MINUTES

Financial Accounting Standards Board

To: Board Members

From: Leases Team—Hoyt (ext. 298)

Subject: Minutes of the June 27, 2007 FASB Board Meeting: Leases— Measurement of a Lessee's Liability and Right to Use Asset under a Simple Lease Contract; Initial Recognition of Assets and Liabilities in Lease Contracts

Date: July 11, 2007

cc: FASB: Bielstein, L. Smith, MacDonald, Lott, Zeyher, Roberge, T. Johnson, C. Smith, Glotzer, Allen, Gabriele, Sutay, FASB Intranet; FASAC: Chookaszian, Polley; IASB: Leisenring, Upton, Hickey, Knubley, Peerless; GASB: Driscoll

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 or Interpretation.

Topic: Leases: Measurement of a Lessee's Liability and Right to Use Asset under a Simple Lease Contract; Initial Recognition of Assets and Liabilities in Lease Contracts

Basis for Discussion: Board Memorandum Nos. 8, 9, 10, & 11

Length of Discussion: 10:45 a.m. to 12:00 p.m.

Attendance:

Board members present: Batavick, Crooch, Linsmeier, Seidman, Trott, and Young

Board members absent: Herz

Staff in charge of topic: Zeyher and Sledge

Other staff at Board table: Bielstein, T. Johnson, Roberge, Hoyt

Outside participants: IASB staff: Knubley and Peerless (by phone)

Summary of Decisions Reached

The Board discussed a staff analysis of alternative approaches for the initial and subsequent measurement of a lessee's liability for its obligation to make payments to the lessor arising under a simple lease contract. The Board directed the staff to further explore the following approaches:

a. The lessee would initially measure its obligation to pay for the right to use asset at fair value.
b. The lessee would subsequently measure that liability using the effective interest method; however, the lessee also would have an option to subsequently measure the liability at fair value.

The Board discussed a staff analysis of alternative approaches for the initial and subsequent measurement of a lessee's right to use asset arising under a simple lease contract. The Board generally agreed with the staff's view that a lessee's right to use asset is neither an intangible asset nor an asset that is similar in nature to the leased item. For that reason, the existing guidance for the initial measurement of an intangible or tangible asset may not be the most relevant measure of a lessee's right to use asset. The Board directed the staff to develop an approach for the initial and subsequent measurement of a lessee's right to use asset for consideration at a future meeting.

The Board also discussed whether assets and liabilities arising in a lease contract should be recognized upon signing of the lease contract or upon access to or delivery of the leased item, but did not reach any tentative conclusions.

Objective of the Meeting:

The objective of the meeting was to facilitate an informational discussion of (a) alternative approaches to initial and subsequent measurement of a lessee's liability to the lessor and a lessee's right to use asset under a simple lease contract, and (b) to discuss the timing of initial recognition of assets and liabilities in a lease contract. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

MEASUREMENT OF A LESSEE'S LIABILITY TO THE LESSOR

1. Mr. Sledge began the meeting by stating that the meeting's discussion was to be focused strictly on measurement issues and would not include discussion of presentation or disclosures. He stated that the purpose of the discussion is to analyze alternative approaches for the initial and subsequent measurement of a lessee's liability for its obligation to make payments to the lessor arising under a simple lease contract. The example used in discussion is a noncancellable lease with a fixed term, no options to extend or purchase, and no residual value guarantees. Lease payments are due at regular intervals over the lease term after the item has been delivered. These are fixed amounts that are specified in the original agreement and are payable in advance. No maintenance or other arrangements are entered into. The staff would also not be discussing transaction costs under this simple lease example. The staff has concluded that the obligation meets the definition of a liability.

Initial Measurement

2. Mr. Sledge stated that the staff considered two alternative approaches to measuring the lessee's liability upon initial recognition—(a) present value of expected cash flows discounted using the implicit rate in the lease, if practicable; otherwise, using the lessee's incremental borrowing rate or (b) fair value. The staff recommends that the lessee's liability should be measured initially at fair value. Mr. Sledge stated that the reasons for the staff's recommendation were that the staff has concluded that the lessee's liability meets the definition of a *financial* liability and, as such, should be measured similarly to other financial liabilities. Further, the Boards have both publicly stated that fair value is the most relevant measure of a financial liability.

3. Ms. Seidman stated that, after a lessor performs (or delivers the leased item), the lessee does have a financial liability, but that you do not necessarily have to conclude that a financial liability exists prior to that. She stated that she wanted to clarify whether the paper assumes that delivery has occurred in discussing the lessee liability. Mr. Sledge confirmed that the discussion is around initial measure *at the delivery point.*

4. Mr. Trott stated that there are nonfinancial elements with respect to the lessee liability and some of those nonfinancial elements could determine whether the liability is ranked above other financial liabilities—in other words, is the liability collateralized or effectively collateralized or is it integral equipment (even if not collateralized) with respect to the operations of the lessee. All of these elements determine the ranking of the liability and affect measurement of the both the asset and the liability.

5. Mr. Linsmeier stated that the staff chose one approach to measurement that builds off of existing accounting guidance for the assets subject to the lease. While this is one viable approach, he believes that the staff perhaps also should consider the objective within the conceptual framework of facilitating users' decisions by communicating financial information. In other words, another approach to measurement may be to consider the economics underlying the transactions, to consider what users are trying to understand related to leasing transactions, and whether or not there may be other measurement attributes that might better achieve that objective. That said, he believes for the simple lease contracts described in this memo that a fair value measurement approach makes most sense, but he is unsure whether his opinion will change once the project attempts to address more complex leasing arrangements, which would require fair valuing options that have both financial and nonfinancial components.

6. Mr. Batavick stated that he believes that the contractual cash flows discounted to a present value in a simple lease contract where an implicit borrowing rate can be determined are more representational rather than a fair value approach. The reason is

that fair value attributes such as credit worthiness or risk premium would determine a different fair value measurement for the liability depending upon the lessee. He stated that fair value, in this case, would not be useful information. Furthermore, fair value may introduce a measurement difference between entry and exit price.

7. Mr. Trott clarified that the measurement of the liability should actually take into consideration the interest rate that would be demanded for the obligation, including non-financial elements such as collateralization and how integral the leased item is, rather than the notion of the lessee's incremental borrowing rate.

8. Mr. Sledge confirmed with the Board that there appears to be no support for using the implicit rate in the lease in discounting contractual cash flows. He stated that it appears that the Board supports a Statement No. 157, *Fair Value Measurements,* definition of fair value in initially measuring the lessee liability, and that the use of an incremental borrowing rate would be counterparty-specific just like any fair value discount rate notion and would take into consideration attributes specific to the obligation itself. Mr. Sledge also confirmed with the Board that there is also some concern about Day 1 gains or losses and the staff remains aware of that going forward.

Subsequent Measurement

9. Mr. Sledge stated that the staff has considered three approaches to the subsequent measurement of a lessee's liability for its obligation to make payments to the lessor:

    a. Fair value
    b. Amortized cost (initial measurement) using the effective interest method
    c. Amortized cost (initial measurement) using the effective interest method with an option to fair value.

10. Mr. Sledge stated that the staff recommendation is that a lessee's liability to the lessor be subsequently measured using the effective interest method (employing a "catch-up approach" for changes in cash flow estimates) with an option to measure at fair value.

11. Ms. Seidman stated that she would prefer, for purposes of a preliminary views document, to state that the liability should be accounted for similar to other financial obligations. She stated that she would not introduce new mixed-attribute models between items that are financed with a lease and other types of obligations. If there is no disagreement as to whether the lessee's liability is a financial obligation, then the staff should not spend time in this project deliberating subsequent measurement of financial obligations in this project. Those issues will be addressed in the financial instruments project.

12. Mr. Trott stated that he supports the staff's recommendation keeping in mind that the objective of the Board is to do away with a fair value option and require the liability to be measured at fair value.

13. The Board directed the staff to further explore the approach that subsequent measurement of the lessee's liability will be at amortized cost (initial measurement) using the effective interest method with an option to fair value.

14. Mr. Roberge reiterated to the Board that the staff's recommendation would change current GAAP, because right now, a fair value option does not exist.

15. Ms. Seidman stated that the staff's conclusions, as well as the Board's tentative decisions with respect to measurement, remain subject to discussion with users of the financial statements.

MEASUREMENT OF A LESSEE'S RIGHT TO USE ASSET

Initial Measurement

16. Mr. Sledge stated that the staff has analyzed alternative approaches for the initial and subsequent measurement of a lessee's right to use asset arising under a simple lease contract. That is, a noncancellable lease with a fixed term, no options to extend or purchase, and no residual value guarantees. The Boards have tentatively concluded that under such a lease, the lessee's contractual right to use the item being leased meets the definition of an asset.

17. Mr. Sledge stated that the staff has considered three approaches to determining the initial and subsequent measurement of a lessee's right to use asset:

    a. Alternative A—Intangible Asset Approach: A lessee's right to use asset is deemed similar in nature to an intangible asset acquired outside of a business combination. Thus, the initial and subsequent measurements should be consistent with the Boards' existing standards on accounting for intangible assets acquired outside of a business combination (IAS 38, *Intangible Assets*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*).

    b. Alternative B—Nature of the Leased Item Approach: A lessee's right to use asset is deemed similar in nature to the item the lessee obtains the use of via the lease contract. Thus, a lease of property, plant and equipment (PP&E) should have initial and subsequent measurements consistent with the Boards' existing standards on accounting for PP&E acquired outside of a business combination (IAS 16, *Property, Plant and Equipment*, FASB Statement No. 141, *Business Combinations*, and ARB 43, Ch. 9, "Depreciation"). Similarly, a lease of an intangible asset (if within the scope of the revised standard) should have initial and subsequent measurements consistent with the Boards' existing standards on accounting for intangible assets acquired outside of a business combination (IAS 38 and Statement 142).

    c. Alternative C—Separate Accounting Model Approach: Either (1) a lessee's right to use asset is deemed different in nature from both an intangible asset and the nature of the item being leased or (2) another measurement approach would result in more decision-useful information and the incremental benefits of that approach exceed the incremental costs. In either case, a separate accounting model should be developed for the initial and subsequent measurement of a lessee's right to use asset. That measurement approach might make greater use of fair value.

18. Mr. Trott stated that he supports Alternative C, but would be considering the attributes of intangible assets in developing an approach. He stated that he does not support Alternative B primarily because he views a right to use asset as entirely different from recognizing the leased item on the balance sheet. He stated that pursuing Alternative B defeats the whole purpose of the leases project. Alternative A, on the other hand, is probably most well-received; however, Mr. Trott believes that there are still unresolved issues relating to the application of Statement 142.

19. Ms. Seidman stated that she supports the conceptual notion underscored in Alternative A, which purports that there is a distinct difference between a right to use the leased item and the underlying leased item itself. She stated that she would

characterize the right to use asset as an intangible asset and supports developing a separate model that would attempt to recognize the asset over the period being benefited. However, she does not support an approach that would move toward fair value, the reasoning being that, under current GAAP, PP&E is not marked to market.

20. Mr. Linsmeier stated that he supports Alternative C and agrees with other Board members who support an accounting distinction between a right to use and the underlying leased item itself. However, Mr. Linsmeier stated that, in supporting Alternative C, it does not mean that the right to use asset should necessarily be classified as an intangible asset and accounted for accordingly under current guidance. Ultimately, the model needs to be evaluated with users to determine if it serves them well, whether the model is consistent with existing literature or not.

21. The Board generally agreed that a lessee's right to use asset is neither an intangible asset or similar in nature to the leased item and, therefore, a separate accounting model should be developed for the initial and subsequent measurement of a lessee's right to use asset.

INITIAL RECOGNITION OF ASSETS AND LIABILITIES IN LEASE CONTRACTS

22. Ms. Zeyher stated that the staff has considered two alternative approaches for the timing of **when** initial recognition of assets and liabilities that arise in a simple lease contract should take place: (a) at the signing of the lease contract and (b) at the delivery. She stated that the staff has analyzed the promises exchanged at both points in time and whether or not those promises are characterized as conditional or unconditional. From this determination, the staff has identified those assets and liabilities that arise from the exchange of promises at each point in time.

23. Ms. Zeyher stated that, although there may be some conceptual basis for initial recognition of assets and liabilities upon the signing of the lease contract, the staff

recommends that initial recognition should only take place upon acceptance of the leased item by the lessee.

24. Mr. Trott stated that the timing of recognition is going to depend upon conclusions with respect to initial recognition of the liability and the asset. Similar to accounting for the purchase of financial instruments which settle subsequent to initial purchase, the accounting unit is probably a net contract from the period of signing the lease contract to delivery of the leased item, and there could be potential gains or losses during that period. Upon delivery of the leased item, the net contract would be grossed up.

25. Mr. Batavick supports the staff recommendation to initially recognize assets and liabilities arising in a lease contract once the lessor has performed his promise to deliver the leased item. He supports the notion that, until delivery has been performed, the lease contract is executory.

26. Ms. Seidman stated that she is not prepared to respond to the staff's recommendation and that much of the decision would depend upon the facts and circumstances surrounding the lease contract. In the simple analogy raised by Mr. Trott with respect to financial instruments, she stated that she would view the time lag between the trade date and the settlement date as normal course of business and, in most cases, would not recognize anything until delivery. The answer to dealing with price changes between trade date and settlement date depends upon how the asset is accounted for upon recognition. In other words, if the item is to be accounted for subsequently at fair value, one would likely account for the item between trade date and settlement similarly to how it would be accounted for after settlement date.

27. Mr. Linsmeier stated that it would seem that the real issue with respect to the timing of initial recognition has to do with circumstances in which there is a long period of time between signing and delivery of the asset. If the time lag were very short, timing would not be a material issue. A large lag time raises the questions of price risk, and

whether or not the contract should be considered a forward contract—recognizing a net contract between signing and delivery and then grossing up the asset upon delivery of the leased item. However, like Ms. Seidman, Mr. Linsmeier is concerned about the accounting of the leased item upon settlement date (or delivery) and the possible introduction of settlement gains or losses along with other possible accounting inconsistencies between prior-settlement and post-settlement time periods.

28. Overall, the Board did not reach any tentative conclusions with respect to timing of initial recognition of assets and liabilities under a lease contract.