



Board Meeting Handout

LEASES

January 14, 2009

PURPOSE

At the November 2008 FASB meeting, questions were raised about whether in-substance purchases should be in the scope of the leases project. In addition, the FASB asked the staff to further analyze the accounting for subleases for the FASB's consideration before publication of the proposed Discussion Paper on leases. The FASB also asked the staff to analyze how a model for sublessors might apply broadly to all lessors. Therefore, the purpose of this meeting is to: (a) reconsider the scope of the leases project, (b) provide an overview of lessor accounting under the right-of-use model, and (c) consider sublessor accounting.

ISSUE 1: RECONSIDERATION OF SCOPE

At the April 2007 joint meeting, the Boards tentatively decided that the leases project will initially focus on the accounting for lease arrangements within the scope of existing lease accounting literature. Recently, the FASB has been discussing whether there should be a distinction between leases that are in-substance purchases and leases that only convey a right of use.

Staff Recommendation

The staff recommends that the scope of the project should not be modified. The staff believes that if a lease is truly "the same as a purchase" then it will be *priced* the same as a purchase. If that is the case, the accounting model in the proposed Discussion Paper should result in accounting that is the same as the accounting for a purchased asset, based on the following preliminary views that are currently included in the staff draft of the proposed Discussion Paper (the comments in parentheses are not currently in the proposed Discussion Paper):

- a. The obligation to pay rentals and the right-of-use asset will initially be measured at the present value of the lease payments, discounted at the lessee's incremental borrowing rate (that is, the rate that the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset)
- b. For leases of items in which it is expected that the lessee will obtain title at the end of the lease term, the amortization period for the right-of-use asset would be the economic life of the leased item (that is, the exact same period over which one would depreciate a purchased asset).
- c. The obligation to pay rentals should be subsequently measured on an amortized cost basis (that is, the same approach that would be used for debt incurred to purchase an asset).

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

The staff believes that the attempt to distinguish between leases that are “truly purchases” and those that are a “right of use” will inevitably fail, or will result in unintended consequences. The staff notes that if the Boards agree that leases in which title to the leased property transfers are “purchases,” then it is only logical to assume that leases that extend for 100 percent of an asset’s economic life also are purchases. Similarly, a lease in which title transfers for the payment of a nominal sum also would represent a purchase. It is unclear to the staff where the line would be drawn between a purchase and a lease.

The staff believes that if Board members are concerned with the distinction between leases that are “truly purchases” and those that are a “right of use” because of lessor accounting issues, then the Boards should instruct the staff to perform a full, robust analysis of the lessor’s accounting before issuing the proposed Discussion Paper. The staff also does not believe that this distinction will necessarily resolve the potential concerns with the application of the right-of-use model to the lessor’s accounting.

Questions for the Boards

Question 1: Do Board members agree with the staff recommendation to not modify the scope of the project?

Question 2: If Board members believe the scope of the project should be modified, on what basis should some lease contracts be excluded from the scope:

- a. Only those lease contracts that transfer title to the lessee?
- b. Some other basis (please describe)?

ISSUE 2: LESSOR APPLICATION OF THE RIGHT-OF-USE MODEL

The staff has analyzed the contractual promises exchanged and the related rights and obligations arising in a leasing arrangement. The Boards should note that this analysis is symmetrical to the analysis in the Discussion Paper of the lessee’s rights and obligations in a lease arrangement. The lessor’s rights and obligations are summarized as follows:

- a. Obligation to permit use of leased item during the lease term
- b. Right to receive payments during the lease term
- c. Right to return of the leased item at end of the lease term
- d. Right to the economic benefits derivable from use of the leased item in the period after the lease term (this right does not arise out of the lease contract itself, but is included for completeness).

The staff has performed an analysis of the lessor’s assets and liabilities that result from entering into a lease arrangement as follows.

Lessor Assets

Once the leased item has been delivered to the lessee, the lessor’s right to receive payments becomes unconditional and is controlled by the lessor (it is legally enforceable). The unconditional right arises out of a past event (the delivery of the leased item) and gives rise to future economic benefit. Consequently, this right meets the definition of an asset.

The lessor's right to have the leased item returned at the end of the lease does not in itself meet the definition of an asset because it does not result in an inflow of economic benefits (the lessor has always controlled the right to use the leased item after the end of the lease and never surrendered that right).

The lessor's right to the economic benefits deliverable from the use of the leased item in the period after the lease term (the residual rights) does not arise from the lease contract, but, rather, existed before the lease contract. However, the residual rights are considered here for completeness. Control of the residual rights is established through the lessor's legal rights over the leased item. The past event giving rise to these rights was the original acquisition of the leased item. Future economic benefits will flow to the lessor generally through sale or re-lease of the leased item after the end of the lease term. Thus, these rights meet the definition of an asset.

Lessor Liabilities

The lessor's only obligation after delivery of the leased item is to permit the use of the leased item by the lessee over the lease term. However, once the leased item is delivered to the lessee, the lessor has performed its obligation under the lease and generally does not have the contractual right to recall the item from the lessee unless the lessee breaches the contract. Consequently, this obligation does not meet the definition of a liability because it does not result in a future outflow of economic benefits. The outflow of economic benefits has already taken place (that is, the leased item has been delivered). The staff notes this analysis is consistent with the Boards' preliminary view that the lessee has an unconditional obligation to pay rentals once the leased asset is delivered to the lessee.

In the past, some working group members have questioned whether it is possible for the lessor to deliver the full right to use on delivery of the leased item. Therefore, some believe that the lessor has a performance obligation to deliver the right to use the leased item over the term of the lease. That performance obligation would be recognized by the lessor as a liability upon delivery of the leased item, and that obligation would be settled over the term of the lease.

The staff believes it is difficult to reconcile a conclusion in which the lessor has an ongoing performance obligation with the Boards' preliminary view that the lessee has an unconditional obligation to pay rentals once the leased asset is delivered to the lessee.

Under some leasing arrangements, the lessor also may have some remaining performance obligations once the leased item has been delivered. For example, the lessor may provide a warranty that the leased item will continue to work over the period of the lease. If this is the case, a performance obligation may need to be recognized in respect of this warranty. This is similar to the situation of a manufacturer who sells goods with a warranty attached.

Derecognizing the Leased Asset

The issue of asset derecognition was not specifically discussed in previous staff papers on the lessor's accounting. However, the staff believes there are four possible approaches to derecognition of the leased asset:

- a. View A: Lessor derecognizes the whole of the leased asset—The lessor removes the whole of the leased asset from its balance sheet and records an asset for its lease receivable and an asset for its interest in the residual value (if any) in the leased asset.

- b. View B: Lessor derecognizes a portion of the leased asset—The lessor removes a portion of the leased asset from its balance sheet representing the right to use the leased item over the lease term and records an asset for its lease receivable.
- c. View C: Lessor does not derecognize the leased asset (gross presentation of lease liability)—The lessor leaves the leased item on its balance sheet and records an asset for its lease receivable and a liability for its performance obligation to allow the lessee to use the leased asset.
- d. View D: Lessor does not derecognize the leased asset—The lessor leaves the leased item on its balance sheet and records an asset for its lease receivable and a contra-asset for its performance obligation to allow the lessee to use the leased asset.

Revenue Recognition

The lessor right-of-use model would result in the lessor recognizing interest income. The Boards could further consider whether there are situations in which the interest income could be classified as rental income and what situations would result in the lessor recognizing profit other than financing income (perhaps in situations in which the lease payments and the estimated residual value are in excess of the purchase or manufacturing cost of the leased asset).

ISSUE 3: CONSIDERATION OF SUBLESSOR ACCOUNTING

A right-of-use model could be applied to sublessors only. Under this approach, the intermediate lessor would not be required to classify the leases as a finance lease or as an operating lease. Instead, the intermediate lessor would record assets and liabilities based on the analysis described above (see *Lessor Assets* and *Lessor Liabilities*).

Staff Recommendation

Due to potential problems that could arise if accounting for sublessors is completed prior to lessor accounting (constituents would have to obtain knowledge of three lease models; different models for sublessors and lessors would provide structuring opportunities), the staff does not recommend developing a right-of-use model for sublessors only.

Some staff members believe that accounting for sublessors and lessors is critical to the success of a new leasing standard. Accordingly, those staff members recommend that the Boards defer the issuance of the proposed Discussion Paper until accounting for lessors and sublessors is addressed.

An alternative staff view (FASB Memorandum No. 28) recommends the issuance of the proposed Discussion Paper in February, as planned. The Discussion Paper would include the following:

- a. A description of the problems associated with subleases
- b. A description of the possible additional guidance
- c. A question asking for respondents' views on the proposed approach.

Additional guidance for subleases would be developed in accordance with the existing standards as part of work on the Exposure Draft. A lessor accounting model would be developed after the revised standard on lessee accounting has been completed.

Questions for the Boards

Question 3: Do Board members agree with the staff recommendation not to develop a right-of-use model for sublessors only?

Question 4: Do Board members want the proposed Discussion Paper to include a discussion of lessor (including sublessors) accounting?

Question 5: Do Board members want a final standard on leases to include lessor accounting?

Question 6: If Board members agree that the proposed Discussion Paper should include lessor accounting, how much discussion of lessor accounting should be included?

- a. Include the issues identified in Memorandum 27?
- b. Perform additional analysis for inclusion in the proposed Discussion Paper? If so, what additional analysis should be performed?



**Board Meeting Handout
Conceptual Framework**

January 14, 2009

1. At today's meeting, the Board will discuss:
 - a. Measurement: *Narrowing the Set of Measurement Bases for the Framework and Consequences for Viewing Measurement Issues*
 - b. Issues from the Exposure Draft on the Conceptual Framework for Financial Reporting: *The Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*
 - c. Issues from the Preliminary Views Document on the Conceptual Framework for Financial Reporting: *The Reporting Entity*

MEASUREMENT

Recasting the Set of Potential Measurement Bases

2. As a result of the discussion of measurement bases at the November 2008 Board meetings, the staff recast the set of potential measurement bases for the framework into two groups:
 - a. **Actual, estimated, and forecast prices.** This group includes actual and estimated past entry prices, estimated past exit price, actual and estimated current entry prices, estimated current exit price, and forecasts of future entry and exit prices. Those prices are before any transaction costs or other adjustments. Entry prices may be actual or estimated, depending on whether a transaction price is used or an estimate is made of what an entry price would be in the absence of a transaction price. Exit prices are all estimates, because actual exit prices are available only when assets are disposed of or liabilities are extinguished, in which case those items are no longer reported. Price bases and possible adjustments to them are summarized in Table 1 on page 2.
 - b. **Non-price amounts.** This group includes value in use, prescribed present value computations, and fair-value-based amounts. Prescribed present value computations and fair-value-based amounts could be used either for individual assets or liabilities or for groups of identical or similar assets or liabilities that might be transferred together at a price different from the sum of the individual prices. Value in use, however, may be suitable only for groups of assets or liabilities. This group of bases is summarized in Table 2 on page 3.

Table 1: Actual, Estimated, and Forecast Prices

Possible prices	Possible adjustments	Comments
Actual or estimated past entry price (including accumulation of prices and costs of constructed assets)	a. Actual transaction costs b. Systematic increase or decrease to a terminal value c. Valuation allowances for impairment	Similar to historic cost or historical cost (or proceeds) except that those amounts may include transaction costs
Estimated past exit price	a. Actual transaction costs b. Systematic increase or decrease to a terminal value c. Valuation allowances for impairment	Used for some impairments
Actual or estimated current market entry price	Actual or estimated transaction costs	Sometimes used as a surrogate for exit price and possibly instead of exit price under IFRS or GAAP prior to Statement 157
Estimated current market exit price	a. Estimated transaction costs b. Prepayment penalty c. Early withdrawal penalty d. 'Fire sale' discount e. Costs to complete or otherwise prepare for sale	Fair value computed under the "in exchange premise" as defined in Statement 157
Forecast future entry price	Estimated transaction costs	Not currently used except as an input to value in use estimations
Forecast future exit price	a. Estimated transaction costs b. Prepayment penalty c. Early withdrawal penalty d. 'Fire sale' discount e. Costs to complete or otherwise prepare for sale	Basis for recognizing contingent losses under Statement 5

Table 2: Non-price Amounts

Possible nonprice amounts	Description	Comments
Value in use	Probability weighted future cash flows to be generated by using (not selling) an asset discounted to current date	This would not seem to apply to liabilities. Cash flows could be market based or entity specific. If market based, it would seem to be the fair value in Statement 157 determined under the “in use premise.”
Prescribed present value computation	Probability weighted or most likely future cash flows discounted at a specified rate	One of the options for impaired loans under Statement 114
Fair-value-based amounts	A form of prescribed present value. It starts with a fair value computation similar to that of Concepts Statement 7, but omits one or more factors that market participants would consider.	Used in Statement 123R. Fair value without changes in credit risk would be in this category.

3. Based on the preceding tables, the Boards may wish to consider:

- a. Whether it is possible to reduce the number of measurement bases that might be used in the framework before discussing the choice between current and non-current values in more detail.
- b. What aspects of the remaining measurement bases need to be considered to develop conceptual guidance for an improved mixed-basis measurement system, assuming that a choice of measurement basis is from among current values or from among non-current values (rather than between a current value and a non-current value)?

Reducing the Number of Potential Measurement Bases

4. Reducing the number of measurement bases to choose from in the conceptual framework is one way to simplify, and thus improve, the current mixed-basis measurement system. Initial options for reducing the number of measurement bases to choose from include:

- a. Eliminate past prices as a measurement basis (this would not preclude presenting assets or liabilities at past prices in financial statements)

- b. Eliminate future prices as measurement bases
- c. Eliminate value in use as a measurement basis.

Considering Remaining Measurement Bases

- 5. The remaining measurement bases would include:
 - a. Adjusted past entry price
 - b. Adjusted estimated past exit price
 - c. Actual or estimated current entry price
 - d. Estimated current exit price
 - e. Prescribed present value computation
 - f. Fair value-based amount.
- 6. With respect to the remaining measurement bases, the Boards may wish to:
 - a. Consider whether it is desirable to default to adjusted past prices when current prices are not used for remeasurement
 - b. Consider whether it is desirable to adjust current-value impairments
 - c. Consider limiting measurement at initial recognition to current entry price
 - d. Consider limiting remeasurement to current exit price.

QUALITATIVE CHARACTERISTICS AND CONSTRAINTS OF DECISION-USEFUL FINANCIAL REPORTING INFORMATION

Distinction between Fundamental and Enhancing Qualitative Characteristics

7. Chapter 2 of the Exposure Draft, *An improved Conceptual Framework: Chapter 1: The Objective of Financial Reporting* and Chapter 2: *Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* (ED) asked whether the distinctions—fundamental and enhancing qualitative characteristics (QCs) and pervasive constraints of financial reporting—are helpful. The fundamental QCs are relevance and faithful representation. The enhancing QCs are understandability, comparability, verifiability and timeliness. The constraints are materiality and costs.
8. A majority of respondents supported the distinctions. Those who disagreed with the proposed classification of QCs and constraints made the following points:
 - a. Understandability and verifiability should be considered fundamental rather than enhancing
 - b. The distinctions are arbitrary, of little or no use, and not adequately justified
 - c. All QCs are equally important
 - d. The most important QCs vary depending on circumstances
 - e. Materiality should be part of relevance.
9. Other issues to discuss include how to apply the components of faithful representation.

Questions for the Board

Q1: Should we distinguish the QCs as fundamental and enhancing?

Q2: Are the fundamental QCs relevance and faithful representation?

Q3: Are the enhancing QCs verifiability, timeliness, understandability and comparability?

Q4: Are the constraints of financial reporting materiality and costs?

Replacement of ‘Reliability’ with ‘Faithful Representation’

10. The ED proposed to replace the term *reliability* with the term *faithful representation* because constituents seldom use the term *reliability* as defined in the frameworks. Rather, many respondents to due process documents often used the term *reliability* to mean whatever they chose. Many respondents to the ED continued to equate reliability to mean whether an item can be measured or estimated precisely.

Question for the Board

Q5: Do you confirm that we should replace the term *reliability* with *faithful representation*?

THE REPORTING ENTITY

11. For this meeting, the Boards will discuss the following issues:

- a. Description of the reporting entity, including the use of the terms *circumscribed*, *business activities*, *of interest to*, and *capital providers*
- b. Implications of the description of the reporting entity, including whether a reporting entity must be a legal entity, whether a legal entity is always a reporting entity, and whether a reporting entity could be a branch or segment of a legal entity
- c. Group reporting entity, including the controlling entity model, the common control model, and the risks and rewards model
- d. Whether (i) consolidated and (ii) parent-only financial statements constitute general purpose financial statements.

Questions for the Board

Q1: Does the Board agree to refer to a definition rather than a description of a reporting entity and that no special emphasis be placed on whether that definition is broad or precise?

Q2: Does the Board agree with the revised description (or now definition) of a reporting entity, which incorporates the following changes?

- a. Replace *business activity* with *economic activity*
- b. Clarify that the interest of capital providers is to obtain financial information that has the potential to be useful in making decisions
- c. Clarify that capital providers refer to those in their capacity as capital providers.

Q3: Does the Board agree to clarify that a circumscribed area of business activity will usually be circumscribed by legal or contractual rights or, in their absence, by an effective mechanism of sanctions?

Q4: Does the Board agree to clarify that a reporting entity should be determined based on the economic activities the entity is capable of or authorized to conduct?

Q5: Does the Board agree that any changes in Phase A regarding the primary users of financial reports should be carried over to the definition of a reporting entity?

Q6: Does the Board agree with the following in relation to the implications of the definition of the reporting entity?

- a. Continue to support that a reporting entity need not be a legal entity
- b. Clarify that a legal entity would likely, but not necessarily, meet the definition of a reporting entity
- c. Continue to support that a branch or segment of a legal entity could meet the description of a reporting entity.

Q7: Does the Board agree with the following regarding the group reporting entity?

- a. The forthcoming Exposure Draft should not prioritize among the controlling entity model and the common control model, although it would acknowledge that the controlling entity model would be used in most cases and the common control model in some cases
- b. The forthcoming Exposure Draft should not discuss the risks and rewards model as a standalone model but rather discuss it in the context of complementing the controlling entity model (if appropriate)
- c. The forthcoming Exposure Draft should not discuss other possible models (that is, models other than the controlling entity model and the common control model). Those models would be addressed at the standards level or by each jurisdiction if necessary.

Q8: Does the Board agree with the following regarding consolidated and parent-only financial statements?

- a. Consolidated financial statements represent a set of financial statements that are most likely to provide decision-useful information to the greatest number of primary users
- b. Financial statements of an entity that does not have a subsidiary, affiliate, or venturer's interest in a jointly controlled entity should be considered consolidated financial statements
- c. Parent-only financial statements, in themselves, do not constitute general purpose financial statements but should be viewed as either special purpose financial statements or additional information to general purpose financial statements
- d. The forthcoming Exposure Draft should not discuss whether and, if so, how parent-only financial statements should be presented.