



Dataline

A look at current financial reporting issues

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What's inside:

<i>Overview</i>	1
<i>At a glance</i>	1
<i>The main details</i>	2
<i>Status of redeliberations</i>	2
<i>Key decisions reached</i>	2
<i>Status of discussions on other key areas</i>	4
<i>The path forward</i>	6
<i>Questions</i>	6

Leasing

FASB and IASB agree on changes that will reduce complexity of the proposed leasing standard

Overview

At a glance

- In August 2010, the FASB and IASB (the "boards") jointly issued an exposure draft of a proposed accounting standard for leases (the "ED"). The proposals would change the accounting for lease transactions and have significant business implications.
- The comment period ended on December 15, 2010 and the boards have begun redeliberating the ED.
- The boards have considered the extensive feedback received that the ED was overly complex and, in some areas, inconsistent with the economics of the underlying transactions. The proposed changes address some of the specific concerns raised and should make implementation of the standard more operational and less costly and complex.
- Thus far, the boards have made tentative decisions to change the proposals in the ED with respect to the definition of lease term (threshold for inclusion of extension options) and inclusion of variable or uncertain cash flows (i.e., contingent rent), and have instructed the staff to conduct additional outreach with respect to their tentative decision concerning variable or uncertain cash flows.
- The boards are also considering changes in the definition of a lease, profit and loss recognition patterns and the lessor accounting model. However, no decisions in these areas have yet been reached and the staff will conduct additional outreach.

The main details

.1 In January 2011, the boards issued a preliminary redeliberation plan that identified five key areas for discussion:

- Definition of a lease (including "embedded leases")
- Lessor accounting
- Definition of lease term (including extension options)
- Variable/uncertain cash flows
- Profit and loss recognition pattern

.2 Decisions made during redeliberation of these items could significantly change the scope and direction of the project. The staff also identified a more extensive list of other areas and application issues to be addressed once the boards address the main concerns listed above.

.3 The boards have discussed each of these items in their redeliberation meetings and have identified possible alternative approaches which may reduce complexity and address certain application issues. For several of these areas, the boards have directed their staff to conduct targeted outreach and prepare additional analysis.

.4 In the paragraphs that follow, we have summarized the decisions reached at the January and February 2011 joint meetings, as well as the status of discussions for each of the remaining key areas. We have also included PwC observations on the potential implications of these issues.

.5 As the boards have not yet completed their redeliberations or issued a final standard, all FASB and IASB decisions noted in this Dataline are tentative and therefore subject to change. A complete summary of the boards' decisions on the leases project is available on the FASB's website at www.fasb.org or the IASB's website at www.ifrs.org.

.6 For more information on key aspects of the ED and how it may impact you, refer to [Dataline 2010-38, A new approach to lease accounting – Proposed rules would have far reaching implications](#) (which provides an overview and various insights into the ED), [Dataline 2011-05, Leasing - the responses are in...](#) (which summarizes comment letters received), and [10Minutes on the future of lessee accounting](#) (which provides insight into how companies will be impacted by the proposals in the ED and next steps to consider).

Status of redeliberations

Key decisions reached

Lease term

.7 The boards have tentatively decided to raise the threshold for inclusion of extension options in the lease term from the "more likely than not" threshold in the ED to those that provide "a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease."

.8 The boards decided to provide a list of indicators to help entities assess whether this threshold has been met. Indicators will likely include the existence of substantive bargain renewal options and economic penalties if the lease is not renewed (for example, direct penalty payments, tenant improvements with significant value that would be

forfeited, or a lessee's guarantee of lessor debt related to the leased property). Under the revised approach, management intent and past business practice would not be included as part of the evaluation.

.9 The boards also decided that reassessment of lease term should be performed when there is a significant change in one or more of the indicators such that the lessee would then either have, or no longer have, an economic incentive to exercise an option or terminate the lease.

.10 The definition of lease term will be consistent for both lessees and lessors. The boards acknowledged that different conclusions could be reached related to the same lease as lessees and lessors may have different levels of information or make different judgments.

PwC observation:

The higher threshold for including extension options would generally result in shorter lease terms and lower amounts recognized on the balance sheet than would have resulted under the ED. The revised threshold is more consistent with today's treatment of including renewal periods in the lease term only when they are "reasonably certain" of being exercised, which is well understood in practice. It would also mitigate concerns about structuring opportunities, improve operability of the new standard, reduce volatility and more closely align the inclusion of these additional periods with the actual economic decisions to exercise extension options.

Variable or uncertain payments

.11 Many respondents to the ED believed that certain types of contingencies should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments. However, they were concerned about the complexity of using a probability-weighted approach and the need to forecast certain types of contingencies such as performance-based contingencies tied to sales. Conversely, if all contingencies were to be excluded, the boards were concerned about potential structuring opportunities whereby leases could be structured such that lease payments appear entirely contingent, but where both parties expect significant payments to be made.

.12 The boards tentatively decided that the following variable lease payments should be included in the measurement of lease obligations and assets:

- All contingencies that are based on a rate or an index
- Any contingency that is a "disguised" minimum lease payment (i.e., an anti-abuse provision)
- Any portion of residual value guarantees that are expected to be paid
- Any other contingencies (i.e., usage or performance) that are "reasonably certain" (as that term is used in IFRS) or "probable" (as that term is used in U.S. GAAP) of being paid

.13 The boards tentatively decided that any contingent amounts would be included using a best estimate approach rather than the probability-weighted approach proposed in the ED. The boards also tentatively concluded that "term option penalties" should be included or excluded in a manner that is consistent with the thresholds for including extension options.

.14 The boards have not yet discussed the reassessment of contingencies or how contingent rents included in the measurement would impact the profit and loss recognition pattern. The staff will be conducting additional targeted outreach on these topics.

PwC observation:

The boards' revised proposal strikes a balance between the complexity of including contingencies and the structuring concerns if all contingencies were excluded. The elimination of the requirement to use a probability-weighted approach will also improve operability. When coupled with the revised threshold for inclusion of extension options, this approach will reduce complexity as compared to the ED, though not to the extent that some constituents were looking for. Significant practical application issues remain in this area to be debated prior to the issuance of a final standard, including the profit and loss recognition pattern to be utilized for any contingent amounts recognized.

Status of discussions on other key areas

Profit and loss recognition pattern

.15 The ED implicitly treats all leases as financing transactions with an accelerated profit and loss recognition pattern more commonly associated with financing transactions. Many respondents across a wide range of industries had significant concerns about this approach.

.16 Many respondents did not believe the proposed recognition pattern was consistent with the economics of many types of lease transactions that are not priced like financing transactions, but rather in reference to other market transactions (e.g., by reference to market rent rates, not interest rates). They also observed that while many users of financial information (such as analysts and rating agencies) make adjustments to the balance sheet of lessees, they are not making adjustments to the income statement as they are generally satisfied with the current income statement recognition pattern and characterization of most leases. As a result, many were concerned about the continued usefulness of the income statement as a measure of performance under the ED with respect to leasing transactions that were not financing transactions in nature.

.17 In their redeliberations, the boards have been discussing whether there should be a fundamental distinction between those leases that are primarily financing transactions in nature and those that are "other than financing." The boards may conclude that there is a fundamental difference and while all leases would be on balance sheet, the profit and loss recognition pattern may be different for different types of leases.

.18 If the boards ultimately adopt this approach, those leases that are primarily financing transactions in nature would have a recognition pattern similar to a financed purchase. Those that are deemed to be "other than financing" would have a recognition pattern more closely aligned with today's straight line rent under an operating lease. The boards tentatively agreed that distinguishing between these two types of leases would be based on two new sets of indicators and have instructed the staff to conduct additional targeted outreach in this area.

.19 While some may argue that this approach for "other than financing" leases would represent a significant theoretical departure from the recognition patterns of other assets and liabilities, the boards have acknowledged that it may be necessary given the unique nature of leases, through which the asset and liability are inextricably linked.

PwC observation:

If the boards ultimately conclude that a dual model by lessees for financing and "other than financing" leases is appropriate, this may alleviate many of the concerns about the project. However, we believe that the boards have substantial work remaining in this area—in particular, describing the lease characteristics under each model and how each model would be applied.

Definition of a lease

.20 The ED predominantly carried forward the definition of a lease contained in existing leasing guidance. Perhaps most surprising to many is the level of concern raised regarding the fundamental question of whether an arrangement contains a lease, both in relation to the current accounting for leases and the proposed model.

.21 The boards have acknowledged that there may be many more multiple-element arrangements that contain an embedded lease than originally expected, which would substantially increase the complexity and costs of applying the proposed standard. Conversely, some respondents indicated that many transactions characterized as a lease within an agreement may not be a lease for accounting purposes under the proposed definition.

.22 Feedback received by the boards has also indicated that under current practice, whether an arrangement contains a lease often does not have a significant accounting impact if any lease identified would be an operating lease. However, under the ED, the difference in accounting could be very significant and, as a result, the judgments about whether or not a lease exists and the allocation between lease (so called "embedded leases") and non-lease elements would be much more important.

.23 The definition of a lease contained in the ED was "a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration." The boards have been discussing potential revisions to the definition that may help clarify when transactions are leases or service contracts or both. The boards have also discussed how to apply the definition to a number of practical examples (such as rail cars) where there may be questions as to whether there is a "specified asset" or whether control of the asset has been conveyed to the lessee. The boards have also begun exploring whether they should exclude embedded leases in arrangements that are "predominantly service contracts" or "where the embedded lessee asset is merely incidental to the delivery of a service" such as a cable TV set-top box. The boards also briefly discussed whether certain types of executory costs should be excluded from the measurement when the transactions are predominantly leases.

.24 The boards have instructed the staff to conduct additional targeted outreach in this area and to return to the boards with detailed proposals.

PwC observation:

There remains a significant amount of discussion to be held in this area. We anticipate that the boards will make further progress on these discussions in the near term. We also observe that the changes in lease term described previously and the potential changes in profit and loss recognition patterns may significantly reduce the concerns raised about embedded leases.

Lessor accounting

.25 Many respondents to the ED (including many in the user community) did not believe that the proposed lessor model in the ED represented sufficient improvement to warrant the substantial additional costs to implement and apply the new proposals.

.26 In response to this feedback, the boards have discussed the possibility of allowing the current lessor accounting guidance to continue (with the potential exception of eliminating leveraged lease accounting in the U.S.). The boards have also discussed adjusting the existing lessor model to conform with changes in the definition of a lease, lease term and contingent rents to those that will be contained in the final standard.

.27 It is expected that the issue of lessor accounting will be revisited as soon as decisions in the other key areas have been finalized.

.28 The boards have also clearly indicated that they will be focused on making sure that the other current joint projects, most notably revenue recognition, are based on consistent core principles.

The path forward

.29 The boards will continue redeliberations in the coming months. A final standard remains targeted for issuance in mid-2011. We will continue to keep you informed of the significant redeliberation decisions.

Questions

.30 PwC clients who have questions about this Dataline should contact their engagement partner. Engagement teams that have questions should contact members of the Leasing team in the National Professional Services Group (1-973-236-7805).

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