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Leases

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Agenda

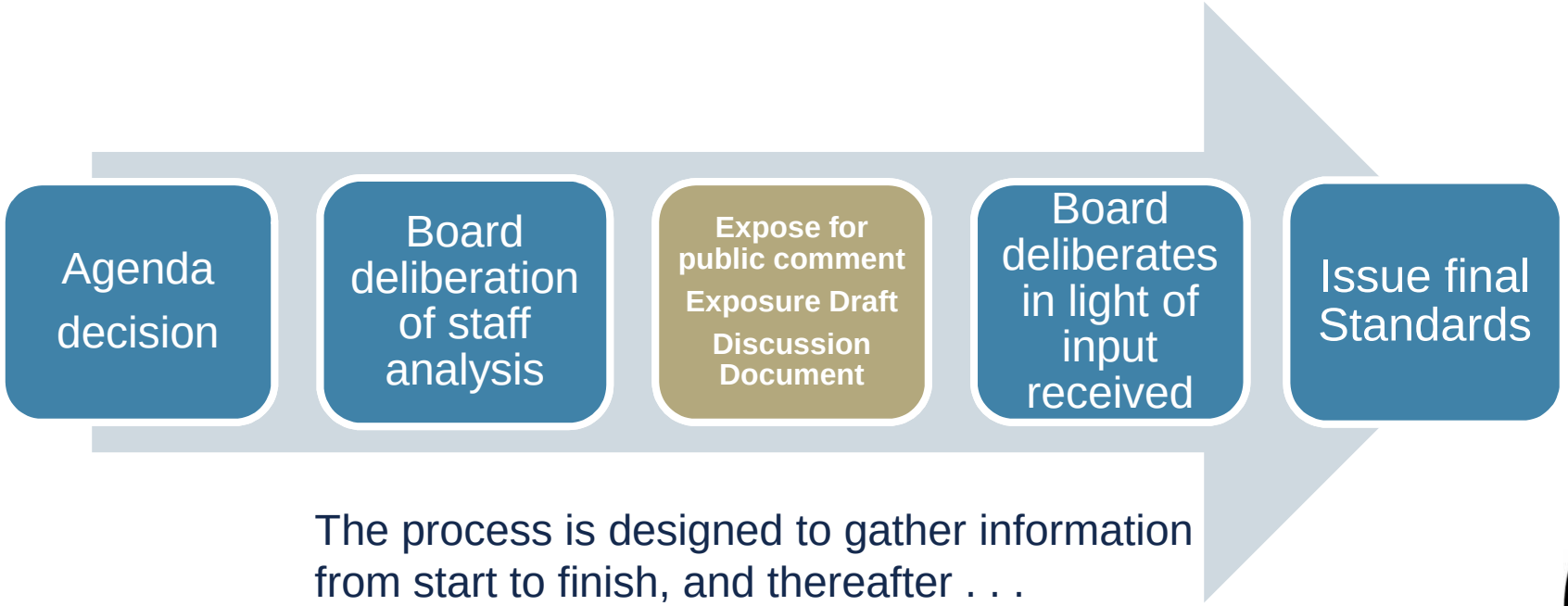
- Overview of the FASB
- Convergence with IASB
- Summary of Proposed Guidance
- Outreach Activities

Overview of the FASB

- The Financial Accounting Standards Board establishes standards of financial accounting that govern the preparation of financial reports in the private sector.
  - Standards are officially recognized as authoritative by the SEC and the State Boards of Accountancy
- Source of Authoritative Standards
  - *FASB Accounting Standards Codification*
- Mission of the FASB:
  - To establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.

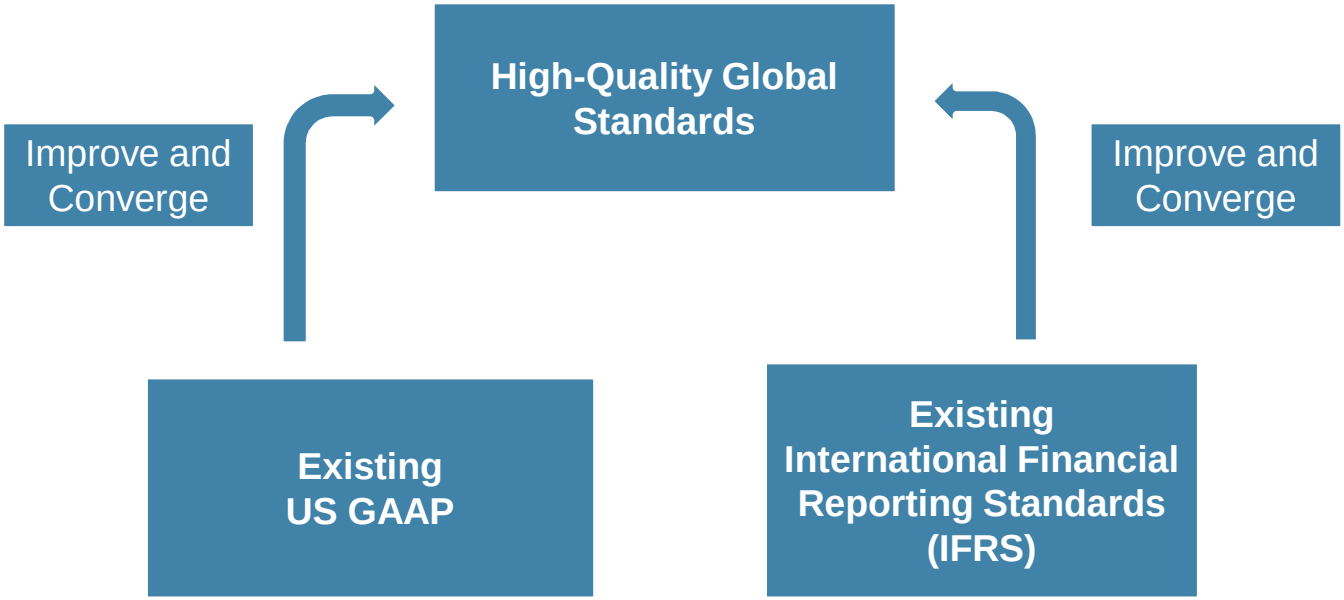
FASB Standards-Setting Process

- Comprehensive and independent process that encourages broad participation and objectively considers all stakeholder views.
  - The FASB is committed to following an open, orderly process for setting standards – comprehensive due process procedures.



The process is designed to gather information from start to finish, and thereafter . . .

Convergence: Improving quality and comparability of financial statements



- Consistent with Section 108 of Sarbanes-Oxley Act and 2003 SEC Policy Statement
- FASB priorities: (1) process; (2) improvement; (3) convergence

Norwalk Agreement and Memorandum of Understanding (MoU)

- Describe what convergence means and the tactics used by the FASB and the IASB to achieve it.
- Collaborate through joint projects to develop common standards.
  - The FASB issues those standards as US GAAP and the IASB issues them as IFRS
  - Overtime, the two sets of standards are expected to both improve quality and become increasingly similar if not the same
- June 24, 2010 – FASB and IASB revised the strategies, plans and milestones for each project

FASB workplan: June 2010

MoU Projects	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4
Priority projects											
Financial instruments	E		R		F						
Revenue recognition	E		R		F						
Leases		E	R		F						
Other comprehensive income	E		F								
Netting financial instruments			E	R	F						
Fair value measurement	E			F							
Other projects											
Fin. instruments w/char. of equity				E		R	F				
Consolidation: investment cos.			E		F						
Consolidation: voting interest entities (note 1)		R									
Financial statement presentation/discops		S		E		R	F				
Derecognition (note 2)											
Other Joint Projects											
Insurance contracts (note 3)		E/D	R								
Emissions trading schemes						E		R			F
Effective date and transition		D									

Notes and Legend:

E: Exposure Draft
D: Discussion Paper
R: Public roundtable
S: Staff draft

Comment period
Redeliberations
Final standard
Outreach & deliberations
Post-issuance review

Note 1: After public roundtable meetings, the FASB will decide whether to issue an Exposure Draft proposing IFRS requirements for voting interest entities.
Note 2: The FASB and IASB will determine the scope and direction of further work after a post-issuance review of the FASB's recent amendments.
Note 3: The FASB will decide in July how to seek input on insurance contract accounting proposals, whether by an Exposure Draft or a Discussion Paper.

Proposed Lease Accounting

Project added to agenda July 2006

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Discussion paper March 2009

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Exposure Draft August 17, 2010

Comment period ends December 15, 2010

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Outreach and fieldwork

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FINAL STANDARD planned 2011

Why did the FASB & IASB add the project

- Rules are very complex and consist of several bright-line tests (difficult to define the dividing line between capital and operating leases)
- Current operating lease accounting understates assets and liabilities and, consequently, indicators of leverage are understated and users adjust these indicators based on inadequate information in the notes
- Increased focus on off-balance sheet financing
- Global activity; we should have a converged standard with IASB
- SEC's off-balance sheet study

Overall Project Objectives

- To develop a new model for the recognition of assets and liabilities arising under lease contracts
- Lessors and lessees present relevant, faithfully representative information about the rights and obligations arising from leases
- To ensure that investors and other users of financial statements are provided useful, transparent, and complete information about leasing transactions in the financial statements
- To assist users of financial statements in their assessment of the amounts, timing, and uncertainty of cash flows arising from leases

Summary of Proposed Guidance

Summary of main proposal

- A lease is a contract in which right to use a specified asset is conveyed for a period of time in exchange for consideration
- Lessees will account for all leases under the right-of-use approach, which records asset and liability for all leases
- A hybrid accounting model will be required for lessors
  - Performance obligation approach for leases that expose lessor to significant risks or benefits associated with underlying asset
  - A (partial) derecognition approach would be applied to all other leases

Scope

- Lease definition – broad, but narrow in scope:
  - "A lease is a contract in which the **right to use** a **specified** asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration."
- Apply this guidance to all leases, including leases of *right-of-use assets* in a *sublease, except:*
  - Leases of intangible assets
  - Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
  - Leases of biological asset
- Include:
  - Long-term leases of land
  - Non-core assets
- Simplified accounting for short-term leases:
  - Lessee (optional): recognize gross asset and gross liability
  - Lessor (optional): use accrual accounting

Lessee model

Lessee has acquired a right to use the underlying asset and is paying for that right with its lease payments

Leases in scope	
Balance sheet	**Income Statement**
• Right-of-use asset X	• Amortization expense X
• Liability to make lease payments X	• Interest expense X

Lessee measurement

	Initial Measurement	Subsequent Measurement
Liability to make lease payments	Cost = PV of lease payments discounted (using incremental borrowing rate or rate lessor charges the lessee if it can be readily determined)	Amortized cost (effective interest method) No revision of discount rate
Right-of-use asset	Cost = PV of lease payments + any initial direct costs incurred by lessee	Amortized cost (straight-line) Impairment

Lessor model

- Based on exposure to risks or benefits of the underlying asset <u>during</u> or <u>subsequent</u> to the expected term of the lease contract
- Counterparty credit risk is not considered

Does the lessor retain significant risks or benefits of the underlying asset?

No → **Derecognition approach**

Yes → **Performance Obligation approach**

Lessor model: Derecognition Approach

Statement of Financial Position	Income Statement
Recognition and Initial Measurement	
Residual Value Asset: **Derecognize** the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the lease term Reclassify the remaining portion of the carrying amount of the underlying asset **(residual asset)** that represents the rights in the underlying asset that the lessor retains. **Right to Receive Lease Payments (lease receivable):** Cost = PV of lease payments + any initial direct costs incurred by the lessor	**Lease Income** = PV of lease payments (classify as revenue) **Lease Expense** = Cost of the portion of the underlying asset derecognized (classify as cost of sales)
Subsequent Measurement	
	Interest Income
Measure the **lease receivable** at amortized cost using the effective interest method. Reassess **lease receivable** if facts and circumstances indicate there would be a significant change Assess the **residual asset** for impairment.	

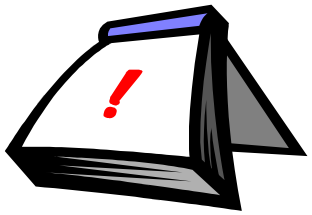
Lessor Model: Performance Obligation Approach

Statement of Financial Position	Income Statement
Recognition and Initial Measurement	
Lease Liability = Cost (PV of lease payments discounted using the rate the lessor charges the lessee) **Right to Receive Lease Payments (lease receivable)** = Cost (PV of lease payments discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor)	
Subsequent Measurement	
Measure the **right to receive lease payments** at amortized cost using the effective interest method. Reflect decreases in **lease liability** over the lease term (straight-line). Reassess **right to receive lease payments** if facts and circumstances indicate there would be a significant change.	**Interest income** **Lease income** **Depreciation expense**

Renewal or purchase options

Initial recognition	• Recognize obligation to pay rentals/lease liability for **longest <u>possible</u> lease term** that is **more likely than not** to occur • Consider all relevant factors

Subsequent recognition	• Reassess term at each reporting date if facts or circumstances indicate a significant change
	• Recognize change in liability (lessee)/asset (lessor)
	  • **Lessee** – as adjustment to right-of-use asset
	  • **Lessor**
	  • Derecognition – derecognize or re-recognize portion of residual value asset
	  • Performance obligation – as adjustment to lease liability



Purchase option is not recognized until exercised!

Example – Lease Term

An entity has a lease that has a non-cancellable 10-year term, an option to renew for 5 years at the end of 10 years and an option to renew for an additional 5 years at the end of 15 years. Assume that the entity determines the probability for each term as follows:

Lease Term	Probability	Cumulative Probability
10 yrs	40%	100%
15 yrs	30%	60%
20 yrs	30%	30%

There is a 60 percent chance that the term will be 15 years, which is the longest possible term more likely than not to occur. Therefore, the lease term is 15 years.

Contingent rent, penalties and RVGs

Initial recognition/ measurement	• Measure using expected outcome technique (probability weighted average) • **Lessee** – Recognize as part of obligation to make lease payments • **Lessor** – Recognize as part of lease receivable, to the *extent contingent rentals can be measured reliably*
Subsequent measurement	• Reassess at each reporting date if facts or circumstances indicate a significant change • **Lessee** – Recognize change in lease liability and: –If arising from current or prior periods, in profit or loss –All other changes as adjustment to right-of-use asset • Lessor - Recognize change in lease receivable – Derecognition – P/L – Performance obligation –If attributable to satisfied lease liability, recognize in revenue –If attributable to unsatisfied lease liability, adjust lease liability

Example – Contingent Payments

- Company A enters into an arrangement to lease a retail outlet in an office building.
- 15-yr non-cancellable lease with no renewal options.
- Annual lease payments of $2M/yr plus an additional contingent rent of 2% of gross revenue per year
- Company A's incremental borrowing rate is 8%
- No purchase option or residual value guarantee

Expected Contingent Rentals

	Outcome 1 Constant Revenue	Outcome 2 Revenue Growth 5%/Year	Outcome 3 Revenue Growth 8%/Year	Outcome 4 Revenue Decline 2%/Year	Total
Sales over 15 years, assuming $10M in year 1	$ 150,000,000	$ 215,785,636	$ 271,521,139	$ 130,715,449	
Total contingent rent 2%	3,000,000	4,315,713	5,430,423	2,614,309	
Present value .	1,711,896	2,297,568	2,777,778	1,534,344	
Probability .	40%	25%	25%	10%	
	$ 684,758	$ 574,391	$ 694,444	$ 153,434	$ 2,107,027

Right-of-Use Asset/Obligation

Contingent rentals	$ 2,107,027
Annual lease payments (PV of $2M/year for 15 years)	17,118,957
Total right-of-use asset/obligation	**$ 19,225,984**

Disclosures

- To enable users to evaluate the nature, amount, timing, and uncertainty of cash flows arising from lease contracts and how the entity manages those cash flows
- Includes:
  - Nature of lease contracts
  - Nature and amount of significant subleases
  - Information about short-term leases
  - Maturity analyses
  - Significant assumption and judgments (including discount rate)
  - Lessee: reconciliation of right of use assets and liabilities; information about sale and leaseback transaction
  - Lessor: information about exposure to risks; impairment losses; reconciliation of (a) right to receive lease payments (b) lease liability (c) residual asset; class of residual assets; service obligations

Transition

- All outstanding leases at date of adoption
  - Simplified retrospective approach
  - Present value of remaining lease payments at:
    - Incremental borrowing rate at date of adoption (lessee)
    - Rate charged in the lease (lessor)
  - Date of adoption = earliest period presented in F/S
- Scope exception for transition
  - “Simple” capital leases – carry forward prior accounting
  - Short term leases

Outreach Activities

Outreach

- Meetings with constituents to discuss the lease proposal (individual companies, accounting firms, users of financial statements, conferences, etc.)
- Webcasts and podcasts (IASB and FASB)
- Preparer and User questionnaires on websites
- Field work – workshops late November/early December
- Roundtables – late December/early January
  - London, Hong Kong, Chicago, Norwalk
- Working Group Meeting January 2011

What we have heard so far

Lessees

- Basic agreement with right-of-use model
- Concern with:
  - Complexity in considering contingent rents and estimating lease term
  - Income statement impact (amortization and interest expense instead of rent expense)
  - Differentiating leases from services
  - Cost/benefits (non core assets, short-term leases)
  - Transition

What we have heard so far

Lessors

- Concern with:
  - Determining whether to apply the performance obligation or the derecognition approach
  - Complexity in considering contingent rents and estimating lease term
  - Income statement impact (no rental income for current operating leases)
  - Differentiating leases from services
  - Transition

Project timeline

August 17, 2010 → **December 15, 2010** → **2011**

Exposure Draft

Targeted outreach

Comment letters received

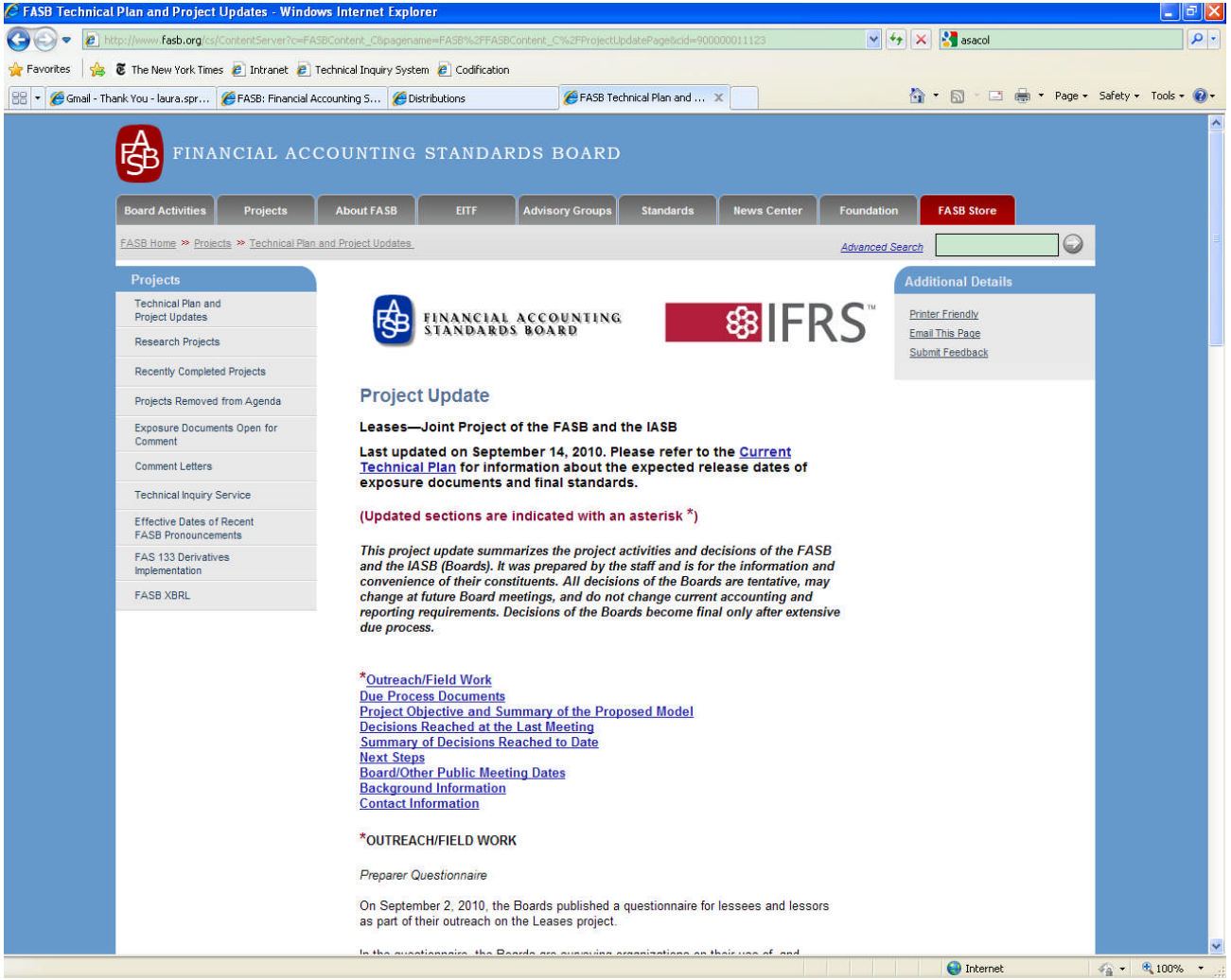
Boards' re-deliberations

Public roundtables

Final standard

To be held in London, Hong Kong, Chicago and Norwalk.

To Learn More and Submit Feedback



- FASB website: www.fasb.org
  - Projects Tab
  - Leases

- Press Release
- FASB In Focus/IASB Snapshot
- Podcast
- Exposure Draft (FASB/IASB)
- Comment Letters
- Outreach/Fieldwork Info

Questions or comments?