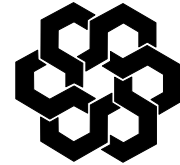




Financial Accounting  
Standards Board



International  
Accounting Standards  
Board

**To:** FASB and IASB Board Members  
and Leases Working Group Members **Date:** October 28, 2008

**From:** Leases Team—Yust (x 442)

**Subject:** Summary Report of the October 7,  
2008, Leases Working Group Meeting

**cc:** FASB: Bielstein, Golden, Lott, Stoklosa, Proestakes, Zeyher, Nickell, Homant,  
Yust, C. Smith, Glotzer, Mechanick, Gabriele, Allen, Sutay, Klimek, FASB  
Intranet; FASAC: Chookaszian, Posta; IASB: Francis, Knublely, Peerless

Topic: Leases Working Group Meeting

Basis for Discussion: Staff Draft of the Leases Discussion Paper

Length of Discussion: 9:00 a.m. to 4:00 p.m. (EST)

Attendance:

Board members present: FASB: Linsmeier, Seidman, and Smith  
IASB: Engstrom and Leisenring

Staff in charge of topic: FASB: Zeyher  
IASB: Knublely

Other staff present: FASB: Golden, Stoklosa, Nickell, Homant, and  
Yust

Observers: Janet Luallen, International Organisation of Securities Commissions (IOSCO)

Working Group Members: Bill Bosco, Leasing 101  
David Maxwell, Classic Technology  
George Yungmann, NAREIT  
Iain Robertson, Canadian Pacific Railway  
John Bober, GE Energy Financial Services  
Kevin Davies, AngloGold Ashanti  
Mark Venus, BNP Paribas Lease Group  
Neri Bukspan, Standard and Poor's (by phone)  
Peter Kilgour, Swire Properties Limited  
Richard Jones, Ernst & Young  
Thomas Gruber, Berlin School of Economics  
Thomas Schröder, Leaseurope

**Summary Report of the Leases Working Group Meeting  
7 October 2008  
Norwalk**

**Purpose of Report**

1. The purpose of this report is to summarize the views and discussions held during the working group meeting. This report does not attribute any of the views expressed to individuals nor does it attempt to assess the extent of support for each view.

**Welcome**

2. The working group members were thanked for their time and dedication to the project and for traveling to attend the working group meeting.

**Purpose of Meeting**

3. It was explained that the purpose of the meeting was to discuss the staff draft of the proposed Discussion Paper. The staff wanted to get feedback to ensure that the proposed Discussion Paper and the questions asked were complete and understandable.

**Chapter 1—Background**

4. The questions asked for this chapter and the responses received are summarized below.

*Is the background explained clearly and are there any other problems with the existing standards that should be described?*

5. Some working group members raised the following additional problems with the existing standards that they feel should be addressed:
  - a. How to treat costs to return a leased asset or costs to maintain a leased asset under an operating lease
  - b. The treatment of leasehold improvements.

*Are there other implications of the Boards' decision to defer consideration of lessor accounting that should be described in this section?*

6. A number of working group members questioned the decision to defer lessor accounting. Comments raised include the following:
  - a. Lessor accounting would provide insight that could be used when developing the accounting model for lessees.
  - b. Whether the Boards could solve a multi-variable equation (lease accounting) by addressing only one variable (accounting for lessees).
  - c. Deferring lessor accounting would require additional effort for companies and users and could be confusing because they will adopt changes in lessee accounting at one date and then have to adopt lessor accounting at a later date.
  - d. Deferring lessor accounting could result in a lack of symmetry, both in terms of the overall theoretical model for lease accounting and in the accounting for specific items (for example, contingent rentals).
  - e. It was difficult to know how to address situations where a lessee acts as both a lessee and a lessor without addressing lessor accounting.
  
7. Several working group members questioned whether it would be possible to consider lessor accounting prior to the completion of the project, such as for the Exposure Draft.
  
8. However, some working group members supported the decision to defer lessor accounting. They noted that:
  - a. Deferring lessor accounting would result in a more expedient fix for lessee accounting.
  - b. Most of the criticism related to lease accounting existed because of the off-balance-sheet nature of operating leases.
  - c. Symmetry does not always exist for current lease accounting.
  - d. Lessor accounting was inextricably linked to revenue recognition.
  - e. Lessor accounting was less of a problem than lessee accounting.

9. A member of the IASB questioned whether there were significant economic differences between lessors of real estate and other lessors. The working group noted that the accounting for real estate under International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (GAAP) was very different and also highlighted the following additional differences:
  - a. It was more common for leases of real estate to be components of an asset (such as two floors of a building).
  - b. It was more common for there to be trading of investment property than equipment.

## **Chapter 2 and Appendix B—Scope**

10. The questions asked for this chapter and the responses received are summarized below.

*Are the two approaches to scope explained clearly?*

11. A number of working group members noted problems with the existing scope of lease standards. These members stated that:
  - a. Leases were often accounted for based on the title of the legal document. As such, some things that were scoped into the leasing standard and accounted for as leases were not really leases.
  - b. The Boards should reconsider whether the existing scope exception for licenses was still appropriate.
12. Additionally, a number of working group members noted the following problems specifically with IFRIC 4, *Determining whether an Arrangement Contains a Lease*, and EITF Issue No. 01-8, “Determining Whether an Arrangement Contains a Lease”:
  - a. They are too rules based.
  - b. There would be more pressure on the framework for determining whether an arrangement was a lease or a service if all leases are capitalized.

- c. It would be more difficult to identify service arrangements if those service arrangements were combined with certain types of variable rents, such as usage-based rentals.
- d. They are not consistent with the new right-of-use model because the guidance focuses on whether an arrangement contains a lease of a single asset, not multiple assets; accordingly, a lessee could avoid recognition of a lease by using multiple assets. For example, one working group member stated that a lease could provide the right to use a taxi, but that lease could permit for a different taxi every day.

*Are the arguments for and against short-term/immaterial lease exemptions adequately described?*

13. Some members of the working group believed that non-core, short-term, and immaterial leases should not be capitalized. These members stated:
- a. It would be misleading to users of financial statements to capitalize these types of leases.
  - b. It would be difficult for such an entity to get a system in place to track all of its immaterial or short-term leases.
  - c. It would lessen the burden on smaller businesses.
14. However, other working group members did not think an exception needed to be provided for such types of leases. These members stated:
- a. Materiality is a judgment call throughout GAAP; it is not unique to leases.
  - b. A company can set a capitalization policy threshold by considering the company, its business practices, and the type of assets it is acquiring.
  - c. Individually immaterial leases can be material to the company in the aggregate.
  - d. Short-term leases and non-core leases could still provide significant rights over the life of the lease.

### **Chapter 3 and Appendix C—Approach to Lessee Accounting**

15. The questions asked for this chapter and the responses received are summarized below.

*Is the analysis of the rights and obligations arising in a simple lease understandable?*

16. Several working group members were unclear how the discussion addressed the obligation to return an asset or the obligation to return an asset in a specified condition.

*Are the issues and analysis pertaining to the approach explained clearly?*

17. Some working group members questioned what the definition of the term *in-substance purchase* was and why a lessor would structure an in-substance purchase like a lease. A couple of working group members proposed that an in-substance purchase is a sales agreement where the lessee has, or has in effect, taken ownership of an asset. These members noted that leases had different legal and tax rights.

18. A member of the IASB stated that the term could not successfully be defined or operationalized and noted that legal and tax standards are not constant across jurisdictions.

*Is the analysis regarding lease classification clear?*

19. One working group member stated that the chapter should elaborate on reasons why the classification should be retained, such as for Day 2 accounting or presentation.

### **Chapter 4—Initial Measurement**

20. The questions asked for this chapter and the responses received are summarized below.

*Are the issues, approaches, and analysis regarding initial measurement of the obligation to pay rentals and the right-of-use asset explained clearly?*

21. A number of working group members stated that the discussion on the use of present value, rather than fair value, for the measurement of the obligation was not clear. Some working group members said that the present value of the right to use an asset was presumptively the same as fair value, and others said that present value was clearly not the same as fair value because of things like taxes, transaction costs, and the discount rate. A member of the FASB stated that it would be clearer to describe the initial measurement approach as a cost accumulation model, which is the required accounting for a purchase and financing of an asset.

*Is the discussion of the discount rate to be used clear and understandable?*

22. A number of working group members were unclear on how to arrive at the incremental borrowing rate. A member of the IASB stated that it would be the borrowing rate that the lessee could get to purchase the leased asset, given the terms of the lease contract and the credit risk of the leased asset and the lessee.

23. A FASB staff member questioned how a lessor priced a lease to see how the lessor discounted the lease payments. Working group members stated that:

- a. Lessors generally focus on the market rate, not the lessee's borrowing rate, when pricing a lease.
- b. Lessors priced a lease based on (1) the cost of money, (2) the cost of doing business, and (3) normal profit.
- c. Lessors will look at the lessee's investment grade for large ticket leases.

24. One working group member stated that he believed the implicit rate was appropriate for discounting payments under a lease that was an in-substance purchase. This working group member also noted that the implicit rate was used for tax purposes.

## Chapter 5—Subsequent Measurement

25. The questions asked for this chapter and the responses received are summarized below.

*Are the issues, approaches, and alternatives regarding subsequent measurement of the obligation to pay rentals explained clearly?*

26. A number of working group members noted that the lease obligation was economically similar to any other debt and recommended that it be accounted for accordingly. These working group members recommended the following:

- a. Amortizing the obligation with a charge to interest expense
- b. Incorporating a fair value option.

27. However, a couple of working group members noted that the lease obligation was a unique obligation because it was essentially “linked” to an asset. Accordingly, if the lease was just a right to use the asset, these working group members recommended a linked approach for rights of use because of the following:

- a. It would distinguish between in-substance purchases and rights to use.
- b. It would keep the asset and liability “linked” throughout the life of the lease.
- c. It would better reflect the economics by recognizing rent expense ratably.
- d. It would prevent having deferred tax accounting for such lessees.

28. Additionally, a member of the FASB noted that such an approach could make sense for cost-benefit reasons for certain leases. Additionally, a second member of the FASB noted that users in the financial guarantee project had explicitly stated that they didn’t want to break out interest expense.

29. However, a member of the FASB and a member of the IASB noted the following arguments for not following a linked approach:

- a. The time value of money should be incorporated because a lessor would accept less money if it was paid upfront.
- b. The lease was a *purchase* of the right of use.

- c. In many cases, such as depreciation based on the pattern of use, the asset would not decline at the same rate as the payments.
- d. Any impairment would essentially “delink” the asset and liability.

*Are the issues, approaches, and alternatives regarding subsequent measurement of the right-of-use asset explained clearly?*

30. Some working group members question whether the right-of-use asset is an intangible or considered plant, property, and equipment (like the underlying). Additionally, some working group members proposed the following additional alternatives for subsequently measuring the right-of-use asset:
- a. Decrease the asset on a present value basis, including an interest component.
  - b. Decrease the asset with a sinking fund amortization.

*Is the analysis regarding impairment and revaluation clear?*

31. A member of the FASB stated that an additional alternative would be for the United States to adopt IAS 36, *Impairment of Assets*.

## **Chapter 6—Options to Extend or Terminate a Lease**

32. The questions asked for this chapter and the responses received are summarized below.

*Are the examples regarding “best estimate” clear? Are any additional examples needed?*

33. The working group members did not think the term *best estimate* was clear. They stated that:
- a. They did not know how to get probabilities associated with each lease term.
  - b. Assigning arbitrary probabilities could prejudice the decision.
  - c. They did not know how it compared to the existing threshold for assessing options.
  - d. It seemed like a more-likely-than-not threshold.

34. A member of the FASB stated that the intention of the term *best estimate* was to use all qualitative factors to pick the lease term that one thinks is going to happen. A member of the IASB noted that the goal of *best estimate* was to arrive at the substantive lease term.
35. A couple of working group members stated that lessees would have some estimate of the lease term because they have to anticipate how long the lease term would be for their budgets.
36. One working group member questioned whether there was an incremental benefit involved in changing the threshold for assessing options since operating leases would now be recognized for some amount.

*Are the analysis and examples regarding reassessment of the lease term clear?*

37. One working group member stated that there should be additional discussion of the advantages and disadvantages of each alternative for reassessment.

## **Chapter 7—Contingent Rentals**

38. The questions asked for this chapter and the responses received are summarized below.

*Are the approaches to the recognition of contingent rentals explained clearly?*

39. Working group members made the following comments about the recognition of contingent rentals:
- a. They should only be recognized if they are outside of the lessee's control.
  - b. Usage-based rentals are often tantamount to maintenance charges, so such obligations would be recognized as contingent rentals when they might not be recognized for owned assets.
  - c. Some payments based on an index would not have a value that moves in relation to the right-of-use asset, so they should be treated like embedded derivatives.

- d. It was unclear when changes in contingent payments based on tax rate variables would be recognized.

*Is the approach to measurement of contingent rentals described clearly?*

40. Several working group members were unsure how to probability weight the contingent rental payments to come up with a best estimate. However, other working group members believed lessees could come up with some estimate of the contingent rental payment because, at lease inception, both the lessor and the lessee come up with an expected amount or range of contingent rentals that is fair to both parties when pricing the lease. Additionally, one working group member stated that a lessee could arrive at an amount for the contingent rentals by estimating the total amount payable if the lease did not incorporate contingent rentals.

41. A FASB staff member questioned whether lessors would accept leases that were 100 percent contingent. Two working group members that were equipment lessors stated that they would not accept a fully contingent lease because of the risk involved. However, a working group member that was a real estate lessor stated that it was not uncommon for certain real estate leases to be entirely contingent and based on sales turnover.

## **Chapter 8—Other Issues**

42. The questions asked for this chapter and the responses received are summarized below.

*Are the issues and analysis explained clearly?*

43. Working group members stated that the following additional issues needed to be discussed in this chapter:

- a. Componentization of depreciation
- b. What to do if a lease contract involves multiple assets

- c. The interaction of multiple elements in a lease, such as contingent rentals, a residual value guarantee, or a bargain purchase option
  - d. The impact on regulated industries for having to capitalize leases that were previously recognized off balance sheet
  - e. The impact on the change in earnings before interest, taxes, depreciation, and amortization (EBITDA) from requiring depreciation expense and interest expense to be recognized, rather than rent expense, which would result in companies having to amend debt covenants and other legal documents
  - f. One hundred- and 200-year land leases for property rentals.
44. Additionally, some working group members stated that the following issues that were included in the chapter should be discussed in more detail:
- a. Subleases
  - b. Sale and leaseback transactions
  - c. Purchase options
  - d. Residual value guarantees
  - e. Costs required to return a leased asset in a specified condition
  - f. Presentation and disclosure.

#### **Appendix D—Implications of Adopting IAS 17 for Lessors Applying Statement 13**

45. The questions asked for this chapter and the responses received are summarized below.

*Are there any additional significant differences between FASB Statement No. 13, Accounting for Leases, and IAS 17, Leases, that should be described in the proposed Discussion Paper?*

46. One working group member stated that the appendix should also address the following:
- a. Renewal options and their exercise under IFRS
  - b. Revenue recognition for sales of real estate
  - c. Treatment of embedded software in a lease.

*Are the differences and analyses explained clearly?*

47. One working group member stated that the treatment of leveraged leases was the most significant issue and that it could be addressed by providing a longer transition for lessors to restructure their leases.

*Are there any other advantages for the United States to require lessors to adopt IAS 17?*

48. One working group member stated that adopting IAS 40, *Investment Property*, in U.S. GAAP would likely make a lot of U.S. lessors more likely to accept a change to IAS 17.

#### **Other Comments**

49. The FASB staff questioned whether working group members believed the Boards should try to reach a converged preliminary views (where they currently have different preliminary views) prior to publication of the proposed Discussion Paper. The responses received are summarized below:

- a. It would be ideal if the Boards could reach a converged preliminary views where they currently have different preliminary views prior to the issuance of the proposed Discussion Paper.
- b. Multiple preliminary views could be confusing and make the chapters more difficult to read.
- c. The Boards need to obtain additional preliminary views where they currently do not have any.

50. However, one working group member stated that issuing the document as currently drafted could still be useful because it would allow the Boards to get additional feedback from constituents.

#### **Closing Comments**

51. The staff thanked working group members and stated that the staff would plan to have another working group meeting near the end of the comment period to talk about additional issues that are raised.