



Board Meeting Handout

LEASES

November 19, 2008

PURPOSE

The purpose of this meeting is 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 Board will specifically discuss (a) initial recognition and measurement of the lessee's obligation to pay rentals, (b) subsequent measurement of the lessee's obligation to pay rentals, (c) presentation, and (d) subleases.

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

Background

The preliminary views that the Boards reached at the July 2008 joint Board meeting describe the determination of the lease term as both a recognition *and* a measurement question. The staff believes that the Board should clarify whether the assessment of the lease term is done for *recognition* or *measurement*. In other words, for a 10-year lease with an option to renew for 5 years, is the lessee recognizing (a) a 10-year lease with a 5-year option to renew or (b) a 10-year lease or a 15-year lease.

The staff has identified two approaches to address this issue:

- a. Approach 1—Lessee recognizes an obligation to pay rentals; so uncertainty regarding lease term is addressed through measurement
- b. Approach 2—Lessee recognizes an obligation to pay rentals for a specified lease term, so uncertainty regarding lease term is addressed through recognition.

Staff Recommendation

The majority of staff members recommend Approach 2 because they believe it more appropriately reflects the binary nature of a recognition decision; a lessee will either renew a lease or it won't. One staff member recommends Approach 1.

Question for the Board

Q1: Does the Board agree with the staff's recommendation to require an assessment of the lease term to determine what the item is that the lessee is going to recognize?

If the Board selects Approach 1, then the Board can ignore the sections titled "Determining the Lease Term" and "Purchase Options" under Approach 2. If the Board selects Approach 2, then the Board can ignore the sections titled "Determining the Lease Term" and "Purchase Options" under Approach 1.

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Determining the Lease Term under Approach 2

If the Board agrees with the staff's recommendation in question 1 that uncertainty regarding the lease term should be addressed through recognition, it will have to specify how the lessee determines whether it is recognizing a 10-year lease or a 15-year lease. Because this approach views renewal options as a yes-or-no decision, an expected outcome approach would not be used. The staff has identified three approaches to assess the lease term:

- a. Approach 2A—A probability threshold
- b. Approach 2B—A best estimate
- c. Approach 2C—A best estimate; most likely lease term.

Staff Recommendation

The majority of the staff recommends Approach 2C because it is simple but provides some clarity around the phrase *best estimate*. One staff member recommends Approach 2A.

Question for the Board

Q2: Does the Board agree with the staff recommendation that the lease term should be the term that the lessee believes is most likely to occur? If not, how does the Board believe the lease term should be determined?

Purchase Options under Approach 2

Purchase options allow the lessee the option to purchase the leased property on or after a specified date. Existing standards require the exercise price to be included in the minimum lease payments if it is reasonably certain at lease inception that the lessee will exercise the option.

Staff Recommendation

The staff believes a purchase option is essentially the “ultimate renewal option,” therefore, the staff does not believe it should be recognized separately nor be subject to a different recognition threshold than renewal options.

Questions for the Board

Q3: Does the Board agree with the staff's recommendation to require an assessment of whether or not the lessee will exercise a purchase option to determine what the item is that the lessee is going to recognize?

Q4: Does the Board agree that the purchase option price should be included in the obligation to pay rentals if the lessee believes the exercise of the purchase option is the most likely outcome?

Determining the Lease Term under Approach 1

If the Board decides in question 1 to address lease term uncertainty through measurement (that is, Approach 1), then they will need to decide how to address uncertainty through measurement. Most Board members have agreed that an expected outcome technique should be the starting point when measuring conditions of uncertainty; however, the staff has identified two additional alternative approaches. The three approaches are as follows:

- a. Probability-weighted best estimate (expected outcome)
- b. Best estimate

- c. Best estimate; most likely amount.

Staff Recommendation

Some staff members recommend that the measurement of the lessee's obligation be based upon the lessee's best estimate, described as the most likely lease term. Those staff members believe that the disadvantages of an expected outcome approach outweigh the benefits and that such a model would be inconsistent with a cost accumulation model. Other staff members believe the only approach to measurement that is consistent with Approach 1 is an expected outcome approach.

Question for the Board

Q5: Which of the approaches to measurement does the Board support?

Purchase Options under Approach 1

If the Board selects Approach 1, they will need to decide how to address the uncertainty regarding purchase options. The staff believes the same three approaches to determine the lease term under Approach 1 would apply for the determination of purchase options.

Staff Recommendation

All staff members recommend a consistent approach for the measurement of the lease term and purchase options, so the staff has the same recommendation for lease term under Approach 1 as for purchase options.

Q6: Which approach to measurement does the Board support?

Issue 1(b): Contingent Rentals

Background

The Boards have preliminarily decided that the assets and liabilities recognized by the lessee should reflect the obligation to make contingent rentals and that contingent rentals should be included in the initial measurement based on the lessee's best estimate. The FASB tentatively decided to require the lessee to use a best estimate of contingent rentals payable; the IASB tentatively decided to require the lessee to use a probability-weighted best estimate. To reach a converged preliminary view, the staff believes there are three approaches for the initial measurement of contingent rentals:

- a. Best estimate
- b. Best estimate; most likely amount
- c. Probability-weighted best estimate (expected outcome) .

Staff Recommendation

Some staff members recommend that the initial measurement of contingent rentals be based upon the lessee's best estimate of contingent rentals, described as the amount that the lessee believes is the most likely to occur. Other staff members recommend that, as this is a measurement under conditions of uncertainty, a probability-weighted best estimate approach would provide the most useful information to users.

Question for the Board

Q7: Which approach to measurement does the Board prefer?

Issue 1(c): Residual Value Guarantees

Recognition

Under a residual value guarantee, the lessee will compensate the lessor if the value of the leased item at the end of the lease falls below a specified value. Under existing accounting standards, the maximum amount payable under a residual value guarantee is included in the minimum lease payments.

The Board could decide to require separate recognition of residual value guarantees or could require that residual value guarantees be included in the initial value of the assets and liabilities recognized by the lessee.

Staff Recommendation

The staff recommends that residual value guarantees be included in the initial value of the assets and liabilities recognized by the lessee at the inception of the lease.

Question for the Board

Q8: Does the Board agree with the staff's recommendation that the initial assets and liabilities recognized by the lessee should reflect the obligation to make payments under a residual value guarantee?

Measurement

The staff believes there are four alternative approaches for the measurement of residual value guarantees:

- a. Current approach
- b. Best estimate
- c. Best estimate; most likely amount
- d. Probability-weighted best estimate (expected outcome).

Staff Recommendation

Some staff members recommend that the initial measurement of residual value guarantees be based upon the lessee's best estimate of contingent rentals, described as the amount that the lessee believes is the most likely to occur. Other staff members recommend that, as this is a measurement under conditions of uncertainty, a probability-weighted best estimate approach would provide the most useful information to users.

Q9: Which approach to measurement does the Board support?

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

Issue 2(a): Subsequent Measurement

The IASB reached a preliminary view that a lessee should amortize the right-of-use asset on a systematic basis. The IASB also reached a preliminary view that a lessee should apportion the lease payments between a finance charge and a reduction of the outstanding liability so interest expense and amortization/depreciation would be presented in the income statement. The FASB

discussed the subsequent measurement of both the right-of-use asset and lease obligation but was not able to reach a preliminary view because there was some support for recognizing rental expense in the income statement instead of amortization/depreciation and interest expense.

To reach a preliminary view, the staff believes there are two alternative approaches to subsequent measurement for the Board to consider:

- a. Approach A—Amortize/depreciate the right-of-use asset, apportion the lease payments between a finance charge and a reduction of the outstanding obligation, and present interest expense and amortization/depreciation in the income statement.
- b. Approach B—Link the subsequent measurement of the right-of-use asset and the obligation to pay rentals (amortize the right-of-use asset using interest based amortization, reduce the obligation to pay rentals on a mortgage-type basis), and present rental expense in the income statement.

Staff Recommendation

The staff recommends Approach A, which is the IASB’s preliminary view. The staff discussed this issue with constituents including rating agencies, the CFA Institute, and the leases working group, all of which generally favored Approach A. Those users stated their view that lease liabilities should be accounted for as debt. This approach also is consistent with the purchase and financing of an asset recognized on an accumulated cost basis.

Question for the Board

Q1: Does the Board agree with Approach A?

Issue 2(b): Reassessment of the Lease Term

Background

Current lease accounting standards do not require reassessment of the lease term unless particular conditions are met. Consequently, the initially recognized assets and liabilities are usually not adjusted for changes in the assessed lease term. The Board needs to decide if the lease term should be subsequently reassessed.

Staff Recommendation

The staff recommends that the lease term be reassessed at each reporting date to determine the best estimate of the expected lease term. Because there will be many assumptions when initially determining the best estimate of the lease term, allowing reassessment will provide a more refined and relevant best estimate of the lease term to users. Whether a purchase option will or will not be exercised also should be reassessed to determine the lease term.

Question for the Board

Q2: Does the Board agree with the staff recommendation?

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

Background

The staff has recommended that the lessee’s obligation to pay rentals should be initially measured by determining a best estimate of the amounts payable under the lease contract. However, circumstances or events that occur subsequent to the initial measurement could change

the assumptions used to determine the best estimate of the lessee's obligation. Current lease accounting guidance does not require a reassessment of the obligation to pay rentals. Accordingly, the Board should consider whether the obligation to pay rentals should be remeasured for changes in expected cash flows.

Staff Recommendation

The staff recommends that the obligation to pay rentals be reassessed at each reporting date over the lease term. Remeasuring the liability to reflect current best estimates of the rental payments is likely to provide users of financial statements with more relevant information.

Question for the Board

Q3: Should obligations to pay rentals be reassessed at each reporting date over the lease term?

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

If the Board decides to require remeasurement of the obligation to pay rentals, FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, identifies three different techniques that can be used to address changes in estimated cash flows under an interest method:

- a. The prospective approach—A new effective interest rate is computed based on the carrying amount and remaining cash flows.
- b. The catch-up approach—The carrying amount of the liability is adjusted to the present value of the revised estimated cash flows, discounted at the original effective interest rate.
- c. The retrospective approach—A new effective interest rate is computed based on the original carrying amount, actual cash flows to date, and remaining cash flows, which are used to adjust the carrying amount to the present value of the revised estimated cash flows, discounted at the new effective interest rate.

Staff Recommendation

The staff recommends 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) because it is more consistent with how similar financial liabilities are subsequently measured under existing international financial reporting standards and U.S. generally accepted accounting principles, increasing the comparability of financial reports. The effective interest rate also results in a consistent measurement basis for the present value of estimated future cash flows discounted at the original effective interest rate.

Question for the Board

Q4: Does the Board agree with the staff recommendation?

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

If the Board decides to require remeasurement of the obligation to pay rentals, it will need to determine how to recognize the resulting difference. There are two possible approaches:

- a. Recognize any change in the liability in profit and loss

- b. Recognize any change in the liability as an adjustment to the carrying value of the right-of-use asset.

Staff Recommendation

The staff recommends 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. Because the right-of-use asset is initially measured based on the present value of the expected lease payments, the staff thinks increases (or decreases) in the expected lease payments should also be reflected as increases (or decreases) to the right-of-use asset.

Questions for the Board

Q5: Does the Board agree that changes to rental payments be accounted for similarly (changes in lease term, contingent rentals, purchase options, residual value guarantees, etc.)?

Q6: Does the Board agree that any change in the liability, as a result of a change in the estimated rental payments, should be recognized as an adjustment to the carrying value of the right-of-use asset?

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

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

Background

Leased assets recognized as finance (capital) leases are currently required to be presented in the statement of financial position as property, plant, and equipment (unless the lease is for an intangible asset under IAS 17, *Leases*). The staff believes there are three possible ways to present the right-of-use asset in the statement of financial position:

- a. Approach A—Present the right-of-use asset based on the nature of the underlying leased item; owned assets could be presented separately from leased assets.
- b. Approach B—Present the right-of-use asset as an intangible asset.
- c. Approach C—Use a different presentation for the different types of leases; for example, leases that are in-substance purchases would be presented based on the underlying and all other leases would be presented as intangible assets.

Staff Recommendation

The staff recommends Approach A because it provides useful information about the nature of the leased asset. The staff also recommends that leased assets be presented separately from, but adjacent to, owned assets because a short-term right-of-use asset is very different from outright ownership of an asset.

Questions for the Board

Q1: Does the Board agree with the staff recommendation to present the right-of-use asset based on the nature of the underlying asset? If you disagree, please explain why.

Q2: Does the Board agree with the staff recommendation to present the right-of-use assets adjacent to, but separately from, owned assets in the statement of financial position? If you disagree, please explain why.

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

Background

Obligations under a finance lease are presented as liabilities in the statement of financial position and are classified as current or non-current as appropriate. FASB Statement No. 13, *Accounting for Leases*, explicitly requires the lease obligation to be separately presented in the statement of financial position.

Staff Recommendation

The staff recommends that the lease obligation be presented the same as any other financial liability in the statement of financial position. Accordingly, the staff recommends that the obligation to pay rentals should not be required to be presented separately from other liabilities.

Questions for the Board

Q3: Does the Board agree that the obligation to pay rentals should be presented as a financial liability in the statement of financial position? If you disagree, please explain why.

Q4: Does the Board agree with the staff recommendation that obligations to pay rentals should not be required to be presented separately from other financial liabilities? If you disagree, please explain why.

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

The staff believes that the Board's decisions regarding subsequent measurement and presentation of the assets and liabilities arising under a lease contract will drive the presentation of whether the lessee presents rent expense or interest and depreciation/amortization expense. The staff will not ask the Board whether the expenses recognized under a lease should be separately presented at this time, but will include a related question in the Discussion Paper for financial statement users to see if separate presentation would be beneficial. Additionally, the staff will include a related question in the Discussion Paper on whether any alternative presentations of lease-related cash flows should be required for the statement of cash flows.

ISSUE 4: SUBLEASES (FASB MEMO NO. 25)

Background

A reporting entity will sometimes act as both a lessor and a lessee of the same asset. For example, a reporting entity may lease a piece of equipment from one party (the head lease) and then sublet the equipment to another party (the sublease). Because the Boards have tentatively decided to address lessee accounting only, this results in a number of accounting problems for subleases.

The staff has identified the following four problems when applying IAS 17 to subleases (Statement 13 results in similar problems):

- a. Determining which asset to apply the classification test to
- b. Classification inconsistencies

- c. Inconsistencies in measurement when the sublease is classified as a finance lease
- d. Income statement ‘mismatches’ when the sublease is classified as an operating lease.

The staff has identified four possible approaches to address these problems in the accounting for subleases:

- a. Approach 1—Require intermediate lessor to apply IAS 17/Statement 13 to their subleases.
- b. Approach 2—Exclude the head lease from the scope of the proposed new standard.
- c. Approach 3—Develop a lessor right-of-use model.
- d. Approach 4—Apply IAS 17 classification requirements to the sublease but amend the measurement requirements.

Staff Recommendation

Some staff members recommend that the Board does not attempt to reach a preliminary view on subleases at this stage of the project, but, rather, include with the 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 are concerned that a technically feasible solution to the problems associated with subleases may not be possible without a reconsideration of lessor accounting. Those staff members believe a more thorough analysis of subleases should be developed prior to releasing the Discussion Paper.

Questions for the Board

Q1: Does the Board agree to defer consideration of subleasing until after publication of the Discussion Paper. If you disagree, please describe how you would like to proceed.

Q2: What additional analysis (if any) do you believe should be included in the Discussion Paper on this issue?

ISSUE 5: PROCEED TO BALLOT AND COMMENT PERIOD

Questions for the Board

Q1: The staff recommends a comment period of 120 days. Does the Board agree?

Q2: Does the Board authorize the staff to proceed to ballot the Discussion Paper?



Financial Accounting Standards Board

Board Meeting Handout

Financial Instruments with Characteristics of Equity

November 19, 2008

PURPOSE

1. The Board will be asked to address the following basic classification questions:
 - a. Should perpetual basic ownership instruments be classified as equity?
 - b. Should other perpetual instruments be classified as equity?
 - c. Should derivatives held or issued by an entity be classified as equity if the underlying is the entity's own equity instruments?
2. Additionally, the staff will ask the Board for guidance on how to proceed with further analysis of the following issues:
 - a. Which hybrid instruments should be separated into equity and non-equity components?
 - b. How should redeemable ownership instruments be reported?
 - c. Should instruments that are classified as equity in the financial statements of a subsidiary retain that classification in the consolidated financial statements?
 - d. How do the Boards want to address income statement presentation (especially disaggregation of gains and losses on derivatives and hybrid instruments)?

ISSUES TO BE RESOLVED AT THE BOARD MEETING

Should Perpetual Basic Ownership Instruments Be Classified As Equity?

3. A basic ownership instrument has both of the following characteristics: (a) the holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made and (b) the holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of net assets available.

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Question 1: Should perpetual basic ownership instruments be classified as equity?

Should Other Perpetual Instruments Be Classified As Equity?

4. The advantages of classifying preferred shares as equity are as follows:
 - a. It would address concerns of the majority of respondents to the FASB Preliminary Views and the IASB Discussion Paper both titled *Financial Instruments with Characteristics of Equity*, who objected to classifying preferred shares as liabilities.
 - b. If preferred shares are classified as liabilities, the Boards would have to decide how to measure instruments without settlement requirements (or at least to allocate a portion of retained earnings to those classified as liabilities). Classifying preferred shares as equity would eliminate the need to address that issue.
5. One potential disadvantage of classifying preferred shares as equity involves increasing dividend rates or similar features that become so punitive that future settlement is a high probability, even without a contractual settlement requirement.

Question 2: Should perpetual instruments with a preference in liquidation be classified as equity?

Should Derivatives on an Issuer's Own Equity Instruments Be Classified As Equity?

6. To date, the Boards have focused on two alternatives for classifying derivatives on an issuer's own equity instruments:
 - a. Alternative 1—Classify indirect ownership instruments settled with equity instruments as equity (or contra-equity).
 - b. Alternative 2—Classify all equity derivatives as assets or liabilities.

Question 3: Should derivatives on an issuer's own equity instruments be classified as liabilities or assets?

ISSUES THAT NEED FURTHER CONSIDERATION

Which Hybrid Instruments Should Be Separated?

7. The basic ownership approach as written in the Preliminary Views requires an instrument to be separated into an equity component and a non-equity component if it requires a payment and, after the payment is made, an equity instrument remains outstanding.

8. Some Board members have suggested that the following additional instruments should be separated:

- a. Some or all puttable instruments
- b. A bond that grants an option to the holder to convert it into fixed numbers of equity instruments.

Question 4: Have we identified the instruments that should be considered for separation? If not, what others should we include in the list?

How Should Redeemable Ownership Instruments Be Reported?

9. If the Board decides not to separate redeemable ownership instruments into components, three alternatives for classifying redeemable ownership instruments are:

- a. Alternative 1—Classify all redeemable ownership instruments as equity.
- b. Alternative 2—Classify all redeemable ownership instruments as assets or as liabilities.
- c. Alternative 3—Classify some specific types of redeemable ownership instruments as equity.

Question 5: Should some redeemable instruments be classified as equity? If so, which ones and what are your initial views about them?

Should Instruments Issued by a Subsidiary Be Classified the Same Way in the Consolidated Financial Statements As in the Subsidiary's Separate Financial Statements?

10. Two alternatives for determining how instruments issued by a subsidiary should be classified in the consolidated financial statements of the group are:

- a. Alternative 1—Carry over classifications from subsidiary financial statements into consolidated financial statements unless the nature of the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group.
- b. Alternative 2—Always reconsider classifications of instruments issued by a subsidiary in the consolidated financial statements, regardless of how the instruments are classified by the subsidiary.

Question 6: Have we identified the appropriate alternatives? If so, what are your initial views? If not, what other alternatives should we analyze?

How Do the Boards Want to Address Income Statement Presentation?

11. The FASB Preliminary Views does not address any income statement presentation issues that arise from measuring financial instruments at fair value. Based on input received, users would like additional disaggregated information about changes in fair value. Users have suggested varying types and levels of disaggregation of changes in the fair value of liabilities. However, almost all the users commented that they would like to see interest expense for non-derivative instruments and changes in the value of derivatives related to an entity's share price separately displayed. Some users also suggested separate presentation for the change in an instrument's fair value related to the reporting entity's own credit risk.

Question 7: Should separate presentation be required of (1) interest expense for all non-derivative instruments classified as liabilities and (2) changes in the fair value of equity derivatives classified as liabilities?