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STAFF PAPER

February 20, 2013

FASB | IASB Meeting

IASB education session February 18-20, 2013
FASB education session February 13, 2013

Project	**Leases**		
Paper topic	Sweep Issue—Transition		
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Background and Objective of the Paper

1. Several external review comments requested that the Boards provide additional guidance within the revised Leases Exposure Draft about the tentative decision regarding the transition of leases that are currently classified as finance leases under IAS 17 *Leases* and as capital/sales-type/direct finance leases under Topic 840, Leases. As the staff reviewed the Boards' tentative decision, the staff considered several ways that current capital/finance leases could be transitioned to the new leases guidance. This paper suggests improvements to the leases guidance to clarify the transition from current capital/finance leases to the proposed leases guidance.

2. This paper is structured as follows:

   (a) Staff Analysis

   (b) FASB-Only—Leveraged Leases

   (c) Questions for the Boards.

Staff Analysis

3. The external review draft of the proposed Leases Exposure Draft indicated the following for transitioning from current capital/finance leases to the proposed new leases guidance:

Lessees

> C9. For leases that were classified as [IASB: finance/FASB: capital] leases in accordance with [IASB: IAS 17/FASB: Topic 840], the carrying amount at the date of initial application of the right-of-use asset and the lease liability shall be the carrying amount of the lease asset and liability immediately before that date in accordance with [IASB: that Standard/FASB: Topic 840].

Lessors

> C11. For Type 2 leases, the carrying amount of the underlying asset and any lease assets or liabilities at the date of initial application shall be the same as the amounts recognized by the lessor immediately before the date of initial application in accordance with [IASB: IAS 17/FASB: Topic 840].
>
> C12. For Type 1 leases that were classified as [IASB: finance/FASB: capital] leases in accordance with [IASB: IAS 17/FASB: Topic 840], the sum of the carrying amounts of the lease receivable and the residual asset at the date of initial application shall be the carrying amount of the net investment in the lease immediately before that date in accordance with [IASB: that Standard/FASB:: Topic 840].

4. The staff has identified three approaches for the Boards to consider to provide additional clarity about how to transition current capital/finance leases to the new Leases Exposure Draft. The staff notes that the Boards also decided to permit, but not require, a fully retrospective transition to the new leases guidance.

View A—Grandfather current capital/finance leases

5. Both a lessee and lessor would continue to apply existing standards (that is, IAS 17 / Topic 840) to leases classified as capital/finance leases in terms of recognition and measurement. A lessee would reclassify any lease assets arising

from capital/finance leases as right-of-use assets and treat them as Type 1 leases for presentation and disclosure purposes. A lessor would treat any lease receivables arising from capital/finance leases as Type 1 lease receivables for presentation and disclosure purposes.

6. The following are the advantages of this approach:

   (a) Relief would be provided to lessees and lessors who already account for their leases as capital/finance leases. Respondents to the 2010 Exposure Draft and participants at outreach meetings are supportive of providing transition relief for those leases, particularly in light of the changes proposed to the measurement of lease assets and liabilities (that is, the proposed accounting for variable lease payments and lease payments in optional periods is similar to how those amounts are accounted for in existing standards).

   (b) Because of the similarity between the accounting for current capital/finance leases under existing guidance and the proposed new guidance, there may be little benefit for users of financial statements from requiring an entity to apply the new proposals to those leases. Consequently, the costs of applying the new proposals to those leases may outweigh any additional benefit for users. For example, one of the main differences between the proposals and the existing accounting for finance/sales-type/direct finance leases is that a lessor would recognise a lease receivable and a residual asset under the proposals whereas, under existing guidance, a lessor would only recognise a receivable (which would embed any residual asset). Nonetheless, because the residual asset relating to a lease currently classified as a finance/sales-type/direct finance leases would be expected to be relatively insignificant, there may be little benefit in requiring a lessor to separate any residual asset from the lease receivable.

7. The following are the disadvantages of this approach:

(a) At least some, if not all, of the existing guidance in IAS 17/Topic 840 would need to be maintained/carried forward. If the boards did not wish to retain existing guidance in IAS 17/Topic 840, the staff is of the view that the proposed leases standard could include, for example, some guidance to state that an entity would continue to account for the lease liability (lessee) or the lease receivable (lessor) arising from a capital/finance lease using the amortised cost basis already applied, subject to impairment testing.

(b) There would be a lack of comparability going forward between the accounting for leases that are grandfathered under existing lease guidance and leases that are accounted for under any new lease guidance. That lack of comparability could continue for many years. For example, there is a difference for lessees in accounting for residual value guarantees under the existing requirements in which the maximum amount payable under a residual value guarantee is included in the minimum lease payments and under the proposed guidance in which only the amount expected to be paid is included in the obligation. Similarly, lease receivables would be measured differently under the proposed guidance (residual value guarantees are not included in the lease receivable) than under existing guidance, which includes residual value guarantees in the measurement of the lease receivable.

View B—Reclassify current carrying amounts and then apply the new leases guidance to those amounts

8. For leases classified as capital/finance leases under IAS 17/Topic 840, the carrying amounts of lease assets and liabilities on the date of transition are the carrying amount of lease assets and liabilities on that date measured in accordance with IAS 17/Topic 840. However, from the day after transition (day 2), the new proposals are applied.

9. The following are the advantages of this approach:

(a) There would be no need to carry forward the existing lease guidance in IAS 17/Topic 840.

(b) All leases would be accounted for on an ongoing basis under the new leases guidance as of the date of initial application, which would provide comparability.

(c) Some relief would be provided to lessees and lessors in that they would not have to retrospectively apply the new leases guidance as of the lease commencement date. For example, lessees and lessors would not have to remeasure any lease assets or lease liabilities for initial measurement upon transition to the new leases guidance.

10. The following are the disadvantages of this approach:

(a) Any potential relief provided to lessees and lessors on transition to the new leases guidance may only provide one day of relief because adjustments would need to be made on day 2 for subsequent accounting. For example, the following adjustments may be required:

(i) A day 2 adjustment for leases with residual value guarantees (that is, under capital/finance lease accounting, the lessee and lessor would account for the maximum amount of the guarantee whereas under the proposals, only the estimated amount payable is included for the lessee and many RVGs are excluded from the receivable for the lessor)

(ii) A day 2 adjustment for lessors regarding any residual asset embedded in the lease receivable—on day 1, there is no requirement to recognise a residual asset; on day 2, that residual asset would need to be recognised.

(b) External review comments suggest that, under this approach, additional guidance would be needed on how to account for the day 2 adjustments. The potential complexity introduced by that additional guidance could call into the question whether there is any benefit from providing such relief for capital/finance leases. That is, it may be easier to apply the proposals retrospectively than apply this approach.

View C—Modified Retrospective Transition

11. View C would require a lessee and lessor to apply the same transition guidance to current capital/finance leases as is applied to other leases. That would mean that there would not be different transition guidance for current capital/finance leases. Therefore, on the date of initial application, lessees and lessors would derecognize any lease assets and lease liabilities measured under existing lease requirements and recognize lease assets and lease liabilities on a modified retrospective basis.

12. Therefore, the guidance for lessors in the proposed new guidance would be consistent with paragraph C10 in the external review draft, modified as follows:

> At the date of initial application for each Type 1 lease, a lessor shall:
>
> a. Derecognize the underlying asset (if applicable). A lessor shall adjust the carrying amount of the underlying asset derecognized by the amount of any previously recognized prepaid or accrued lease payments.
>
> b. Derecognize any net investment in the lease (if applicable).
>
> c. Recognize a lease receivable measured at the present value of the remaining lease payments, discounted using the rate the lessor charges the lessee determined at the commencement date, subject to any adjustments required to reflect impairment.
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> d. Recognize a residual asset according to the initial measurement guidance in paragraph [70], using information available at the date of initial application.
>
> e. Recognize any difference as an adjustment to retained earnings on the date of initial application of the proposed leases guidance.

13. The guidance for lessees in the proposed new guidance would be consistent with the external review draft modified as follows:

> C7. At the date of initial application a lessee shall recognise:

a. a lease liability, measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate at the effective date (see paragraph C8). [FASB: Nonpublic entities are permitted to use a risk-free discount rate with a term comparable to that of the lease term as an accounting policy election for all leases.]

b. for each Type 1 lease, a right-of-use asset measured as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined in accordance with paragraph C7(a). The applicable proportion is the remaining lease term at the date of initial application relative to the total lease term. A lessee shall adjust the right-of-use asset recognised by the amount of any previously recognised prepaid or accrued lease payments.

c. for each Type 2 lease, a right-of-use asset measured at an amount that equals the lease liability. If lease payments are uneven over the lease term, a lessee shall adjust the right-of-use asset recognised by the amount of any previously recognised prepaid or accrued lease payments.

C8. A lessee can apply a single discount rate to a portfolio of leases with reasonably similar characteristics (eg a similar remaining lease term for a similar underlying asset). The lessee shall consider its total financial liabilities, including leases in other portfolios, when calculating the discount rate for each portfolio of leases.

14. This approach has the following advantages:

(a) There is some relief provided because an entity would not have to go back and retrospectively apply the new leases guidance as of the date of commencement for each outstanding lease. Under a full retrospective approach, an entity would have to determine what the lease assets and liabilities would have been upon the date of initial application as if the new guidance had always been in place. That may be difficult for very long-term leases or leases that include options and variable lease payments.

(b) The current guidance in IAS 17/Topic 840 would not have to be retained indefinitely.

(c) No additional guidance would be required when taking the current balances, as determined under IAS 17/Topic 840, and applying the new leases guidance on a subsequent basis

(d) There will be comparability in the accounting for all leases from the date of initial application forward. This approach eliminates having similar leases accounted for differently based on when an entity entered into a lease.

15. This approach has the following disadvantages:

(a) This approach could be more complex to apply than a full retrospective transition for leases that are currently classified as capital/finance leases (whereas the approach should provide relief for leases currently classified as operating leases). In applying the existing standards, a lessee and lessor would already have determined the discount rate at the commencement date of each capital/finance lease, and a lessor would already have determined the residual asset at the commencement date (and embedded the value of that residual asset within the receivable recognized). This approach would, for example, require a lessor to recalculate the residual asset at the date of transition, which may increase transition costs for possibly little benefit.

FASB-Only—Leveraged Leases

16. The FASB tentatively decided the following for leveraged leases:

(a) A lessor would account for leveraged leases under the proposed new leases guidance. There would not be a different lessor approach for leveraged leases.

(b) A lessor would apply the same transition guidance to current leveraged leases as required for all other leases; that is, existing leveraged lease transactions would not be grandfathered.

17. Because the FASB recommended that a lessor would apply the same transition to current leveraged leases as required for all other leases, the FASB staff thought it would be helpful to specify the transition requirements for current leveraged leases in the new leases guidance. Therefore, the FASB staff recommends that the Board transition leveraged leases in accordance with the same decision that is reached above for all other current direct-finance and sales-type leases. That would have the balance sheet for all leases accounted for similarly as of the date of initial application of the new leases guidance. Alternatively, the FASB could decide that current leveraged leases should apply the new leases guidance on a fully retrospective basis. The FASB staff recommends permitting, but not requiring, a full retrospective transition for current leveraged leases.

Questions for the Boards

Question 1
Which transition approach do the Boards prefer for current capital/finance leases?
Question 2 (FASB only)
Which transition approach does the Board prefer for current leveraged leases?