STAFF PAPER

September 20-27, 2012

FASB | IASB Joint Meeting

IASB Education Session September 20, 2012

Project	**Leases**		
Paper topic	Sweep Issues: SLE Approach and Lease Classification		
CONTACT(S)	Cullen Walsh	cdwalsh@fasb.org	+1 203 956 5354
	Lisa Muehlbauer	lamuehlbauer@fasb.org	+1 203 956 5258

Objective

1. This paper seeks the Boards' views on the following sweep issues:

   (a) impairment of the right-of-use (ROU) asset under the single lease expense (SLE) approach;

   (b) whether the intent under the SLE approach is for the total expense to be recognized on a straight-line basis only or whether another systematic basis should also be allowed;

   (c) the timing of the lease classification test, and whether the intent was that this would be performed at commencement only; and

   (d) whether the lease classification test for subleases should be based on the ROU asset or the asset that is leased.

2. These issues, which require further discussion or clarification, were identified when drafting the forthcoming revised exposure draft (ED) on Leases.

Summary of staff recommendations

3. The staff recommends that:

   (a) When the ROU asset is impaired, the ED should include guidance on how to recognize the remaining lease expense.

      (i) When the ROU asset is fully impaired (ie written down to zero), the lessee should recognize the remaining lease expense in each period in an amount equal to the periodic unwinding of the discount on the lease liability.

      (ii) When the ROU asset is partially impaired, the lessee should recognize the remaining lease expense in each period in an amount equal to (a) the periodic unwinding of the discount on the lease liability plus (b) an even allocation of the remaining ROU asset balance over the remaining lease term.

      (iii) In both of those circumstances, the lessee should present lease expenses recognized in the remaining periods in accordance with the SLE approach.

   (b) A lessee with leases accounted for under the SLE approach be permitted to recognize total expense using a straight-line basis, unless another systematic basis is more representative of the pattern in which use is expected to be derived from the underlying asset.

   (c) An entity should determine lease classification at lease commencement only.

   (d) For the purpose of lease classification test in a sublease, an entity should consider the underlying asset to be the asset that is leased, and not the ROU asset.

Structure of this paper

4. The structure of this paper is as follows:

   (a) Issues relating to the SLE approach

      (i) Accounting after impairment of the ROU asset (paragraphs 6-12)

(ii) Lease expense recognition pattern (paragraphs 13-15)

(b) Issues relating to the classification of leases

(i) Date of assessment (paragraphs 16-19)

(ii) The underlying asset in a sublease (paragraphs 20-29)

5. The appendix of this paper contains an example of SLE ROU asset impairment.

Issue 1: SLE approach—accounting after impairment of the ROU asset

6. When a lessee is not expected to consume a more than insignificant portion of the economic benefits embedded in the underlying asset during the lease term, a lessee allocates the total cost of the lease evenly over the lease term, following the SLE approach. The lessee calculates amortization on the ROU asset in each period as the difference between the total lease expense recognized on a straight-line basis and the periodic unwinding of discount on the lease liability. The lessee measures the lease liability similarly to other financial liabilities.

7. In addition, the ROU asset is assessed for impairment using the existing impairment guidance for non-financial assets in U.S. GAAP and IFRSs.

ROU asset is fully impaired

8. If the ROU asset is fully impaired (this is, written down to CU 0), the staff do not think that a lessee should continue to recognize a straight-line total lease expense. This is because it often would require the lessee to recognize another asset to facilitate the recognition of a straight-line expense pattern in each period for the remaining lease term. The staff think such an approach would be inconsistent with the notion of impairing the ROU asset. In other words, why would a lessee be required to recognize impairment on the ROU asset when another asset would be recognized following the impairment? Consequently, the staff recommend that when the ROU asset is fully impaired, the lessee should recognize the remaining lease expense (the total cost of the lease less the amount of lease expense recognized up to and

including the impairment event) in each period in an amount equal to the periodic unwinding of discount on the lease liability. The lessee would continue to measure the lease liability, and present lease expenses recognized, in accordance with the SLE approach. An example illustrating the staff recommendation is included in the appendix to this paper.

ROU asset is partially impaired

9. The staff considered whether a straight-line expense pattern would be appropriate after a partial impairment of the ROU asset (this is, written down to an amount greater than CU 0). When a lessee partially impairs the ROU asset, the lessee would not necessarily have to recognize another asset to continue to recognize a straight-line lease expense because there would be a ROU asset remaining on the balance sheet following a partial impairment. However, that straight-line expense recognized each period after the impairment event would be lower than the straight-line expense prior to the impairment because impairment of the ROU asset has already been recognized. Consider the partial impairment example in the appendix to this paper. After the lessee recognizes a partial impairment of $223 at the beginning of year 3, one approach would be for the lessee to recognize a straight-line total lease expense in years 3 through 5 of $45.62 (calculated as $600 in total payments less expenses already recognized of $240 less impairment of $223, divided by the remaining 3 years).

10. However, the staff are not recommending this approach. This is because, in some situations, the lessee would need to increase the ROU asset to achieve a straight-line expense pattern for the remaining lease term. For example, if a significant portion of the ROU asset balance is impaired in the early part of a lease, the lessee may have to recognize another asset (or write up the ROU asset) in order to recognize a straight-line expense over the remaining lease term, without changing the measurement of the lease liability (for example, using the example in the appendix to this paper, this would be the case if the ROU asset were impaired by $400 at the end of year 1). For the same reasons as noted above in paragraph 8, the staff think this approach would not be

appropriate because it is inconsistent with the notion of impairing the ROU asset. In addition, if the accounting were different for full and partial impairments of ROU assets, then reasonably similar impairment events (for example, one with a full impairment and one with a partial impairment for 95% of the ROU asset) could have different accounting outcomes.

11. Consequently, the staff recommend that when the ROU asset is partially impaired, the lessee should recognize the remaining lease expense in each period in an amount equal to (a) the periodic unwinding of discount on the lease liability plus (b) an even allocation of the remaining ROU asset balance over the remaining lease term. The lessee would continue to measure the lease liability, and present lease expenses recognized, in accordance with the SLE approach. An example illustrating the staff recommendation is included in the appendix to this paper.

12. A common scenario where an impairment test may be required is when a lessee decides to cease using a leased asset before the end of the lease term. For example, assume a lessee enters into a 10-year lease of a building. At the end of year 6, the lessee makes a decision to stop using the building at the end of year 8. The lessee is required to make the contractual lease payments after it ceases use of the asset. Assume that the lessee accounts for the lease under the SLE approach. At the end of year 6 when the entity decides to cease using the leased asset before the end of the lease term, the entity may conclude there is an impairment triggering event. At the time when the leased asset is being used, the leased asset is likely to be considered to be part of a larger asset group or cash generating unit. Consequently, when testing the ROU asset for impairment at the end of year 6, there may be no impairment at that time, and the entity would continue to follow the SLE approach. At the end of year 8 when the entity ceases using the asset, the entity may conclude there is, again, an impairment triggering event. At the time when the entity ceases using the leased asset, the ROU asset may be its own asset group or cash generating unit. The staff think that when the entity ceases to use the asset, in some circumstances, there may be no impairment and, in other circumstances, there would be impairment. For example, if the entity were not permitted to sublease the asset or the estimated sublease income

was less than the ROU asset balance, then there likely would be impairment. Consequently, the entity would recognize an impairment of the ROU asset and then follow the guidance above for accounting for the lease after an impairment. If the entity concluded there was no impairment, then the entity would continue to follow the SLE approach to the end of the lease.

Question 1

Do the Boards agree with the following staff recommendations:

-When the ROU asset is fully impaired, the lessee should recognize the remaining lease expense in each period in an amount equal to the periodic unwinding of the discount on the lease liability. The lessee should present lease expenses recognized in the remaining periods in accordance with the SLE approach.

-When the ROU asset is partially impaired, the lessee should recognize the remaining lease expense in each period in an amount equal to (a) the periodic unwinding of the discount on the lease liability plus (b) an even allocation of the remaining ROU asset balance over the remaining lease term. The lessee should present lease expenses recognized in the remaining periods in accordance with the SLE approach.

Issue 2: SLE approach—lease expense recognition pattern

13. The Boards tentatively decided that, under the SLE approach, a lessee allocates the total cost of a lease evenly over the lease term, which results in the recognition of a straight-line lease expense.

14. Typically under U.S. GAAP and IFRSs, an entity is permitted to allocate the cost of a non-financial asset to the income statement on a straight-line basis *or* another systematic basis if that other systematic basis is more representative of the pattern in which use is expected to be derived from the asset. The Boards have tentatively decided that this is permitted when allocating the cost of a ROU asset under the interest and amortization (I&A) approach. IAS 17 *Leases* and Topic 840 *Leases* also permit a lessee to recognize lease payments arising from operating leases as an expense on a systematic basis other than straight-line if that other systematic basis is more representative of the pattern in which use is derived from the asset.

Although we would expect the vast majority of lessees to recognize lease expenses arising under the SLE approach on a straight-line basis, the staff see no reason to prevent a lessee from using another systematic basis if that other basis is more representative of the pattern in which use is expected to be derived from the asset. This would be more consistent with the accounting for other assets and be more consistent with the pattern of usage. Consequently, the staff recommend that the leases standard should permit a lessee to use another systematic basis if that basis is more representative of the pattern of use (for example, hours or miles used, units of production) when accounting for leases under the SLE approach.

Question 2
Do the Boards agree with the staff recommendation that a lessee with leases accounted for under the SLE approach be permitted to recognize total lease expense on a straight-line basis, unless another systematic basis is more representative of the pattern in which use is expected to be derived from the underlying asset?

Issue 3: Lease Classification Test—date of assessment

15. In June 2012, the Boards' tentatively decided that, for each lease, a lessee and lessor would determine whether the lessee is expected to consume a more than insignificant portion of the economic benefits embedded in the underlying asset during the lease term. The staff paper and Board discussion did not explicitly address when a lessee and lessor would perform that classification test.

16. The staff think the Boards intended for the lease classification test to be performed at lease commencement only and the classification would not be reassessed subsequently if there were a change in the assessment of the lease term.

17. For example, assume a lessee enters into a lease with a 5-year non-cancellable period and a 3-year optional renewal period. At lease commencement, the lessee concludes that it does not have a significant economic incentive to exercise the 3-year optional renewal. Consequently,

the lease term would be 5 years and the lessee would measure the lease liability based on the 5-year lease term. Three years after lease commencement, assume that the lessee reassesses the lease term and now concludes that it has a significant economic incentive to exercise the 3-year optional renewal period. As a result, the lessee would be required to remeasure the lease liability. The staff do not think the lessee should be required to reassess the lease classification at the time it changes its assessment of the lease term.

18. The staff think ongoing reassessment of the lease classification would add cost and complexity to accounting for leases that is likely to outweigh the benefits. The staff do not expect the lessee's or lessor's assessment of the lease term to change frequently because it would require a change (from factors other than market-based factors) in whether the lessee has or does not have a 'significant economic incentive' to exercise the option. The staff view this as a relatively high hurdle and, as such, we do not see any real benefit in adding complexity to the requirements that, in practice, will have little effect. In addition, the staff observe that under current U.S. GAAP and IFRSs, a lessee and lessor perform a lease classification test to determine whether a lease should be accounted for as an operating lease or a capital/finance lease only at lease inception—existing leases guidance does not require reassessment of the lease classification if the entity changes its assessment of the lease term.

Question 3

Do the Boards agree with the staff recommendation that an entity should determine lease classification at lease commencement only?

Issue 4: Classification of leases—the underlying asset in a sublease

19. In a sublease, an entity will be both a lessee and a lessor for the same underlying asset. For example, an entity may lease a building from one party (the head lease) and then sublease the same building to another party (the sublease).

20. Under the Boards' tentative decisions, the entity would account for each lease separately – it would account for the head lease as the lessee and the sublease as the lessor. The entity would be required to perform two separate lease classification tests – one at the commencement of the head lease and one at commencement of the sublease.

21. The underlying asset in a sublease is the ROU asset, and not the (underlying) asset being leased. Accordingly, the staff had previously concluded that, when performing the lease classification test for a sublease, the sublessor would consider the underlying asset to be the ROU asset and not the underlying asset. This would mean that in classifying the lease the sublessor would compare the lease term (of the sublease) to the remaining life of the ROU asset rather than the economic life of the asset being leased. Because of this, the sublessor would be more likely to conclude that it should apply the receivable and residual approach to subleases, rather than recognizing rental income over the sublease term.

22. The staff has identified a number of issues with this approach. The first issue is that the lessee in the sublease may not be aware of the term of the head lease. Consequently, the lessee may refer to the economic life of the asset being leased when classifying the sublease, rather than the term of the head lease. Alternatively, this approach may require the lessee to obtain information about the head lease from the sublessor.

23. The second issue is that the lessee/sublessor could classify the head lease and the sublease differently. The lessee in a head lease could classify the head lease under the SLE approach and the sublease under the I&A approach (requiring the lessee/sublessor to apply the receivable and residual approach to the sublease). For example, assume a lessee enters into a head lease of a building for 15 years. The building has an economic life of 50 years and the lessee classifies the lease under the SLE approach. After using the building for 10 years, the lessee/sublessor decides to sublease the building for the remaining 5 years of the head lease. If the sublessor considers the underlying asset to be the ROU asset arising from the head lease, the sublessor would account for the sublease under the receivable and residual approach.

24. Under the receivable and residual approach, the lessee/sublessor would derecognize the ROU asset, and consistent with the staff recommendation on Issue 1 (refer to paragraphs 6-12 of this paper), the lessee/sublessor would no longer recognize a straight-line lease expense on the head lease. Instead, it would recognize a lease expense at an amount equal to the periodic unwinding of the discount on the lease liability. As the sublessor, it would recognize interest income on the sublease. Although the interest income and lease expense recognized would both typically decline over the remaining lease term, the lessee/sublessor cannot present that interest income and lease expense under the same caption in the income statement.

25. The third issue is that the lessee/sublessor may apply two different accounting approaches to two similar leases, solely because one of those leases relates to an asset that is leased whereas the other relates to an asset that is owned. For example, assume that the lessee/sublessor in the example in paragraph 24 above also leases a similar building to another party on the same date as it enters into the sublease. The second lease is also for 5 years, with similar lease payments to those included in the sublease mentioned above. The main difference between those leases is that the lessor owns the building that it is leasing in the second lease. The lessor is likely to conclude that it can apply an approach similar to current operating lease accounting to the second lease. Consequently, it would not derecognise the building and would recognize rental income over the lease term, on a typically straight-line basis, for the second lease. In contrast, for the sublease, it would recognize interest income over the lease term, which would be lower than the rental income recognized on the second lease and would typically decline over the lease term. In this situation, it may be difficult to explain to users of its financial statements why the accounting for both of these 5-year leases of similar buildings is different.

26. Others think that a consequence of the ROU leases model developed is that the underlying asset in a sublease is the ROU asset, and this should not be different when classifying leases. When considering the example in paragraph 23, they would note that, having entered into the sublease for the remaining 5 years of the head lease, the sublessor no longer has a right to use the building. It has, in effect, 'sold' that right-of-use to the sublessee. Consequently, they think it is

more appropriate for the sublessor to derecognise the ROU asset in this situation.

27. Supporters of this approach note that, in this situation, the declining lease expense being recognized by the sublessor on the head lease is offset by the declining interest income being recognized on the sublease (although the amounts may not be exactly the same and they would not be presented in the same line in the financial statements). Accordingly, accounting for the sublease under the receivable and residual approach would not create inconsistent accounting for the head lease and sublease within the sublessor's financial statements. In addition, in the situation described in paragraph 25 above, they think that the lessor is in a different economic position depending on whether it owns or leases the asset that, in turn, it leases to other parties. In one lease, the lessor owns the underlying asset. In the other, the lessor has only a right to use the asset for a period of time, and has transferred that right to another party via the sublease.

28. On balance, the staff think that the accounting described above, that results from considering the ROU asset to be the underlying asset when classifying subleases, may not provide decision-useful information to users of financial statements. It would also be more complicated to apply (for example, the sublessor would be required to calculate a discount rate relating to the sublease which it otherwise would not be required to). Consequently, the staff recommend that, for the purposes of classifying leases, a lessee and lessor should consider the underlying asset to be the asset that is leased, and not the ROU asset.

Question 4

Do the Boards agree with the staff recommendation that, for the purpose of lease classification, an entity should consider the underlying asset to be the asset that is leased, and not the ROU asset?

APPENDIX—Accounting under the SLE approach after impairment of the ROU

Assumptions:	
Lease term in years	5
Interest rate	5.00%
Impairment event is at the beginning of Y3	

Payment Schedule	
Y1	100
Y2	110
Y3	120
Y4	130
Y5	140
Total	600

NO IMPAIRMENT

Year	0	1	2	3	4	5	
Balance Sheet							
Liability	$515.32	$441.08	$353.14	$250.79	$133.33	$0.00	
ROU asset	$515.32	$421.08	$323.14	$220.79	$113.33	($0.00)	
Income Statement							Total
Lease expense - unwinding discount		$25.77	$22.05	$17.66	$12.54	$6.67	85
Lease expense - ROU		$94.23	$97.95	$102.34	$107.46	$113.33	515
Total Expense		120	120	120	120	120	600

FULL IMPAIRMENT

Year	0	1	2	Beg of year 3	3	4	5	
Balance Sheet								
Liability	$515.32	$441.08	$353.14	$353.14	$250.79	$133.33	$0.00	
ROU asset	$515.32	$421.08	$323.14	0				
Income Statement								Total
Lease expense - unwinding discount		$25.77	$22.05	$0.00	$17.66	$12.54	$6.67	85
Lease expense - ROU		$94.23	$97.95	$0.00				192
Impairment		$0.00	$0.00	$323.14				323
Total Expense		$120.00	$120.00	$323.14	$17.66	$12.54	$6.67	600

PARTIAL IMPAIRMENT

Year	0	1	2	Beg of year 3	3	4	5	
Balance Sheet								
Liability	$515.32	$441.08	$353.14	$353.14	$250.79	$133.33	$0.00	
ROU asset	$515.32	$421.08	$323.14	$100.00	$66.67	$33.33	$0.00	
Income Statement								Total
Lease expense - unwinding discount		$25.77	$22.05	$0.00	$17.66	$12.54	$6.67	85
Lease expense - ROU		$94.23	$97.95	$0.00	$33.33	$33.33	$33.33	292
Impairment		$0.00	$0.00	$223.14	$0.00	$0.00		223
Total Expense		$120.00	$120.00	$223.14	$50.99	$45.87	$40.00	600