

MINUTES



Financial Accounting
Standards Board

To: Board Members

From: Leases Team (Yust)

Subject: Minutes of the November 19, 2008,
Board Meeting: Consideration of Lease
Term, Purchase Options, Contingent
Rentals, and Residual Value
Guarantees; Subsequent Measurement;
Lease Presentation; Subleases

Date: February 3, 2009

cc: FASB: Bielstein, Golden, Lott, Stoklosa, Proestakes, Posta, Chookaszian,
Zeyher, Nickell, Homant, Martin, C. Smith, Brickman, Sutay, Glotzer,
Mechanick, Gabriele, Allen, Klimek, FASB Intranet; IASB: Leisenring,
Francis, Knubley, Peerless, Sunhee

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 #21 (IASB Agenda Paper 8)
Memorandum #22 (IASB Agenda Paper 8A)
Memorandum #23 (IASB Agenda Paper 8B)
Memorandum #24 (IASB Agenda Paper 8C)
Memorandum #25 (IASB Agenda Paper 8D)

Length of Discussion: 9:00 a.m. to 12:15 p.m., 12:40 p.m. to 1:20 p.m.

Attendance:

Board members present:	Herz, Linsmeier, Seidman, Siegel, and Smith
Board members absent:	None
Staff in charge of topic:	Zeyher
Other staff at Board table:	Golden, Stoklosa, Nickell, Homant, and Yust
Outside participants:	Knubley (IASB) and Peerless (IASB)

Summary of Decisions Reached

The Board discussed several areas that were identified by the joint working group meeting as areas that should be further explored before issuance of a Discussion Paper.

The Board decided that the determination of the lease term should be a recognition decision. For example, for a 10-year lease with an option to renew for 5 years, the lessee must determine if it is recognizing a 10-year lease or a 15-year lease, and then the lessee would recognize a right-to-use asset and obligation to pay rentals at the present value of the expected lease payments over that term. For leases with renewal, termination, and/or purchase options, the lessee would make a determination of the most likely lease term based on its own assessment of all contractual, noncontractual, and business factors.

The Board decided that a lessee would measure contingent rentals and any residual value guarantees based on the lessee's best estimate of the expected lease payments over the term of the lease. A lessee would determine its best estimate by considering the range of possible outcomes and the likelihood of each, but the lessee is not required to probability-weight the various possible outcomes in determining the expected lease payments. However, if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee would measure the contingent rentals using the index or rate existing at the inception of the lease in its initial determination of the best estimate of expected lease payments.

The Board decided that a lessee would be required to reassess the lease term and its lease obligation using its current assumptions at each reporting date. The Board decided that a lessee should subsequently measure its lease obligation at the present value of its current best estimate of expected lease payments over the revised lease term, discounted at the effective interest rate determined at lease inception. A lessee would recognize changes in the lease obligation through a corresponding adjustment to the carrying value of the right-of-use asset to the extent that the change arises from updated expectations about the lease term (for example, a revised assessment of the likelihood that the entity will exercise a renewal option) and through profit or loss to the extent that the change arises from

updated expectations about the measurement of contingent rentals or residual value guarantees.

The Board decided that a lessee would amortize/depreciate the right-of-use asset and apportion the lease payments between a finance charge and a reduction of the outstanding obligation, with interest expense and amortization/depreciation presented on the income statement. However, a majority of the Board believed that there were differences between leases that are in-substance purchases and leases that only convey a right to use that may merit differences in the subsequent measurement or presentation. Accordingly, the Board instructed the staff to include questions for financial statement users in the Discussion Paper to assess whether users believe that leases that are in-substance purchases should be measured or presented differently from leases that only convey a right to use.

The Board decided that leases should be presented separately from owned assets on the statement of financial position as either in-substance purchases or rights to use. The Board also decided that the obligation to pay rentals should be presented separately from other financial liabilities on the statement of financial position. The Board decided that presentation of the lease on the income statement and the statement of cash flows would be determined based on feedback from financial statement users regarding subsequent measurement and presentation of the right-of-use asset.

The Board instructed the staff to further analyze the accounting for subleases for its consideration before publication of the Discussion Paper. The analysis would (1) develop a proposed model to account for subleases, (2) indicate how that model would broadly apply to lessor accounting (in situations other than a sublease), and (3) indicate how the proposed model would compare to the Board's tentative decisions regarding revenue recognition.

Objective of Meeting:

The objective of the meeting was for the Board to discuss several areas that were identified at the working group meeting as areas that should be further explored before issuance of a proposed Discussion Paper. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1: INITIAL RECOGNITION AND MEASUREMENT OF THE LESSEE'S OBLIGATION TO PAY RENTALS (FASB MEMO NO. 22)

ISSUE 1(a): Lease Term and Purchase Options

1. **Staff Recommendation:** The majority of staff members recommended that the Board clarify that the assessment of the lease term is done for *recognition*. The majority of staff members recommended that for leases with renewal, termination, and/or purchase options, the lessee would make a determination of the most likely lease term based on its own assessment of all contractual, noncontractual, and business factors.
2. **Board Vote:** The Board unanimously voted to clarify that the assessment of the lease term is done for recognition. The Board also unanimously voted to require the lessee to determine the most likely lease term after consideration of all contractual, noncontractual, and business factors.
3. **Board Comments:** Mr. Linsmeier noted that the determination of the most likely term would require judgment and would not be a purely statistical analysis. For example, a lessee may have to first identify the most likely range of lease terms and then select the most likely lease term within that range, rather than simply selecting the lease term with the highest probability.
4. Ms. Seidman noted that because the assessment of the lease term is done for recognition, the guidance should not use measurement language such as “best estimate.” She recommended the term *most likely*.

5. Mr. Smith questioned what the lease term would be if the lessee determined it was most likely that it would exercise the purchase option. Mr. Nickell stated that the lessee would amortize the right-of-use asset over the economic life of the asset if it was determined that the lessee essentially purchased the asset.
6. Mr. Golden questioned whether the lease would be presented as a lease or as the underlying asset if the lessee determined that it was most likely that the lessee would exercise the purchase option. Ms. Knubley stated that the staff recommends that the leased asset be presented separately from, but adjacent to, owned assets. Mr. Stoklosa noted that there was likely a business reason why the lessee would have entered into a lease with a purchase option, rather than purchase the asset outright. Additionally, Ms. Seidman noted that leases were subject to different estimates and remeasurements from purchased assets.

Issue 1(b): Contingent Rentals and Residual Value Guarantees

7. **Staff Recommendation:** Some staff members recommended that the initial measurement of contingent rentals and residual value guarantees be based upon the lessee's best estimate of expected lease payments, described as the amount that the lessee believes is the most likely to occur. Other staff members recommended that an expected outcome (probability-weighted) best estimate approach should be used.
8. **Board Vote:** The Board unanimously voted to require the lessee to measure contingent rentals and any residual value guarantees based on the lessee's best estimate of the expected lease payments over the term of the lease. A lessee would determine its best estimate by considering the range of possible outcomes and the likelihood of each, but the lessee would not be required to probability weight the various possible outcomes in determining the expected lease payments. However, if lease payments were contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee would measure the contingent rentals using the index or rate existing at the inception of the lease in its initial determination of the best estimate of expected lease payments.

9. **Board Comments:** Mr. Herz noted that the first question that the Board must address is whether the lessee (a) determined its expected lease payments after consideration of both fixed and contingent payments under the lease contract or (b) componentized its contingent payments and determined its expected contingent payments and added that amount to its fixed payments.
10. Mr. Smith questioned whether any amount would be accrued for contingent payments if the contingent rents would be required 50 percent of the time, but the lease was negotiated such that the fixed amounts were equal to the best estimate of expected lease payments. Mr. Golden stated that one way to address those concerns would be to have a recognition threshold for contingent rents.
11. Mr. Stoklosa stated that a lessee would determine the expected amount of sales under a lease that (a) had both fixed and contingent payments and (b) was only contingent payments. Based on that determination of the expected sales, the lessee would determine its best estimate of the expected lease payments. Ms. Seidman agreed and stated that the amount determined as the best estimate of the expected lease payments should be independent of the amount of minimum fixed lease payments.
12. Mr. Linsmeier noted that the biggest issue the Board had to address was whether to require an expected outcome approach. He noted that the IASB had previously expressed a preliminary view to require an expected outcome approach for contingent rents. Mr. Linsmeier stated that the expected outcome, mode, and mean, were very similar in a symmetric distribution; however, those amounts were very dissimilar in an asymmetric distribution.
13. Mr. Linsmeier stated that the index-based-contingent rents were probably symmetric. However, he noted that performance targets and usage targets could be set at levels that would only require a lessee to pay additional lease payments if it did better than expected; as a result, the distribution would be asymmetric and the lessee would only accrue for the minimum fixed lease payments at the inception of the lease. However, an expected outcome approach would force a lessee to

consider the tail of the distribution for the contingent payments and would result in a higher amount being accrued for the estimated lease payments.

14. Mr. Stoklosa noted that the fundamental question that the Board had to answer was whether the lessee would be required to make a very scientific, mathematical calculation under an expected outcome approach or whether the lessee could attempt to come up with a similar answer based on its own expectations without having to show the auditors a spreadsheet assigning probabilities to every possible outcome. Under the later approach, he noted that the lessee could use any technique, including an expected outcome technique, to justify its own best estimate of what it expects to pay.
15. Mr. Linsmeier stated that the proposed Discussion Paper should ask constituents how formally the lessee should be required to consider the probabilities of possible outcomes in its determination of the best estimate of expected lease payments. For example, Ms. Seidman noted that many preparers will, as part of their budget process, establish sales targets that include a base case, worst case, and most likely case for expected sales. She noted that those sales targets would not be explicitly probability weighted, but believes that the process should be sufficient to demonstrate that a lessee had considered the probabilities of possible outcomes when it determines its best estimate of expected lease payments. However, Mr. Linsmeier noted that academic research had demonstrated that a preparer could get a very good estimation by only assigning probabilities to three outcomes: low, middle, and high.
16. Ms. Zeyher questioned how preparers applied the current probability-weighted best estimate requirement in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, in practice. Ms. Knubley stated that it depended on the type of estimate and noted that some estimates were more statistical while others were more informal. However, Mr. Herz noted that in the U.S. accounting environment, a requirement to perform an expected outcome approach would result in preparers being required to perform a rigorous probability-weighted best estimate for accounting purposes only.

Additionally, Mr. Herz noted that a lessee could reverse engineer an expected outcome approach to result in a lower best estimate, so he questioned whether it would result in a better estimate.

17. Ms. Seidman clarified that the lessee would be using its own assumptions, not market participant assumptions, under either approach.
18. Ms. Seidman stated that it should not be necessary to discount a forward curve for contingent rent payments based on an index, such as the consumer price index or prime rate. Rather, she stated that the lessee should be able to use the current price of the index in its estimation of expected lease payments, updated at each remeasurement.
19. Mr. Smith noted that any problems with the initial measurement would be fixed by the requirement to reassess the best estimate of the expected lease payments.

ISSUE 2: SUBSEQUENT MEASUREMENT (FASB MEMO NO. 23)

Issue 2(a): Subsequent Measurement

20. **Staff Recommendation:** The staff recommended that a lessee should amortize/depreciate the right-of-use asset systematically over the shorter of the lease term and the economic life of the leased asset. The staff also recommended that the lessee should apportion the lease payment between a finance charge and a reduction of the outstanding liability. As a result, interest expense and amortization/depreciation would be presented on the income statement
21. **Board Vote:** The Board unanimously voted to support the staff's recommendations for purposes of the proposed Discussion Paper. However, Messrs. Herz, Linsmeier, and Siegel and Ms. Seidman believed that there were differences between leases that are in-substance purchases and leases that only convey a right to use that may merit differences in the subsequent measurement or presentation. Accordingly, the Board instructed the staff to include questions for financial statement users in the proposed Discussion Paper to assess whether users believe that leases that are in-

substance purchases should be measured or presented differently from leases that only convey a right to use.

22. **Board Comments:** Mr. Smith supported the staff recommendation. He stated that he viewed any lease as a *purchase* of a right-of-use asset that has been financed, so he believed it should be accounted for similarly to any other purchase with a financing.
23. However, Mr. Siegel believes there were economic differences between leases that were in-substance purchases and leases that were rights to use. He agreed that leases that were in-substance purchases should be depreciated; however, he believes that leases that were rights to use should continue to show rent expense on the income statement. He noted that users generally viewed depreciation/amortization as non-cash charges and viewed rent expense as actual cash outflows. Nonetheless, he agreed that there was an interest component in all leases and stated that he would support recognition of interest expense accordingly.
24. Mr. Linsmeier stated that one needed to think about lessor accounting and its implications on symmetry for the presentation of the lease by the lessee. For example, if a lease was an in-substance sale by the lessor, it would make sense that it was an in-substance purchase by the lessee. However, if a lease was only a right to use conveyed by the lessor, it would support that the lease was only a right to use by the lessee. He believes that those differences could merit different presentation on the income statement.
25. Mr. Herz agreed that there were some differences between leases that were in-substance purchases and others that were rights to use. He also stated that he was concerned about the implications for users of presenting all leases the same. As a result, Mr. Herz stated that he would support rent expense without interest expense for certain leases that were rights to use because there could be a substantive difference between renting an asset and buying an asset and financing it. Mr. Herz also questioned whether all users would find separate presentation of interest expense useful and stated that users did not want interest expense presented in the

financial guarantee project. However, he noted that history had shown it was difficult to identify the differences between in-substance purchases and other leases.

26. Ms. Seidman noted that the revenue recognition project took a more holistic approach to determining whether the transaction involved a good or a service, and questioned whether the leasing project could take a similar approach. While she noted that users wanted capitalization of the lease on the balance sheet, she also noted that there had not been much focus on problems on the income statement. Hence, she questioned whether the existing income statement presentation of rent expense should be changed.
27. Mr. Linsmeier proposed that the proposed Discussion Paper support the staff recommendation with discussion that some Board members believe there may be a difference between in-substance purchases and other leases, with a request for feedback from financial statement users. Additionally, Ms. Seidman noted that the Board needed information from users on what benefit a distinction between different types of leases would provide and what would be the most representationally faithful presentation.

Issue 2(b): Reassessment of the Lease Term

28. **Staff Recommendation:** The staff recommended that the lease term be reassessed at each reporting date to determine the best estimate of the expected lease term.
29. **Board Vote:** The Board unanimously voted to support the staff recommendation.
30. **Board Comments:** None.

Issue 2(c): Reassessment of the Lessee's Obligation to Pay Rentals

31. **Staff Recommendation:** The staff recommended that the obligation to pay rentals be reassessed at each reporting date over the lease term.
32. **Board Vote:** The Board unanimously voted to support the staff recommendation.

33. **Board Comments:** Ms. Seidman clarified that the reassessment only would occur based on new information.

Issue 2(d): How to Record Changes in the Estimated Lease Payments

34. **Staff Recommendation:** The staff recommended that a lessee’s liability to the lessor be subsequently measured using the effective interest rate (employing a “catch-up approach” for changes in cash flow estimates).
35. **Board Vote:** The Board unanimously voted to support the staff recommendation.
36. **Board Comments:** None.

Issue 2(e): How to Recognize the Resulting Difference in the Measurement of the Liability

37. **Staff Recommendation:** The staff recommended that all changes to the estimated rental payments be accounted for similarly as an adjustment to the carrying value of the right-of-use asset.
38. **Board Vote:** Messrs. Herz, Linsmeier, and Siegel and Ms. Seidman voted to require a lessee to recognize changes in the lease obligation through a corresponding adjustment to the carrying value of the right-of-use asset to the extent that the change arises from updated expectations about the lease term (for example, a revised assessment of the likelihood that the entity will exercise a renewal option) and through profit or loss to the extent that the change arises from updated expectations about the measurement of contingent rentals or residual value guarantees. Mr. Smith voted to require a lessee to do a cumulative catch up to adjust the lease obligation and the right-of-use asset to reflect the amounts they would have been recorded at on the inception of the lease using the current assumptions, with any offsetting amount being recognized in profit and loss.
39. **Board Comments:** Mr. Herz agreed with a corresponding adjustment to the right-of-use asset in cases in which the value of the asset was actually changing, such as a change in the assessment of a renewal option or a purchase option. However, he

stated that a change in the assessment of contingent rents or residual value guarantees was a change in the cost of the lease without a change in the benefit; therefore, it should go to profit and loss.

40. However, Mr. Smith believed that all changes should be treated the same whereby the lease obligation and the right-of-use asset would both be cumulatively adjusted to reflect the amounts they would have been recorded at on the inception of the lease using the current assumptions. Any offsetting amount needed to balance the adjusting journal entry would go to profit and loss. Ms. Seidman proposed a similar alternative whereby the lease obligation and the right-of-use asset would both be adjusted to reflect the amounts for future periods without requiring a retrospective adjustment.
41. Mr. Linsmeier and Mr. Siegel believed that Mr. Smith's approach was conceptually superior, but questioned its operationality for a lessee with multiple leases. Ms. Seidman did not think Mr. Smith's approach would be operational, but questioned whether the alternative approach was much less complicated.

ISSUE 3: LEASE PRESENTATION (FASB MEMO NO. 24)

Issue 3(a): Presentation of the Right-of-Use Asset

42. **Staff Recommendation:** The staff recommended that the right-of-use asset be presented based on the nature of the underlying leased item separately from, but adjacent to, owned assets.
43. **Board Vote:** Messrs. Herz, Linsmeier, and Siegel and Ms. Seidman voted to require that leases be presented as either in-substance purchases or rights to use. In-substance purchases would be presented as the underlying asset and rights to use would be presented separately from, but adjacent to, owned assets on the statement of financial position. Mr. Smith voted to require that all leases be presented based on the nature of the underlying leased item separately from, but adjacent to, owned assets on the statement of financial position.

44. **Board Comments:** Mr. Linsmeier believes that some leases should be presented as in-substance purchases by the lessee and in-substance sales by the lessor. He noted that if a lessor was deemed to have an in-substance sale of an asset, (such as in very limited circumstances when there is a transfer of title or a bargain purchase option) that asset should be presented as an in-substance purchase by the lessee.
45. Ms. Seidman agreed and stated that the Boards should discuss in-substance sales and purchases prior to the issuance of the proposed Discussion Paper.
46. Mr. Smith believed the model for leases was a right-to-use model, so all leases should be presented as rights to use.

Issue 3(b): Presentation of the Obligation to Pay Rentals

47. **Staff Recommendation:** The staff recommended that the obligation to pay rentals should not be required to be presented separately from other financial liabilities.
48. **Board Vote:** The Board unanimously voted to require that the obligation to pay rentals be presented separately from other financial liabilities on the statement of financial position.
49. **Board Comments:** Ms. Seidman noted that leases were subject to numerous distinct estimates and revaluations as compared to other financial liabilities; therefore she believes they should be presented separately from those financial liabilities on the statement of financial position.

Issue 3(c): Presentation of the Income Statement and Statement of Cash Flows

50. **Staff Comments:** The staff stated that the Board's decisions regarding subsequent measurement and presentation of the assets and liabilities arising under a lease contract would determine the presentation of whether the lessee presents rent expense or interest and depreciation/amortization expense. The staff stated that it will include a question for users on whether any separate or alternative presentation of those items on the income statement or statement of cash flows should be required.

51. **Board Comments:** Mr. Herz agreed that the basic cohesive principle would apply to the items on the income statement and statement of cash flows.

ISSUE 4: SUBLEASES (FASB MEMO NO. 25)

52. **Staff Recommendation:** Some staff members recommended that the Board not attempt to reach a preliminary view on subleases at this stage of the project, but, rather, include with the proposed Discussion Paper a description of the problems associated with subleases, a description of possible solutions, and a question asking for respondent's views on which solutions they would favor and why. Other staff members recommended that a more thorough analysis of subleases should be developed prior to releasing the proposed Discussion Paper.
53. **Board Vote:** The Board unanimously voted to require the staff to further analyze the accounting for subleases for its consideration before publication of the proposed Discussion Paper. The analysis would (a) develop a proposed model to account for subleases, (b) indicate how that model would broadly apply to lessor accounting (in situations other than a sublease), and (c) indicate how the proposed model would compare to the Board's tentative decisions regarding revenue recognition.
54. **Board Comments:** Mr. Linsmeier believes that accounting for subleases needs to be addressed prior to the issuance of the proposed Discussion Paper. He also believes that model needs (a) to be considered for its applicability to lessor accounting and (b) to address whether there were leases that were in-substance sales and in-substance purchases. Mr. Herz also believes that the model for subleases should be applied to the current revenue recognition model because no revenue recognition should be permitted for a lessor upfront on a lease unless the lease was considered an in-substance purchase.
55. Ms. Seidman noted that the members of the leases working group stated that subleases needed to be addressed prior to the issuance of the proposed Discussion Paper to have a coherent and complete model. However, she stated that any partial approach to fix subleases may be broadly applicable for lessor accounting. She

recommended that the staff develop a model for sublessors and that the model should be used to address lessor accounting.

56. Mr. Smith noted the complexities identified in the proposed Discussion Paper with applying a FASB Statement No. 13, *Accounting for Leases*/IAS 17, *Leases*, model to subleases; he believes a simple sublease accounting fix may be possible without undue delay. He noted that most lessees were not entering into subleases for revenue recognition purposes. Accordingly, he believes that the right-of-use asset should be derecognized to the extent that it was subleased. However, Mr. Linsmeier questioned whether derecognition was appropriate. He noted that derecognition may be appropriate if there was a sale. Otherwise, a performance obligation would be recognized for rights of use. Ms. Knubley noted that the Boards would have to address if subleases should be presented gross or net.
57. Mr. Golden was concerned that if a different model existed for lessors and sublessors, it may lead to structuring to achieve a favorable accounting treatment. As a result, he believes that the Board may either have to address those concerns through the scope of the subleasing model or by reconsidering its previous decision to defer lessor accounting.
58. The Board recommended that the staff come back with a paper on subleases that applies a right-of-use model for subleases. Then a sense check can be done against broader lessor accounting. The revenue recognition model also should be considered broadly as it applies to lessors. The Board recommended considering these issues further prior to issuance of a proposed Discussion Paper.

Follow-up Items:

None.

General Announcements:

None.