



Financial Accounting
Standards Board

To: Board Members
From: Leases Team (Yust, ext. 442)
Subject: Minutes of the July 23, 2008 Board Meeting: Leases Technical Discussion
Date: July 29, 2008
cc: FASB: Bielstein, Leisenring, Golden, Lott, Stoklosa, Proestakes, Posta, Chookaszian, Zeyher, Nickell, Yust, C. Smith, Sutay, Zhu, Cappiello, Glotzer, Mechanick, Gabriele, Allen, Klimek, FASB Intranet; IASB: Francis, Knublely, Peerless

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Leases Technical Discussion

Basis for Discussion: Memorandum #15 (IASB Agenda Paper 13)
Memorandum #16 (IASB Agenda Paper 13A)
Memorandum #17 (IASB Agenda Paper 13B)
Memorandum #18 (IASB Agenda Paper 13C)
Memorandum #19 (IASB Agenda Paper 13D)
Memorandum #20 (IASB Agenda Paper 13E)

Length of Discussion: 9:00 to 11:00 a.m.

Attendance:

Board members present: Batavick, Herz, Linsmeier, Seidman, and Smith

Board members absent: None

Staff in charge of topic: Zeyher

Other staff at Board table: Golden, Stoklosa, Nickell, and Yust

Outside participants: Knublely (IASB) and Peerless (IASB)

Summary of Decisions Reached

The Board decided to defer development of a new accounting model for lessors for coordination with related projects such as revenue recognition; the current project will address only the development of a high quality standard of accounting for lessees. The Board also agreed with an overall approach under which lessees would generally apply the finance lease model in International Accounting Standard (IAS) 17, Leases, to all leases, adapted where necessary.

The Board decided to include options to extend or terminate a lease in the measurement of a right-of-use asset and a lease obligation based on the best estimate of the expected lease term. The Board also agreed that contractual factors, non contractual factors, and business factors should be considered when determining the lease term.

The Board decided to require lessees to include contingent rentals in the measurement of the right-of-use asset and the lease obligation based on their best estimate of expected lease payments.

The Board decided that both the right-of-use asset and the lease obligation should be initially measured at the present value of the best estimate of expected lease payments for all leases. The Board also decided to require the best estimate of expected lease payments to be discounted using the lessee's secured incremental borrowing rate.

The Board discussed the subsequent measurement of both the right-of-use asset and the lease obligation but did not reach a decision. The Board also discussed whether there should be criteria to distinguish between leases that are in-substance purchases and leases that are rights to use an asset but did not reach a decision.

Objective of Meeting:

The objective of the meeting was to discuss the overall approach to the joint leases project in conjunction with the 2008 Memorandum of Understanding, including (1) the scope of the project and whether to include or exclude lessor accounting, (2) the

treatment of options to extend or terminate a lease, (3) the treatment of contingent rentals, (4) the initial and subsequent measurement of a lessee's right-of-use asset and obligation to make rental payments, and (5) whether to retain the classification criteria for operating and finance leases. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1: Overall Approach and Scope

1. **Staff Recommendation:** The staff recommended that the Board defer the development of a new accounting model for lessors and only address lessee accounting in the current project. The staff also recommended an overall approach of applying the finance lease model in IAS 17, adapted where necessary, for all leases.
2. **Board Vote:** The Board unanimously voted to support the staff's recommendations.
3. **Board Comments:** Mr. Herz noted that perfect symmetry did not always exist today but questioned whether there were any potential unintended consequences resulting from asymmetry in accounting due to deferring development of the accounting for lessors. Mr. Linsmeier noted asymmetry would result from the lessor having a constructive sale of the leased asset without the lessee having a constructive purchase of the leased asset.
4. Mr. Linsmeier questioned whether the staff was not going to (a) think about lessor accounting at all in this project or (b) develop a new model for lessors at this time but consider the impact on lessor accounting during development of the model for lessees resulting from any asymmetry. Ms. Zeyher clarified that while the staff would defer development of the full model for lessors, it would follow developments in the revenue recognition and derecognition projects for consideration on lessor accounting and would consider the interaction between the existing model for lessors and the revised model for lessees. Mr. Linsmeier was supportive of the staff recommendation, but would like there to be "sense-checks" with regard to the accounting for the lessor and the transaction on the other side.

5. Ms. Seidman stated that she agreed with the staff recommendation because of the pace for convergence and the need to quickly develop a significant improvement in the accounting for leases. Mr. Smith also noted that the SEC study on off-balance sheet financing had previously identified the off-balance sheet accounting for operating leases as a major fundamental issue.
6. Mr. Batavick also agreed with the staff that the revenue recognition project specifically addresses contracts for customers and there also may be some overlap with the derecognition project. The staff (and Board) will need to monitor all of these projects to determine how they will interact with the accounting for the lessor.
7. Mr. Peerless added that a separate issue for the FASB to address at a later date is whether to adopt IAS 17 for lessors to achieve converged accounting for both lessees and lessors.

Issue 2: Options to Extend or Terminate a Lease

8. **Staff Recommendation:** The staff recommended that the Board include options to extend or terminate the lease in the measurement of the right-of-use asset and in the lease obligation based on an assessment of whether it is reasonably certain that the right to use the leased item in an optional period will be exercised after considering all contractual factors, non-contractual financial factors, and business factors.
9. **Board Vote:** The Board unanimously voted to support the staff recommendation to include options to extend or terminate the lease in the measurement of the right-of-use asset and in the lease obligation based upon an assessment of the lease term.
10. However, the Board unanimously voted to require the lease term to be recognized upon an assessment of the best estimate of the expected lease term. The Board also unanimously voted to support the staff recommendation on the factors to be considered in the assessment.

11. **Board Comments:** Mr. Linsmeier stated that he believes the unit-of-account is the lease contract, so he believes that options should be included in the assessment of the lease term to the extent that the optional periods are expected.
12. Mr. Herz stated that he believes that *reasonably certain* is too high of a threshold and could result in structuring. He also noted that the Board prefers a principle, such as the “substantive term” or the best estimate of expected optional periods, rather than any kind of threshold. For example, Mr. Herz noted that with multiple renewable periods, it may not be reasonably certain that a lessee would renew multiple times, even if the lessee is expected to do so.
13. Mr. Linsmeier stated that a non-probability-weighted approach was appropriate as the exercise of the option was an all-or-nothing decision, and the Board agreed.
14. Mr. Golden questioned whether intent would be considered in the lessee’s expectation of which optional periods would occur. Mr. Batavick stated that contractual, financial, and business factors should largely encompass intent.
15. Ms. Seidman noted that any changes to the treatment of optional periods, contingent rentals, or other issues would result in a change in the accounting for existing on-balance-sheet leases. Accordingly, she considered these issues to be secondary to the decision to require the present value of minimum lease payments to be recognized for leases currently classified as operating.

Issue 3: Contingent Rentals

16. **Staff Recommendation:** The staff recommended that the Board retain the existing guidance for recognition and measurement of contingent lease payments in IAS 17 with enhanced disclosures.
17. **Board Vote:** The Board unanimously voted to include contingent rentals in the measurement of the right-of-use asset and in the lease obligation based on the best estimate of expected lease payments.

18. The Board expressed a preference for a non-probability-weighted estimate. However, Messrs. Batavick, Herz, Linsmeier, and Smith stated that they would generally be willing to consider a probability-weighted estimate consistent with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, if the IASB voted to require such a measurement. Ms. Seidman stated that her preference would be to support the staff recommendation if the IASB did not support a best estimate approach.
19. **Board Comments:** Mr. Linsmeier stated that a lessee should make the best estimate of expected payments, based on a consideration of the factors discussed when addressing optional periods.
20. Mr. Golden questioned whether the best estimate of contingent rents would be consistent with a FASB Statement No. 5, *Accounting for Contingencies*, approach, in order to have a consistent definition throughout U.S. generally accepted accounting principles. Mr. Linsmeier stated that he would prefer it to be consistent with definitions in International Financial Reporting Standards.
21. Mr. Batavick stated that he would not want a probability-weighted approach as it would add too much complexity for unsophisticated lessees. Mr. Herz agreed that it would be more complicated; however, he stated that he would likely fall back to IAS 37 if the IASB did not support a non-probability-weighted approach. Mr. Herz agreed that the Board needed constituent feedback on whether a probability-weighted approach could have operability concerns.

Issue 4: Lessee's Measurement of the Right-of-Use Asset and Obligation to Make Rental Payments

22. **Staff Recommendation:** The staff recommended that the right-of-use asset and the lease obligation be initially measured in the same way as leases currently classified as finance leases under IAS 17—the lower of the present value of the obligation to pay rentals or the fair value of the leased item. The staff also recommended that the Board retain the current guidance for discounting minimum lease payments, which is currently discounted with either the implicit rate, if determinable, or the incremental borrowing rate.
23. The staff recommended that the right-of-use asset should be subsequently accounted for by allocating the depreciable amount of the right-of-use asset each accounting period over the expected use consistent with owned assets. The staff also recommended that the right-of-use asset be considered for impairment under either IAS 36, *Impairment of Assets*, or FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The staff recommended that the lease obligation be apportioned between a finance charge and a reduction in the outstanding liability.
24. **Board Vote:** The Board unanimously voted to initially measure both the right-of-use asset and the lease obligation at the present value of the best estimate of expected lease payments. The Board also unanimously voted to require the estimated payments to be discounted using the lessee's secured incremental borrowing rate.
25. The Board discussed the subsequent measurement of both the right-of-use asset and the lease obligation but was unable to reach a decision and requested additional analysis from the staff.
26. **Board Comments:** In the discussion on initial measurement, Mr. Linsmeier stated that if the lease obligation was greater than the fair value of the leased item, there was probably something going on. Mr. Golden noted that one example could be if

the lessee planned to exercise an option to extend a lease simply to avoid the nuisance of replacing the equipment. He also believes that such a circumstance would be rare.

27. Mr. Herz questioned whether the “lower of” requirement was needed for measurement. Mr. Linsmeier stated that the requirement made more sense for a constructive purchase than a right-of-use asset and questioned whether it remained a reasonable economic check. Mr. Nickell stated that the requirement existed due to a variety of factors, such as discounting the lease payments at the lessee’s incremental borrowing rate, which could result in the obligation being larger than the fair value, and that he believes the requirement is needed to prevent such a circumstance from indicating an initial impairment.
28. In the discussion on the discount rate, Mr. Herz noted that the proposed changes to the existing treatment for options and contingent rentals could impact the determination of the implicit rate in the lease. Mr. Golden stated that he believes a requirement to use the incremental borrowing rate when discounting the expected lease payments would be consistent with the requirement to use the incremental borrowing rate as the discount rate in other accounting literature. Mr. Nickell also noted that difficulty existed in determining the implicit rate in the lease because such a determination required assessments of the fair value of the leased item and the unguaranteed residual value.
29. In the discussion on subsequent measurement, Ms. Seidman stated that from a cost-benefit relationship, requiring interest expense to be imputed would add costs and volatility to the income statement for short-term leases. Mr. Linsmeier noted that feedback from users and the lease working group would be helpful on whether to require interest expense to be imputed.
30. Mr. Stoklosa stated that when he worked for a rating agency, the agency would treat all leases as capital leases and would recognize interest expense, rather than rent expense. However, he stated that there were other users who could have different

needs. Mr. Herz noted that users specifically stated in the financial guarantee project that they did not want to break out interest expense.

31. Mr. Smith clarified that the alternative to reduce the right of use asset and the leased obligation at an equal reducing rate would produce a straight-line expense while a constant period rate model would produce higher initial expenses due to a higher amount of each payment being attributed to interest expense. Mr. Golden stated that another potential implication of permitting straight-line rent expense for all leases, assuming that the Board removes the classification requirement, is that a business may always choose to lease an asset rather than to purchase and finance the asset to avoid the recognition of interest expense.
32. Mr. Herz viewed a right to use a leased asset as a *purchase* of a right to use a leased asset, similar to a purchase of the productive leased asset itself. Additionally, Mr. Herz noted that since the obligation was a present value calculation, it would make sense to have an interest component to it and noted that most assets would be amortized over their useful life based on a pattern of expected benefits. Accordingly, departing from these approaches for a leased asset would be an exception.
33. Mr. Golden noted that the total net income would be the same under either model, but the classification between amortization, depreciation, and interest expense versus rent expense each period would be different.
34. Mr. Linsmeier also noted that the staff still had to address the accounting for impairment. Mr. Golden stated that the question would come down to whether the proposed standard would use the guidance in Statement 144 or IAS 36 or whether it would create new, converged impairment guidance.

Issue 5: Lease Classification

35. **Staff Recommendation:** The staff recommended that the Board remove the requirement for leases to be classified as operating or finance leases and develop a single model of accounting for all lease contracts as a right to use a leased asset.

36. **Board Vote:** The Board discussed whether there should be criteria to distinguish between leases and was unable to reach a decision. It requested additional analysis by the staff.
37. **Board Comments:** Mr. Herz stated that he would be willing to support a single approach, but that he could see potential differences in classification and profit and loss treatment due to whether a lease was an in-substance purchase or a right to use an asset. Accordingly, he believed that the Board should ask constituents questions on whether the distinction should remain, and if so, how that distinction should be made and what differences in accounting should exist.
38. Mr. Linsmeier stated that he believes there were some leases that were effectively in-substance purchases and other leases that were effectively rights to use, but noted that he was not sure how to make that distinction. Mr. Linsmeier further stated that he believed a right to use an asset was an intangible, which could make an alternative classification and income statement recognition appropriate from those leases that are in-substance purchases. He questioned whether the classification criteria in IAS 17 could be retained only to permit for different presentation and income statement classification. Ms. Knublely noted that, in practice, many entities analogize to FASB Statement No. 13, *Accounting for Leases*, for lease classification.

Follow-up Items:

None.

General Announcements:

None.