



■ Public Company Financial Executive Briefing ■

# EXPOSURE DRAFT ON LEASE ACCOUNTING

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**EXECUTIVE SUMMARY:**

The FASB has issued a proposed Accounting Standards Update (ASU), Leases, which would establish a new accounting model for by lessees and lessors (including the elimination of the concept of an operating lease).

**GENERAL RULES:**

- A lessee would recognize an asset representing its right to use an underlying asset and a liability representing the obligation to make lease payments;
  - Asset would be amortized over the shorter of
    - (a) the expected lease term, or
    - (b) the asset’s useful life.
  - Interest expense would be recognized on the lease obligation.
- For short-term leases (generally, lease term is 12 months or less):
  - (1) a lessee could measure the lease liability and right-to-use asset at the undiscounted amount of lease payments, and
  - (2) a lessor could elect (on a lease-by-lease basis) not to recognize an asset or liability or to derecognize any portion of the underlying asset.
- A lessor would recognize an asset representing its right to receive lease payments and would either
  - (1) recognize a lease liability while, at the same time, continue to recognize the underlying asset itself (the performance-obligation approach),
  - (2) derecognize the asset’s underlying rights transferred to the lessee but continue to recognize a residual asset representing its rights to the asset at the end of the lease term (the derecognition approach).

The guidance would generally apply to all leases (including leases of right-to-use assets in a sublease) except in leases:

- of intangible assets,
- to explore for use of minerals, oil, natural gas, and similar resources, and
- of biological assets.

The guidance would also be applied to contracts containing both service and lease components if the respective components are distinct from each other;

- A service component would be deemed distinct if the entity itself (or another entity) sells the identical or similar service separately—or could sell it separately.
- The guidance would not apply to contracts representing a purchase or sale of an underlying asset

- Defined as: at the end of the contract both control of the underlying asset and all but a trivial amount of the risks and benefits associated with such asset are transferred.

**ACCOUNTING BY LESSEES:**

**Recognition and initial measurement**

At inception, a lessee would recognize a right-to-use asset and a liability to make lease payments.

- The liability would be measured at the present value of the lease payments discounted at the lessee’s incremental borrowing rate or, if it can be determined, the rate charged by the lessor, and
- The asset would be initially measured as the amount of the liability plus initial direct costs incurred.

The following would be used in calculating the amount of the liability:

- The lease term (i.e., the longest possible term deemed more likely than not to occur) applying estimates of the probability of occurrence of each possible term and taking into account the effects of any options to extend or terminate the lease.
- The present value of payments over the lease term would include estimates of
  - (1) contingent rentals,
  - (2) amounts payable under a residual value guarantee, and
  - (3) expected payments under term option penalties and be based on the present value of the probability-weighted average of cash flows for a reasonable number of outcomes;

The following factors would have to be considered in assessing the probability of each possible term:

- Explicit contractual terms.
- Legal and financial consequences of a decision to extend or terminate the lease.
- The extent to which the underlying asset is specialized or is crucial to the entity's operations.
- The entity's past practices and intentions.

The income statement each period would include

- interest expense on the liability (using the interest method),
- amortization of the asset on a systematic basis over the shorter of the lease term or the underlying asset's useful life, and, if applicable
- any impairment loss on the asset.

### SUBSEQUENT MEASUREMENT

At the end of each reporting period, a reassessment would be made of the carrying amount of the lease liability if facts or circumstances indicate there would be a significant.

If there is a change to the lease term, both the liability and the asset would be adjusted; u

Upon a change in the expected amount of contingent rentals, expected payments under term option penalties, or residual value guarantees, the effect of such changes would be

- Reflected in the income statement if the changes relate to the current period or prior periods, and
- Recognized as an adjustment to the asset and the liability to the extent that the changes relate to future periods.

### PRESENTATION

In the balance sheet, a lessee would have to present lease liabilities separately from other financial liabilities, and right-of-use assets within property and equipment.

Amortization of the asset and interest expense on the liability would have to be presented separately from other amortization and interest expense.

In the cash flow statement, cash payments for leases would be classified as a financing activity.

### Accounting by Lessors:

At inception of a lease, a lessor would have to assess whether the lease should be accounted for in accordance with the (a) performance-obligation or (b) derecognition approach, **based on whether the lessor retains exposure to the significant risks or benefits of the underlying asset** either during the expected term of the lease, or after the expected term by virtue of holding the expectation or ability to generate significant returns by selling or re-leasing the asset.

After the date of inception, a lessor could not change the approach initially determined.

### The performance-obligation approach

If the lessor retains exposure to the significant risks or benefits associated with the underlying asset, the performance-obligation approach would be applied to an asset representing the right-to-receive lease payments and a corresponding liability representing the obligation to allow the lessee to use the underlying asset over the lease term are established.

Under this method, the asset would be initially measured as the present value of the lease payments using the interest rate charged to the lessee plus any initial direct costs incurred.

The liability would be initially measured at the amount of the right to receive the lease payments. (Note that, as in the case of a lessee, the lease term would be the longest possible term deemed more likely than not to occur based on an estimate of the probability of occurrence of each possible term, taking into account the effects of any options to extend or terminate the lease.)

The present value of lease payments receivable would be based on the present value of the probability-weighted average of cash flows for a reasonable number of outcomes. It would include

- Estimates of the expected receipts from the lessee under term option penalties, and
- Estimates of amounts receivable under residual value guarantees and from contingent rentals, but only to the extent that they can be reliably measured.

Under the performance-obligation approach, underlying assets, rights to receive lease payments, lease liabilities, and the net amount (i.e., the net lease asset or net lease liability) would have to be presented together in the balance sheet.

In the income statement, interest income on the asset, lease income from satisfaction of the lease liability, and depreciation on the underlying asset would have to be presented separately, totaling to a net lease income or net lease expense.

Cash receipts from lease payments would be classified as operating activities in the cash flow statement.

### The derecognition approach:

**If the lessor does not retain exposure to the significant risks and benefits of the underlying asset, the derecognition approach would be applied.** Under this method, at inception of the lease the following would be recorded:

- An asset representing the right to receive lease payments would be established,
- The portion of the carrying amount of the underlying asset representing the lessee's right to use the asset during the term of the lease would be derecognized, and
- The remaining portion of the asset's carrying amount representing the rights in the asset retained by the lessor would be reclassified as a residual asset.

Initially, the right to receive lease payments would be measured as the present value of the lease payments discounted at the rate the lessor charges the lessee plus any initial direct costs incurred.

The residual asset would be initially measured as an allocation of the underlying asset's original carrying amount (i.e., before derecognition) based on relative fair values of

- The rights transferred, and
- The rights retained.

Note that, as in the case of the performance-obligation approach, the lease term would be the longest possible term deemed more likely than not to occur based on an estimate of the probability of occurrence of each possible term, taking into account the effects of any options to extend or terminate the lease.

At inception the following would be recorded in the income statement:

- Income representing the present value of the lease payments, and
- Lease expense representing the cost of the portion of the underlying asset that has been derecognized would be recognized.

After initial recording the right to receive lease payments would be measured at amortized cost.

As under the performance-obligation approach, at the end of each reporting period, a reassessment would have to be made in respect of the carrying amount of the right to receive lease payments (the asset) if facts or circumstances indicate there would be a significant change since the previous reporting period.

In the balance sheet (1) rights to receive lease payments would be presented separately from other financial assets (and distinguishing those assets arising under subleases), and (2) residual assets would be presented separately within property and equipment (also distinguishing those arising under subleases).

In the income statement, lease income and lease expense would be presented as follows:

- In separate line items if the business model is such that leasing represents an alternative to selling the underlying asset, or
- As a single line item if the business model is such that leasing is primarily used for the purpose of providing funding for the transaction.

In the cash flow statement, cash receipts from lease payments would be classified as operating activities.

#### **Short-term leases:**

At the inception of a short-term lease (lease term of 12 months or less):

- A lessee could elect to measure (initially and subsequently) the liability to make lease payments at the undiscounted amount and to measure the right-of-use asset at the amount of the liability plus initial direct costs; lease payments would be recognized as expense over the lease term.
- A lessor could elect not to recognize an asset or liability or to derecognize any portion of the underlying asset; lease payments would be recognized as income over the lease term.

#### **Effective Date and Comment Period**

No specific effective date has been proposed. However, all outstanding contracts would have to be measured as of the date of initial application.

The comment deadline is December 15, 2010.

### **FOR FURTHER INFORMATION, PLEASE CONTACT ONE OF THE FOLLOWING:**

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