MINUTES

To:	Board Members		
From:	Leases Team (Kersey, x263)		
Subject:	January 24, 2012, Working Group Minutes: Leases	**Date:**	March 2, 2012

Topic:	Leases Working Group Meeting
Basis for Discussion:	Agenda Papers 2, 2A, 2B, and 3
Length of Discussion:	9:00 a.m. – 1:30 p.m. EST
	2:00 p.m. – 6:30 p.m. GMT

Attendance:

Outside Participants Norwalk:

John Bober	GE Capital
William Bosco	Leasing 101
Richard Jones	Ernst & Young
Bill Solomon	Boeing

Outside Participants London:

Kevin Davies	Anglogold Ashanti Limited
Francoise Flores	EFRAG
Thomas Gruber	Berlin School of Economics and Law
David Maxwell	Classic Technology
Mark Venus	BNP Paribus

Outside Participants via telephone:

Iain Robertson	Canadian Pacific Railway

Board Members Present:

FASB (Norwalk): Buck, Golden, Linsmeier, Schroeder, Siegel, Smith

IASB (London): Cooper, Engström, Danjou, Finnegan, Hoogervost, Kalavacherla, McConnell, Ochi, Pacter, Scott, Smith, Zhang

Staff Present:

FASB (Norwalk): Cosper, Stoklosa, Zeyher, Donoghue, Walsh, Bauer, Kersey, Cranmer

IASB (London): Rees, Buchanan, Vatrenjak, Lion, Geisman

Introduction

1. On January 24, 2012, members and staff of the FASB and the IASB met with members of the Joint Leases Working Group to discuss lessee and lessor accounting issues. The meeting was held jointly in Norwalk and London via video (and teleconference). The Joint Leases Working Group comprises preparers, users, auditors, and academics. Their views and comments from the meeting relating to Working Group papers 2, 2A, 2B, and 3 are summarized below.

Papers 2/2A: Lessee Accounting and Illustrations

General Comments

2. The Working Group members generally agreed that all leases have finance and usage aspects and, therefore, should be capitalized. However, the reasons for supporting the recognition of assets and liabilities by a lessee varied among members.
3. Limitation of the word *debt* was an important topic to some Working Group members because the creation of lease liabilities could cause violations to debt covenants. Some held the view that (a) the liability represents the capitalization of an executory contract, not a loan or debt, and (b) some users look at debt obligations differently from lease obligations.
4. Some Working Group members explained that lessee and lessor accounting should always be considered in tandem and that the lessor accounting should follow revenue recognition.

5. Bankruptcy concerns were voiced throughout the meeting. Some specifically noted that if lease contracts could be cancelled in bankruptcy, the leases may be categorized as executory contracts.
6. The legal right of quiet enjoyment was discussed by several Working Group members. The idea that quiet enjoyment is not a legal right if lease payments are not made was noteworthy for some members. In other words, those members noted that a lessee does not have a right of use unless it pays.
7. There was general agreement on the accounting treatment of the lease liability, but there were mixed comments regarding the treatment of the right-of-use (ROU) asset.
8. Some held the view that the ROU asset and liability should not be treated independently when subsequently measuring those amounts. The lessee receives a benefit evenly over the lease term.
9. That line of thinking on the lessee side led to a question of whether the lessor should account for the transfer of the underlying asset as a good or a service. A Working Group member indicated that the answer to that question could depend on whether the lessor expects to get the asset back at the end of the lease term. That is because, for example, current finance/capital lessors have a different economic risk because they do not expect to receive the asset back whereas current operating lessors are providing a service, not a financing. Some stated that there are different business models that should possibly have different accounting results.
10. One view was that (a) not all leases should be capitalized and (b) there should be a line between those that should and those that should not be capitalized. It was suggested that the line could be drawn based on the business model of the lessor.
11. It also was suggested that a line should be drawn to distinguish purchases from leases. The definition of a lease distinguishes a lease from a service. Everything else should be accounted for under the leases model. Some viewed Approach B (see paragraph 13 below) as appropriate for leases that are neither purchases nor services.
12. There were several requests for clarity around the basis of conclusions for whichever model the Boards ultimately accept.

Specific Comments by Approach

13. Working Group Paper 2 explains the Boards' current tentative lessee accounting decisions and sets out a number of alternative approaches that the Boards could adopt including the reasons for, and concerns about, each approach. Those alternative approaches are as follows:

    a. Approach A—Retain the Boards' current tentative decisions.

    b. Approach B—Use a *modified interest-based amortization* approach for the ROU asset.

    c. Approach C—Use a *modified whole-asset* approach.

    d. Approach D—Use other comprehensive income (OCI) to achieve a straight-line expense recognition pattern.

    e. Approach E—Extend the application of current operating lease accounting to some leases that do not meet the current definition of a short-term lease.

Approach A—Boards' Current Tentative Decisions

14. Comments in support of Approach A included the following:
    a. The approach is considered to be appropriate if the lessee has received an asset on day one in exchange for the corresponding liability.
    b. The approach is straightforward because one model applies to all leases.
    c. The approach is appropriate when the lease is similar to purchasing an asset.
    d. Some Working Group members think that the approach should be applied to all leases because a lessee is acquiring a ROU asset that it pays for over time.
15. Concerns regarding Approach A included the following:
    a. The approach often results in a front-loaded total leases expense. Some do not believe that this expense recognition pattern reflects the economics of leasing because the lessee often receives equal benefit (or the ability to use leased assets) over the lease term.
    b. The approach does not provide the ability to differentiate a purchase from a rental.

c. The separate treatment of the asset and liability, because a termination of a lease could result in a gain when the asset balance is less than the liability balance.
d. Some said that a lease is different from the acquisition of an asset for debt.
e. The approach is complex to apply and there are no systems currently in place that deal with thousands of leases from a lessee's perspective.

Approach B—Modified Interest-Based Amortization

16. Comments in support of Approach B included the following:
    a. The assets and liabilities are inextricably linked and the unit of account should be at the contract level.
    b. The expense profile (often straight line) matches the benefits derived throughout the period.
    c. Interest-based amortization is a valid depreciation method and could be used for all types of assets, including lease assets as well as purchased assets.
    d. Interest-based amortization is a useful way to allocate costs.
    e. One Working Group member thought this approach should be applied to all leases.
17. Concerns regarding Approach B included the following:
    a. The frequency of impairments may increase under this method, but several Working Group members noted that increased impairments do not lower the value of the accounting approach.
    b. The approach could be viewed as a *plug* to get to straight line.
    c. There is no conceptual basis to support this approach.
    d. Interest-based amortization is not currently used for purchased assets under U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRSs).

Approach C—Modified Whole Asset

18. Comments in support of Approach C included the following:

a. A Working Group member said that the depreciation should be the same whether the asset is leased or owned. This approach, in his view, appropriately treats a lease contract as equivalent to purchasing a *piece* of the asset being leased.
b. This approach alleviates concerns over front loading for leases of land and buildings because it would likely yield a straight-line expense pattern for those leases.

19. Concerns regarding Approach C included the following:
    a. The added complexity of the valuation estimates makes this approach less practical than the other approaches.
    b. Whether or not the approach is operational in practice. It would require lessees to track information, which they would not need for any other purpose (for example, the valuation of underlying assets that are not core to the lessee's business).
    c. A Working Group member noted that the approach may conflict with the ROU theory because it changes the focus to account for the underlying asset.

Approach D—Use of OCI for Straight-Line Expense

20. Concerns regarding Approach D included the following:
    a. The approach could be considered a results-driven approach that lacks a conceptual basis and would be hard to justify.
    b. The approach is just a *plug*.
    c. There was generally no support for the approach by members.

Approach E—Extend the Application of Current Operating Lease Accounting

21. Comments in support of Approach E included the following:
    a. The extension of short-term leases was noted as being a very practical approach.
22. Concerns regarding Approach E included the following:
    a. There is potential to structure transactions to achieve off-balance-sheet accounting, similar to current U.S. GAAP and IFRSs.
    b. There was generally no support for the approach by members.

Paper 2B: Should Different Accounting Models Be Applied to Different Types of Lease Contracts?

23. The Working Group members noted that, in the proposed guidance, two distinct lines could be drawn to distinguish between leases and services and between leases and purchases.
24. The definition of a lease would help distinguish leases from services.
25. Some members believe that the line drawn under IAS 17, *Leases,* would be the most preferable distinction between leases and purchases. Others suggested that the concept of control, aligned with the revenue recognition project, could be used to distinguish purchases from leases.
26. Other members thought that one model should be applied to all leases.

Paper 3: Lessor Accounting—The Definition of Investment Property

27. Some questioned the rationale for excluding leases of investment property from the scope of the receivable and residual approach. The initial suggestion was to exclude multi-tenant real estate from the scope.
28. Some thought there could be problems with using an IAS 40, *Investment Property*, definition, for example, for integral equipment. A broader definition of real estate was suggested.
29. Some suggested that a business model approach should be taken into consideration. That approach suggests that there are two types of lessors: (a) one type that expects the asset to be returned at the end of the lease and (b) one type that does not.
30. Some members did not understand why leases of investment property were excluded from the scope of the receivable and residual approach. Some questioned why leases of investment property (for example, a retailer) would not be excluded from the scope of the lessee accounting model if those leases were excluded from the scope of the lessor receivable and residual approach.
31. Some lessors think that leases of other assets also should be excluded from the scope of the residual and receivable approach on the basis that the approach does not reflect the economics of their leasing transactions.

32. It was suggested that an agreement should be reached regarding lessee accounting before moving on to the lessor model.