirements for lessees. That is because, although that approach would be less costly and easier to apply, the accounting for leases after the effective date would not be comparable and would be inconsistent with the Boards' tentative decisions on revenue recognition. The staff also notes that the lessor operating lease accounting under Topic 840 / IAS 17 is significantly different from the tentative decisions on the proposed lessor model from both a balance sheet and an income statement perspective.

22. Topic 250, Accounting Changes and Error Corrections, and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, provide guidance for (a)determining whether retrospective application of a change in accounting principle is impracticable and (b) 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 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. However, the staff has also rejected a full retrospective approach consistent with the requirements in Topic 250 and IAS 8 because it thinks that this approach would be time consuming and burdensome for preparers without providing users with significantly more useful information than a simplified approach (Approach A) or a modified retrospective approach (Approach B).

Approach A: Simplified retrospective approach (full retrospective with reliefs)

23. Approach A would require lessors to transition using a full retrospective approach consistent with the requirements in Topic 250 and IAS 8. That is, entities would be required to calculate the carrying amounts of all outstanding leases as if those leases had always been accounted for in accordance with the proposed requirements. However, under a simplified retrospective approach, entities could elect certain reliefs to ease the burden of transition in the first year of application. Those reliefs are discussed in a separate memo.

24. The staff thinks that a full retrospective approach would provide the best comparative information and is the best starting point from which to apply the new requirements. However, the staff notes that some constituents (mostly preparers) think that the benefits of the information provided in a full retrospective approach would not outweigh the costs. Therefore, similar to the Boards' tentative decisions in the revenue recognition project, the staff thinks it would be possible to reduce the costs of transitioning by providing some relief (for example, not requiring restatement of arrangements that have ended prior to the effective date). Providing some reliefs would create consistent transition requirements between the leases project and the revenue recognition project. Additionally, to reduce the costs of transition for preparers, the staff thinks that this concern could be reduced by allowing appropriate time between the issuance of the final standard and the effective date.

25. Some argue that applying any type of retrospective approach may be difficult when there are estimates and judgments involved. However, the staff thinks that it is important to note that, during redeliberations, the Boards have simplified the recognition and measurement requirements (for example, variable lease payments and lease term). Those simplifications should reduce the amount of judgment and costs associated with applying the new requirements retrospectively. That concern also can be mitigated by providing a relief similar to the relief tentatively decided for revenue recognition to allow the use of hindsight in estimating certain assumptions and judgments such as lease term and variable consideration.

Approach B: Modified retrospective approach

26. Approach B would require lessors to transition using a modified retrospective approach. Approach B is similar to the transition requirements under the derecognition approach in the 2010 ED on the lease receivable, but differs on the measurement of the residual asset.

Lease receivable

27. Under Approach B, the lease receivable would be calculated at the date of initial application that is equal to the present value of the remaining minimum lease payments, subject to any adjustment required to reflect impairment, and consistent with the 2010 ED proposals.

Residual asset

28. As previously mentioned, the 2010 ED requires lessors to recognize a residual asset at fair value that is determined at the date of initial application.

29. Under Approach B, the residual asset would be measured consistent with the tentative decisions the Boards have made to date on the measurement of the residual asset. That is, the lessor would initially measure the residual asset based on whether or not profit is reasonably assured. When profit is reasonably assured, the residual asset is measured using the cost allocation formula (cost – cost x present value of remaining minimum lease payments / fair value of underlying at the date of initial application). When profit is not reasonably assured, the residual asset is measured as cost less the present value of remaining minimum lease payments at the date of initial application. For existing operating leases, the cost of the underlying asset at transition would be the net carrying amount of the underlying asset at the date of initial application.

30. For example, if transitioning in the fourth year of a 10-year operating lease, with yearly payments of 1,000CU and a discount rate of 5.7 percent, the lessor would calculate the residual asset at the date of initial application as 4,878 for a profit "reasonably assured" scenario and 4,733 for a profit "not reasonably

assured" scenario.

Lease term	10 years
Date of original lease commencement	1/1/X1
Date of initial application (transition)	1/1/X5
Net underlying asset (end of Y4), A/D of (1,800)	9,700
Salvage value (end of Y10)	7,000
Annual fixed payment	1,000
Fair value of underlying asset (end of Y4)	9,992
Reasonably assured	
Lease receivable	4,967
Residual asset	
= Cost - Cost x (PV(lease pmts)/ FV of underlying)	
= 9,700 - 9,700 x (4,967/9,992)	4,878
Net lease asset (1/1/X5)	9,845
Not reasonably assured	
Lease receivable	4,967
Residual asset	
= Cost - PV(lease pmts)	
= 9,700 - 4,967	4,733
Net lease asset (1/1/X5)	9,700

31. The staff notes that knowledge of the fair value of the underlying asset is necessary to perform the cost allocation in "reasonably assured" scenarios and that the fair value may not be known in the "not reasonably assured" scenarios. The modified approach would use the fair value at the date of initial application whereas Approach A would require the lessor to compute the fair value at lease commencement, which would further increase the cost of Approach A relative to Approach B.

Operationality

32. The staff thinks that Approach B may be simple to apply to operating leases because lessors still have a cost-based value for the underlying asset on their books.

33. Additionally, Approach B provides useful information in a manner that is practical for preparers while providing comparative information consistent with the lessor model. Additionally, some think that the costs of a simplified

retrospective approach (Approach A) would be excessive and that the benefits provided by the information provided would not outweigh the costs.

34. However, the staff notes that Approach B may create incomparable information that may not be as useful to users as full retrospective information.

Approach C: Optional full retrospective; otherwise Approach B

35. If the Boards prefer Approach B (see paragraphs 26-34), Approach C allows preparers an option to choose either the full retrospective approach as required by Topic 250 and IAS 8 or a modified (Approach B) retrospective approach. That approach would be an election that would need to be applied consistently to all lease arrangements, rather than an option to just apply to some lease arrangements.

36. Although Approach C may provide relief for preparers, it may create incomparability between entities that choose to apply a full retrospective approach and entities that choose to apply a modified retrospective approach. Feedback from users suggests that they are opposed to allowing a choice for transition because of comparability concerns. However, some staff members think that Approach A also allows an option and that an entity could explain in disclosures which transition approach they have applied.

37. Additionally, the staff notes the impracticability guidance in Topic 250 and IAS 8 and thinks that any lack of information about old leases or leases acquired in a business combination would be covered by such a provision.

Staff recommendation

38. All staff members agree that a full retrospective approach gives users of financial statements the best and most comparative information.

39. However, some staff members recommend that lessors should apply a simplified retrospective approach (Approach A) for transition of the new lease requirements. That would be similar to a full retrospective approach but would provide transitional reliefs. The transitional reliefs (discussed in a separate memo) would ease the burden of applying the proposed standard in the first year of application. Those staff members acknowledge the cost concerns of

preparers but do not think that any form of a modified retrospective approach would be any less costly than a full retrospective approach with reliefs. In addition, those staff members note the simplifications to the recognition and measurement requirements when compared to the proposals in the 2010 ED, which should reduce the burden of applying a retrospective approach. The staff also thinks that lessor transition should be consistent with revenue recognition transition.

40. Furthermore, the staff notes comments made by some respondents in which they expect users to request retrospective information regardless of whether it is included in the financial statements. Additionally, the staff thinks that Approach A provides treatment that is more representationally faithful to the lease contract than a modified retrospective approach.

41. However, other staff members recommend Approach B (modified retrospective approach). Those staff members think that Approach B may be easier to apply than Approach A while still providing a meaningful approximation of Approach A and minimizing cost to the lessor. Furthermore, those staff members think that the costs necessary to retrospectively transition in Approach A would not provide substantially better information to users.

42. Proponents of Approach B acknowledge the Boards' decisions on revenue recognition to require full retrospective transition; however, the staff notes differences in the length of lease contracts compared to the length of revenue contracts. Lease contracts are generally longer and, therefore, the costs associated with a simplified retrospective approach (Approach A) or a full retrospective transition for those contracts may be greater than for most revenue contracts. Additionally, the information to determine the fair value of the underlying asset at lease commencement necessary for Approach A or a full retrospective approach may require significant cost to the lessor or even be unavailable.

43. The staff recommends that, for whichever approach the Boards decide is appropriate, transition reliefs should be granted to ease the potential burdens of transition, similar to those provided in the revenue recognition project. Those reliefs are discussed in a separate memo.

Question 2 – Operating leases
Which transition approach do the Boards prefer?

Staff analysis of uneven lease payments

44. The 2010 ED proposes the following in paragraph 91 for lessees with uneven lease payments:

> When lease payments are uneven over the lease term, a lessee shall adjust the right-of-use asset recognized at the date of initial application by the amount of any recognized prepaid or accrued lease payments.

45. The staff thinks that guidance also should be provided for lessors that have received uneven lease payments. Therefore, the staff recommends that when lease payments are uneven over the lease term, a lessor should adjust the cost basis in the underlying asset that is derecognized at the date of initial application by the amount of any recognized prepaid or accrued lease payments.

Question 3 – Uneven lease payments
Do the Boards agree with the staff recommendation that the lessor should adjust the cost basis in the underlying asset that is derecognized at the date of initial application by the amount of any recognized prepaid or accrued lease payments?