STAFF PAPER

16-19 July 2012

FASB | IASB Meeting

FASB Education Session July 11, 2012
IASB Education Session July 17, 2012

Project	**Leases**		
Paper topic	Exposure Draft comment period and permission to begin the balloting process		

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Purpose

1. In July 2011, the Boards decided to re-expose their revised proposals for a leases standard. Re-exposing the revised proposals will provide interested parties with an opportunity to comment on revisions that the Boards have made since the publication of the Exposure Draft (ED) on leases in August 2010.
2. The purpose of this paper is to ask the Boards:
    a. to decide on the length of the comment period for the *Leases* ED.
    b. to authorize the staff to prepare a ballot draft of the ED; and
    c. to review the tentative decisions made.

Exposure Draft comment period

Background

3. The IASB's Due Process Handbook states:

> 98. The IASB normally allows a period of 120 days for comment on its consultation documents. For exposure drafts, if the matter is exceptionally urgent, the document is short, and the IASB

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

> believes that there is likely to be a broad consensus on the topic, the IASB may consider a comment period of no less than 30 days, but it will set such a short period only after formally requesting and obtaining prior approval from 75 per cent of the Trustees. For major projects, the IASB will normally allow a period of more than 120 days for comments.

4. The FASB's Reference Manual states the following about comment periods for a proposed Accounting Standards Update:

> 122. The FASB will expose all Exposure Drafts of Proposed Updates for public comment. In determining the comment period length, the FASB weighs the nature and complexity of the proposal, the amount of time its constituents need to consider and comment on the proposal, and the urgency of the need for change. The following examples illustrate the range of comment periods that would likely result when applying that principle in some common situations:
>
> - A comprehensive amendment of a major topic or subtopic within the Accounting Standards Codification generally would be exposed for a period of 60 days or longer.
> - An amendment that changes, interprets, or provides application guidance in a narrower area generally would be exposed for a period of 25 days or longer.
> - Narrow amendments that are not expected to cause a major change in accounting practice for a significant number of entities, minor technical corrections of existing requirements, or proposed deferrals of effective dates generally would be exposed for a period of 25 days or less.
>
> 123. In exceptional circumstances, when the need for the guidance is particularly urgent, the FASB may establish a comment period of less than 15 days, subject to consultation with the Foundation's Board of Trustees (or designated committee thereof).

5. Factors to consider in determining the comment period are as follows:

    a. The applicable guidance from the IASB Due Process Handbook and FASB Reference Manual.

b. To provide adequate time for non-English speaking constituents to translate the ED into their respective languages.

c. If the Boards agree to commence the balloting process, the next leases ED is expected to be published in the final quarter of 2012. The 2012 ED will propose many changes to the 2010 ED. Refer to Appendix A for a summary of the changes (i.e. lessee and lessor accounting, definition of a lease, accounting for term options and variable lease payments). Consequently, constituents will need some time to assess the impact of the revised proposals.

d. The timing of publication of the revised ED in relation to the year-end financial reporting cycle.

Staff recommendation

6. We recommend a comment period of 120 days. Although the Boards have made numerous changes to the leases proposals since the 2010 ED, the changes were made in response to stakeholders' comments on the first ED and the more significant changes were the subject of outreach performed by the Boards and staff. Furthermore, 120 days is the normal comment period for the IASB and also meets the general guidelines for the FASB's comment period.

Question 1
Do the Boards agree that the 2012 Exposure Draft for leases should have a comment period of 120 days?

Permission to begin drafting

7. The staff requests permission to prepare a draft for balloting by Board members. We also ask if any Board members plan to present an alternative view.
8. Appendix A contains a summary of the decisions made since the 2010 ED.

9. To date (and excluding any possible differences from the July 2012 joint Board meeting), the Boards have made the same decisions for all issues except for the following:

    a. Disclosure requirement for a lessee's future contractual commitments:

        (i) The IASB tentatively decided that a lessee is not required to disclose the future contractual commitments associated with services and other non-lease components that are separated from a lease contract.

        (ii) The FASB tentatively decided that a lessee should disclose the future contractual commitments associated with services and other non-lease components that are separated from a lease contract.

10. The following Board decisions, which reference existing US GAAP and IFRS guidance, have the potential to result in a different accounting treatments:

    a. Scope:

        (i) (FASB only) leases of timber are not within the scope of the Leases guidance

        (ii) (IASB only) service concession arrangements that are within the scope of IFRIC 12 *Service Concession Arrangements* are not within the scope of the Leases guidance

    b. Subsequent measurement:

        (i) Inception versus commencement: between the date of inception and commencement, if the contract is onerous, a U.S. GAAP preparer would apply Topic 405 Contingencies, but an IFRS preparer would apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(ii) Impairment

(a) To assess impairment of the residual asset, the lessor would apply either Topic 360 *Property, plant and equipment* or IAS 36 *Impairment of Assets*.

(b) To assess impairment of the lessee's right-of-use asset the lessee would apply either Topic 350 *Intangibles—Goodwill and Other* or IAS 36.

(c) To assess impairment of the lease receivable the lessor would apply either Topic 310 *Receivables* or IAS 39 *Financial Instruments: Recognition and Measurement*.

(iii) (IASB only): the lessee is allowed to revalue the right-of-use asset.

(iv) Foreign Exchange Differences: when lessees account for leases denominated in a foreign currency, any foreign exchange differences should be recognized in profit or loss, consistent with existing guidance: Topic 830 *Foreign Currency Matters* or IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

c. Embedded derivatives: lease contracts that include embedded derivatives that should be bifurcated and accounted for in accordance with either Topic 815 *Derivatives and Hedging—Embedded Derivatives,* or IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*.

d. Statement of cash flows: cash paid for lease payments relating to interest will be either an operating or an investing activity if applying IFRSs and will be an operating activity if applying U.S. GAAP.

e. Transfer / Securitization of Lease Receivables: lease receivables that are transferred or sold should be accounted for under existing derecognition guidance – Topic 860 *Transfers and Servicing* or IFRS 9 *Financial Instruments*.

(i) Also apply disclosure requirements relating to the topics, as noted in Topic 860 *Transfers and Servicing* or in IFRS 7 *Financial Instruments: Disclosures*.

f. Disclosure of Transition: lessees and lessors should provide transition disclosures consistent with either Topic 250 *Accounting Changes and Error Corrections* or IAS 8 *Accounting Policies, Changes in Estimates and Errors*. Entities are not required to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line item, and any affected pre-share amounts for the current period and any prior period retrospectively adjusted. Additionally, if an entity elects any of the available reliefs, the entity should disclose which reliefs it has elected.

(i) The Boards also allow the lessee or lessor to apply the requirements in the new leases standard retrospectively in accordance with Topic 250 *Accounting Changes and Error Corrections* or IAS 8 *Accounting Policies, Changes in Estimates and Errors*.

g. Business Combinations: when the acquiree is a lessor that applies an approach similar to current operating lease accounting to some or all of its leases, an acquirer should apply the guidance in either IFRS 3 *Business Combinations* or Topic 805 *Business Combinations* relating to acquired operating leases, to those leases.

h. Transition of Secured Borrowings: on transition to the new lease guidance, a lessor would continue to account for the securitization of lease receivables associated with current operating leases as secured borrowings in accordance with existing US GAAP and IFRSs.

Question 2
(a) Do the Boards support preparing a ballot draft based on the package of tentative decisions and related information addressed herein? (b) Do any of the Board members plan to present an alternative view?

Appendix

A1. Although the 2010 ED included one lessee accounting model for all leases, the Boards have tentatively decided through redeliberations that one expense-recognition pattern for all leases would not appropriately reflect the wide spectrum of lease transactions. Under the current proposals, a lessee would either recognise amortization on the ROU asset and interest on the liability, or a single lease expense, in its statement of comprehensive income when accounting for leases. We refer to these approaches as the Interest & Amortization approach ("I&A") or the Single Lease Expense approach ("SLE") in this paper. Regardless of the expense-recognition pattern, a lessee would recognize a liability to make lease payments on its balance sheet and the initial and subsequent measurement of the liability will be identical.

A2. Also under the current proposals, lessors will use one of two accounting approaches: the receivable and residual approach or an approach similar to current operating lease accounting. The Boards developed criteria to distinguish between the approaches that is consistent for lessors and lessees.

A3. The summary below shows the major changes that occurred since the 2010 ED. For clarity, we arranged the topics under the following categories:

a. Scope

b. Recognition

c. Initial & Subsequent Measurement

d. Presentation & disclosure

e. Transition

f. Other items

A4. The following table summarizes the changes and additions to the leases proposals as a result of the Boards' redeliberations in response to concerns expressed during the comment period and subsequent outreach:

<table>
<tr><th>Category</th><th>Changes from the 2010 Exposure Draft</th></tr>
<tr><td>Scope</td><td>Additions to the scope exceptions noted in the ED:
(IFRSs only) Service concession arrangements within the scope of IFRIC 12, Service Concession Arrangements</td></tr>
<tr><td rowspan="2">Recognition</td><td>LESSEE
No changes from what was proposed in the 2010 ED.</td></tr>
<tr><td>LESSOR
The lessor accounting model is different from that proposed in the 2010 ED. Further information is included under initial and subsequent measurement below.</td></tr>
<tr><td>Initial & Subsequent Measurement</td><td>The Line:
Since the 2010 ED, the Boards have tentatively decided the following points relating to the line that distinguishes between the I&A and SLE approaches:
A. The line is based on whether the lessee acquires and consumes a more than insignificant portion of the underlying asset over the lease term.
B. That principle should be applied by using a practical expedient based on the nature of the underlying asset as follows:
a. Leases of property should be accounted for using the SLE approach unless:
i. The lease term is for the major part of the economic life of the underlying asset; or
ii. The present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.
b. Leases of assets other than property should be accounted for using the I&A approach unless:</td></tr>
</table>

	i. The lease term is an insignificant portion of the economic life of the underlying asset; or ii. The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset. The Boards tentatively decided that the line supporting the distinction between the two methods should be symmetrical for lessees and lessors.
	LESSEE Accounting for leases under the I&A approach is consistent with the methodology discussed in the 2010 ED. The Boards tentatively decided that under the SLE approach: A. Initial and subsequent measurement of the lease liability and the initial measurement of the right-of-use asset would be the same as under the I&A approach B. Lessees would allocate the total cost of the lease contract evenly over the lease term resulting in a straight line total lease expense in each period C. Lessees would measure the right-of-use asset at the end of each period as a balancing figure such that the liability would be subsequently measured as previously described in the 2010 ED, and the total lease expense would be recognized on a straight-line basis, regardless of the timing of lease payments D. Lessees would present total lease expense as one amount in its Statement of Comprehensive Income
	LESSOR The lessor accounting proposals have changed significantly compared to the 2010 ED, which proposed that a lessor would apply either the derecognition approach or the performance

	obligation approach, depending on whether significant risks and benefits associated with the underlying asset were transferred to the lessee. The Boards have tentatively decided that a lessor would apply: (a) The receivable and residual approach to leases for which the lessee acquires or consumes a more than insignificant portion of the underlying asset (the receivable and residual approach is similar to the derecognition approach in the 2010 ED, except the residual asset is accreted over the lease term). (b) An approach similar to current operating lease accounting to leases for which the lessee does not acquire or consume a more than insignificant portion of the underlying asset. The Boards also tentatively decided that for all leases within the scope of the receivable and residual approach, a lessor should: A. Initially measure the right to receive lease payments at the present value of the lease payments, discounted using the rate the lessor charges the lessee, and subsequently measure at amortized cost applying an effective interest method. B. Initially measure the residual asset as an allocation of the carrying amount of the underlying asset. The initial measurement of the residual asset comprises two amounts: (i) the gross residual asset, measured at the present value of the estimated residual value at the end of the lease term discounted using the rate the lessor charges the lessee and (ii) the unearned income, measured as the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset. C. Subsequently measure the gross residual asset by accreting to the estimated residual value at the end of the lease term

<table>
<tr><td></td><td>using the rate the lessor charges the lessee. The lessor would not recognise any of the unearned income in profit or loss until the residual asset is sold or re-leased.
D. Present the gross residual asset and the unearned income together as a net residual asset.</td></tr>
<tr><td>Presentation & Disclosure</td><td>LESSEES
Proposals are similar to those included in the 2010 ED.
The Boards will be discussing lessee presentation and disclosure matters during the July 2012 joint Board meeting. Refer to the July 2012 papers for further details on the proposals.

LESSORS
Proposals are similar to those included in the 2010 ED.
If the lessor applies the receivable and residual approach, the lessor is required to disclose information about how it manages its exposure to residual asset risk.</td></tr>
<tr><td>Transition</td><td>LESSEES (TBD based on July 2012 decisions on transition)
Transition requirements would be applied to all leases existing at the beginning of the earliest comparative period presented. The accounting applied on transition is based on previous classification as follows:
A. Current Capital / Finance Leases
a. A lessee would not be required to make any adjustments to the carrying amount of the lease assets and lease liabilities and should reclassify those lease assets and lease liabilities as right-of-use assets and liabilities to make lease payments.
B. Current Operating Leases
a. A lessee should recognize liabilities to make lease payments and right-of-use assets, at transition. A modified retrospective approach is applied.</td></tr>
</table>

	b. A lessee should recognize in retained earnings any differences between the liabilities to make lease payments and the right-of-use asset. A lessee is also permitted to apply a fully retrospective approach to all leases.
	LESSORS Transition requirements would be applied to all leases existing at the beginning of the earliest comparative period presented. The accounting applied on transition is based on previous classification as follows: A. Current Finance / Sales-type and Direct Finance Leases a. A lessor would not be required to make adjustments to the carrying amount of the assets associated with those leases. B. Current Operating Leases (to which the lessor wold now apply the receivable and residual approach) a. A lessor should (1) recognize the right to receive lease payments (2) recognize a residual asset and (3) derecognize the underlying asset. A lessor is also permitted to apply a fully retrospective approach to all leases.
	Additional relief: To ease the potential burden of applying the standard within the first year of application, the Boards tentatively decided that lessees and lessors may elect, and appropriately disclose, the following reliefs: • An entity is not required to evaluate initial direct costs for contracts that began before the effective date. • An entity may use hindsight in comparative reporting periods including the determination of whether or not a contract is or contains a lease.

Other Items	
Definition of a lease	The concept of control has been changed since the 2010 ED to align more closely with other standards / EDs
Accounting for non-lease components	Non-lease components of a contract are to be separated from lease components and accounted for according to other appropriate standards (that is, for a lessor, the revenue recognition standard).
Short-term leases	For leases that have a maximum term of 12 months or less: (c) a lessee need not apply the lease accounting proposals and can elect to apply current operating lease accounting (without recognizing lease assets and liabilities for those leases). (d) a lessor need not apply the receivable and residual approach, and can elect to apply current operating lease accounting.
Variable Lease Payments (“VLPs”)	VLPs are not included in the initial and subsequent measurement of the liability to make lease payments, unless the VLPs are linked to an index or rate. For those VLPs that depend on an index or a rate, the liability to make lease payments should be initially measured using the index or rate that exists at the date of the commencement of the lease and should be reassessed each reporting period. Change in the VLPs that depend on an index or a rate should be recognized in net income or as an adjustment to the ROU asset, depending on the extent that the changes relate to current and future reporting periods. Similarly, VLPs are excluded from the lessor’s receivable (under the receivable and residual approach) unless the VLPs are linked to an index or rate.
Options to Extend or to Purchase	A lease term will include the options to extend or to purchase only when the lessee has significant economic incentive to exercise such options.
Sale & Leaseback	Determination of sale will be in accordance with the revenue recognition proposals.

<table>
<tr><td>Accounting for Changes after the Date of Inception</td><td>Substantive changes to the existing contracts will result in the modified contract being treated as a new contract.

Changes in circumstances that affect the assessment of whether a contract is, or contains, a lease will result in reassessment as to whether the contract is, or contains, a lease</td></tr>
<tr><td>Change in Discount Rate</td><td>The discount rate should not be reassessed if there is no change in the lease payments.

The discount rate is reassessed:
When there is a change in the lease payments due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend the lease or purchase the underlying asset
When there is a change in the lease payments due to the exercise of an option that the lease did not have a significant economic incentive to exercise
To reflect changes in reference interest rates when VLPs are based on those reference interest rates.</td></tr>
<tr><td>Subleases</td><td>A head lease and sublease should be accounted for as separate transactions.</td></tr>
<tr><td>Business Combinations & Borrowing Cost</td><td>In relation to the measurement of lease assets and lease liabilities acquired in a business combination, the tentative decisions include:
If the acquiree is a lessee, an acquirer should recognize a liability to make lease payments and a right-of-use asset. The ROU asset needs to be adjusted for any off-market terms in the lease contract.
If the acquiree is a lessor applying the receivable and residual approach to some or all leases, an acquirer should recognize a right to receive lease payments and a residual</td></tr>
</table>

	asset. • If the acquiree is a lessor applying an approach similar to current operating lease accounting to some or all leases, an acquirer should apply the guidance in IFRS 3 – *Business Combinations* or Topic 805 – *Business Combinations* relating to acquired operating leases, to those leases. • If the acquire has short-term leases, an acquirer does not recognize separate assets or liabilities related to the lease contract (including assets or liabilities associated with off-market terms).
Cancellable Leases	Cancellable leases include those that are cancellable by both the lessee and the lessor with minimal termination payments or include renewal options that must be agreed to by both the lessee and lessor. The Boards tentatively decided that the lease proposals should be applied only to periods for which enforceable rights and obligations arise.
Lessor – Residual Value Guarantees	The leases standard will provide guidance on accounting for all residual value guarantees, regardless of whether they are provided by a lessee, a related party, or a third party. A lessee will include amounts expected to be payable in the measurement of the right-of-use asset and the liability to make lease payments. Changes to the lessee’s liability arising from changes in estimates will be recognized in net income for current periods and as an adjustment to the right-of-use asset for future periods. A lessor will not recognize amounts expected to be received under a residual value guarantee until the end of the lease. However, the lessor will consider those guarantees when determining whether the residual asset is impaired.