Tab F – Appendix
Lease Accounting
Reference Material
(For More Information)

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BACKGROUND

Lease accounting was first addressed by the FASAB during the development of SFFAS 5 and 6. At that time the Board decided to use the high level language on lease accounting from SFAS 13 Accounting for Leases. The FASAB standards only addressed the definition of a capital lease, the criteria for capital leases, and the measurement of a capital lease asset and liability. Between SFFAS 5 & 6 the capital lease guidance is minimal. The Board also had plans to use this preliminary guidance as a placeholder until the Board was prepared to add lease accounting to its agenda as a separate project. Lease accounting has been on the list of potential Board agenda items each time the Board has considered its agenda for new projects.

In October 2002 the Board held an agenda hearing, in which lease accounting was presented as a topic. During that hearing, representatives from the Department of Justice's Office of the Inspector General presented several issues relating to leases and leasehold improvements. At that time it was suggested that if FASAB codified FASB literature some of the issues might be resolved.

The current lease accounting project was initiated by the April 28, 2011 Board discussion.

Excerpts from Technical Agenda - Thursday, April 28, 2011 FASAB Meeting

> Ms. Payne reported Mr. Schumacher's priorities since he was unable to be at the meeting today. His priorities are risk assumed, **leases** (prefers to be right behind FASB on this), cleanup costs, investments in non-federal securities, and public-private partnerships.
>
> Mr. Showalter ranked risk assumed first and supported a broad scope at the beginning of the project…. He places **leases** as number three.
>
> Mr. Dacey ranked risk assumed first and **leases** (following FASB's lead) second.
>
> Ms. Bond ranked risk assumed next but shared Mr. Dacey's concerns about the scope. She felt it was drafted too broadly and would be unwieldy..... She would address **leases** next.
>
> Mr. Allen noted that he linked the evaluation of the component entity reports, the 20 year study of the CFO Act, and reducing burden; he ranked this as a priority for current projects. Risk assumed would be his first. Electronic reporting would be second if there were partnerships. Ultimately, he thought there should be certain minimum standards for electronic reporting. He acknowledged that this was on the fringes of our authority.....After these; **leases** would be next because the time may be right to build on the FASB guidance.
>
> Mr. Reger thought reducing burden should be an under-lying priority in all projects. His number one is risk assumed. He thought integrating the statement of spending and saying how it relates to cost is second. His third was **leases**.
>
> Mr. Jackson noted that the statement of spending will require us to describe the basis of accounting. He thought we would be compelled to address it in GAAP to make it a basic statement. He ranked risk assumed as a top priority. He would not put anything else on the list..... He thought **leases** should be addressed when FASB completes its work. He would simply expense software but did not rank it as a priority. His absolute ranking was risk assumed and nothing else.
>
> Mr. Granof agreed that risk assumed was first. He was troubled by where to rank electronic reporting and ranked it two so we would not forget about it. There is a lot to be done but partnerships would be important. **Leases** he ranked three.

Mr. Allen suggested we summarize the results and let members offer feedback. Some members may wish to change their rankings. Ms. Payne summarized the top ranked projects for the three to five year window as follows:

1 – Risk Assumed

2 – Leases

3 – Investments in non-federal securities

4 – Public-private partnerships

EXISTING RESEARCH

In June 2003 an accountant from FAA was detailed to FASAB to prepare a research report on capital and operating leases. The purpose of the research report was to recommend whether or not additional FASAB guidance on leases is needed. The objectives of the research were two-fold:

1. To develop a summary paper that permits staff and the Board to familiarize themselves with lease accounting under FASAB, FASB, GASB and international public sector accounting standards, and to familiarize them with global issues related to lease accounting, and

2. To aid in determining if new uses of leases by Federal entities create different and/or more urgent needs for FASAB guidance.

The 90-page research report was released in October 2003[1] and included the following topics:

- What is covered in FASAB guidance on leases?
- How is FASAB guidance on leases different from others?
- How does the lessee report and account for leases?
- How does the lessor report and account for leases?
- What other lease accounting guidance is provided by other standard-setting entities but not covered by FASAB?
- What types of leases and lease-like arrangements are used by federal entities?

The following issues were identified in the research report as "global issues" for the Board to consider.

- With the growing use of operating leases to meet long-term commitments, should the accounting, and reporting of such leases be revised?
- How do you determine whether an arrangement is a lease?
- In a public/private venture, should the special-purpose entity that is essentially established and controlled by the Federal agency, be consolidated into an agency's financial statements
- Should Federal agencies disclose information on operating leases with cancellation clauses? Do they?
- Does FASAB need to provide additional guidance on leases?

[1] The full *Capital and Operating Lease Research Report* can be found on the FASAB website at http://www.fasab.gov/pdffiles/combinedleasev4.pdf .

EXCERPTS FROM EXISTING CONCEPTS, STANDARDS, OTHER GUIDANCE, AND LEGISLATION

- Federal Accounting Standards and Concepts

    - **SFFAC 1, *Objectives of Federal Financial Reporting***

Operating Performance - Objective 2

122. **Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities.**

123. This objective arises from a democratic government's duty to be accountable to its citizens for managing resources and providing services economically and efficiently and for effectiveness in attaining planned goals. Also, the government should be accountable for raising resources efficiently.

124. Because government services are not usually provided in exchange for voluntary payments or fees, expenses cannot be matched against revenue to measure "earnings" or "net income" as would be done in business accounting. Moreover, directly measuring the value added to society's welfare by government actions is difficult. Nonetheless, expenses can be matched against the provision of services year by year. The resulting cost can then be analyzed in relationship to a variety of measures of the achievement of results.

125. Certain subobjectives arise from the basic objective of reporting on operating performance, as discussed below.

Federal financial reporting should provide information that helps the reader to determine:

126. **2A. The costs of providing specific programs and activities and the composition of, and changes in, these costs.**

127. Examples of financial information that can help to address this objective include
• information on the costs of programs and activities;
• cost comparisons with estimates, with similar functions, with targets, [footnote [9]: "Performance targets" specify the level of performance that is set as a goal by policy and program officials. Targets may be set in terms of outputs, outcomes, impacts, cost per unit of output, etc].and over time; and
• relevant analyses of the composition and behavior of costs, such as full and incremental costs, fixed and variable costs, direct and indirect costs, and reimbursable and other costs, where appropriate.

128. **2B. The efforts and accomplishments associated with federal programs and the changes over time and in relation to costs.**

129. Examples of information that can help to address this objective include
• financial and nonfinancial indicators of service inputs, outputs, and outcomes, including comparisons with goals;
• indicators of program efficiency and effectiveness;

- work load measures and unit costs; and
- total and marginal costs and benefits, the relationship of these to budget requests, and when the benefits will be realized.

130. **2C. The efficiency and effectiveness of the government's management of its assets and liabilities.**

131. This subobjective implies concern with the management of all federal assets and liabilities used by or under the control of agencies. Users of financial reports focus on the use of these resources in program operations, not solely on their financial value. Reports intended to address this objective would provide information to help users assess the efficiency and effectiveness with which
- cash is used;
- loan, loan guarantee, and other receivables programs are conducted;
- inventories of supplies, materials, and similar items are maintained; and
- forfeited and other tangible assets are handled.

132. Other examples of information relevant to this objective might include
- the service life and replacement cost of major systems and equipment;
- backlogs (and budgetary impact) of delayed maintenance, rehabilitation cost or replacement value of assets;
- the market value of forfeited and other assets, particularly those held for sale;
- the extent of unpaid expenses; and
- estimates (and ranges of estimates) of other known liabilities (such as leases or deposit and other insurance liabilities) and other exposures to loss.

133. Further discussion of performance measurement and how financial reporting can contribute to reporting on performance is provided in Chapter 8.

Stewardship - Objective 3

134. **Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future.** [footnote[10]: The concepts of "financial position" and "financial condition" are discussed in Chapter 7.]

135. This objective is based on the federal government's responsibility for the general welfare of the nation in perpetuity. It focuses not on the provision of specific services but on the requirement that the government report the broad outcomes of its actions. Certain subobjectives arise from the basic objective of stewardship, as discussed below.

Federal financial reporting should provide information that helps the reader to determine:

136. **3A. Whether the government's financial position improved or deteriorated over the period.**

Examples of information relevant to this objective include
- the amount of assets, liabilities, and net assets (or net position);
- an analysis of government debt, its growth, and debt service requirements;
- changes in the amount and service potential of capital assets; and

• the amount of contingent liabilities and unrecognized obligations (such as the probable cost of deposit insurance).

137. Assessing whether the government's financial position improved or deteriorated over the period is important not only because it has financial implications but also because it has social and political implications. This is because analysis of why financial position improved or deteriorated helps to explain whether financial burdens were passed on by current-year taxpayers to future-year taxpayers without related benefits. The latter notion is sometimes referred to as "interperiod equity." [footnote[11]:In paragraph 61 of its first conceptual statement, *Objectives of Financial Reporting*, the GASB noted: "The Board believes that interperiod equity is a significant part of accountability and is fundamental to public administration. It therefore needs to be considered when establishing financial reporting objectives [for state and local governmental entities]. In short, financial reporting should help users assess whether current-year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided." GASB's Statement 11, *Measurement Focus and Basis of Accounting--Governmental Fund Operating Statements*, adds "Conversely, [a measure of interperiod equity] would show whether current-year revenues not only were sufficient to pay for current-year services, but also increased accumulated net resources."]

138. Viewed in this broader context, providing information to meet objective 3 and its subobjectives will help to satisfy the needs expressed by financial report users. It will also help to explain the issuance of new debt in relation to expenditures for activities with current benefits versus expenditures for investment-type activities that yield future benefits.

139. **3B. Whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.**

140. Information about the results of past government operations is useful in assessing the stewardship exercised by the government. Users of financial reports also want help in assessing the likelihood that the government will continue to provide the current level of benefits and services to constituent groups, such as farmers, retirees, and the poor.

141. Information relevant to this objective may include disclosures of financial risks that are likely or reasonably possible from sources such as government-sponsored enterprises, deposit insurance, and disaster relief programs. It could also include information such as

• the long-term financial implications of the budgetary process,
• the status of trust funds, and
• backlogs of deferred maintenance.

142. Providing information of this kind may require the use of reporting mechanisms other than traditional financial statements. For example, special reports may have to be developed to demonstrate whether the level of a particular year's maintenance and rehabilitation expenditures resulted in an improvement or a deterioration of capital assets and infrastructure.

143. **3C. Whether government operations have contributed to the nation's current and future well-being.**

144. Objective 3, in general, and subobjective 3C, in particular, imply a concern with "financial condition," as well as "financial position." Financial condition is a broader and more forward-looking concept than that of financial position. Reporting on financial condition requires financial and nonfinancial information about the national economy and society, as

well as about the government itself. For example, reports intended to help meet this objective might address users' needs for information about
• investments in (or expenditures for) research and development, military readiness, and education;
• changes in the service potential of infrastructure assets;
• spending for consumption relative to investments;
• opportunities for growth-stimulating activities; and
• the likelihood of future inflation.

145. Indicators of financial position, measured on an accrual basis, are the starting point for reporting on financial condition but must be supplemented in a variety of ways. For example, subobjective 3B might imply reporting, among other things, a current law budget projection under a range of alternative assumptions. Reports intended to achieve subobjective 3C might disclose, among other things, the contribution that the government is making to national wealth by financing assets that are not federally owned, such as research and development, education and training, and state-owned infrastructure. Information on trends in total national wealth and income is also important.

- **SFFAC 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements***

Basic Recognition Criteria

5. Basic recognition criteria are the conditions an item should meet in order to be a candidate for recognition in the financial statements. The basic recognition criteria established in this Statement are (a) the item meets the definition of an element of financial statements and (b) the item is **measurable**. As used in this Statement, the term *measurable* means that a monetary amount can be determined with reasonable certainty or is reasonably estimable.

6. The existence or measurability (or both) of many assets, liabilities, and other elements may not be certain, but this Statement does not require certainty. Uncertainty and its effects on financial reporting are discussed in paragraphs 57 through 59. Conclusions about whether an element exists and is measurable may require judgment based on the available evidence.

Additional Considerations for Recognition Decisions

7. Meeting both of the basic recognition criteria established in paragraph 5 is a necessary but not a sufficient condition for recognition. Additional steps are necessary before a recognition decision can be made. For example, a candidate for recognition needs to be measured. **Measurement** of an item entails the selection of an appropriate attribute to be measured, such as historical cost, fair value, or expected value, and application of a measurement method. Measurement may require the use of estimates and approximations as well as an assessment, in a manner consistent with the attribute being measured, of the probability that future inflows or outflows of economic benefits or services will result from the item. Recognition decisions also incorporate the results of assessments of the materiality and benefit versus cost of recognizing the item measured. Thus, it is possible that an item that meets the basic recognition criteria would not be recognized due to measurement, materiality, or cost-benefit considerations.

8. This Statement establishes the basic recognition criteria for elements but does not address these additional considerations for recognition decisions. The Board intends to establish concepts and standards for these additional considerations in future pronouncements. In the meantime, this Statement does not change existing standards for measurement or for assessing probabilities. The Board expects that the selection of an appropriate measurement attribute in specific circumstances will continue to be based on the reporting objectives, **qualitative characteristics**, and cost–benefit constraints applicable to financial information.

9. An item that meets the appropriate definition of an element is an asset, liability, revenue, or expense, even if it is not recognized in the accrual basis financial statements because, for example, it is not measurable or its amount is not material. Unrecognized elements are candidates for disclosure in the notes to financial statements or as supplementary information.

Definition of an Asset

18. An asset is a resource that embodies economic benefits or services that the federal government controls.

19. The definition of an asset addresses only whether an asset exists. It does not address whether the asset is measurable and, if so, how it should be measured or whether or when it should be recognized in the federal government's or a component entity's balance sheet. Nor does the definition address whether or when the economic benefits or services embodied in an asset will be used. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also indicate that measurement issues and other considerations for recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

20. The definition of an asset derives from the nature of assets—that is, their **essential characteristics**. An essential characteristic of an asset is one that is inherent to all assets and, therefore, without it an asset would not exist. Paragraphs 21 through 35 highlight and discuss those characteristics. Also discussed are certain characteristics that are common to many assets but not to all assets. As such, those characteristics are not essential, but they may provide additional evidence that an asset exists.

Definition of a Liability

39. A liability is a present obligation [footnote [5]: The term *obligation* is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It does not mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting or that a liability in accounting or financial reporting is required to exist for budgetary resources to be obligated.] of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

40. The definition of a liability addresses only whether a liability exists and not how it should be measured or whether or when it should be recognized. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5

through 9. Those paragraphs also indicate that measurement issues and other considerations for recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

- **SFFAS 5, *Accounting for Liabilities of the Federal Government***

43. **Capital leases** are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or more of the following four criteria, the lease should be classified as a capital lease by the lessee:
    • The lease transfers ownership of the property to the lessee by the end of the lease term.
    • The lease contains an option to purchase the leased property at a bargain price.
    • The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
    • The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the leased property.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property. If a lease does not meet at least one of the above criteria it should be classified as an operating lease.

44. The amount to be recorded by the lessee as a liability under a capital lease is the present value of the rental and other minimum lease payments during the lease term, excluding that portion of the payments representing executory cost to be paid by the lessor. [footnote [20]: "The cost of general property, plant, and equipment acquired under a capital lease shall be equal to the amount recognized as a liability for the capital lease at its inception. See SFFAS No. 6, Accounting for Property, Plant, and Equipment.] However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the liability should be the fair value. If the portion of the minimum lease payments representing executory cost is not determinable from the lease provisions, the amount should be estimated.

45. The discount rate to be used in determining the present value of the minimum lease payments ordinarily would be the lessee's incremental borrowing rate unless (1) it is practicable for the lessee to learn the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both these conditions are met, the lessee shall use the implicit rate. The lessee's incremental borrowing rate shall be the Treasury borrowing rate for securities of similar maturity to the term of the lease.

46. During the lease term, each minimum lease payment should be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the liability. [footnote[21:] OMB Circular No. A-11, "Preparation and Submission of Annual Budget Estimates," explains the measurement of budget authority, outlays, and debt for the budget in the case of lease-purchases and other capital leases. Circular A-94, "Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs," provides the requirements under which a lease-purchase or other capital lease has to be justified and the analytical methods that need to be followed.]

- SFFAS 6, *Accounting for Property, Plant, and Equipment (PP&E)*

20. Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or more of the following four criteria, [footnote 7: Note that the criteria for identifying capital leases for financial reporting purposes differ from OMB criteria for budget scoring of leases. OMB Circular No. A-11, *Preparation and Submission of Budget Estimates*, includes criteria for identifying operating leases in Appendix B. OMB provides four additional criteria which relate to the level of private sector risk involved in a lease-purchase agreement. This is necessary because, for budget purposes, there is a distinction between lease-purchases with more or less risk. This distinction is not made in the financial reports and, therefore, FASAB does not include the four criteria related to risk levels.] the lease should be classified as a capital lease by the lessee. Otherwise, it should be classified as an operating lease. [footnote 8: "Operating leases" of PP&E are leases in which the Federal entity does not assume the risks of ownership of the PP&E. Multi-year service contracts and multi-year purchase contracts for expendable commodities are not capital leases.]

    • The lease transfers ownership of the property to the lessee by the end of the lease term.
    • The lease contains an option to purchase the leased property at a bargain price.
    • The lease term is equal to or greater than 75 percent of the estimated economic life [footnote 9: "Estimated economic life of leased property" is the estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.] of the leased property.
    • The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value [footnote 10: "Fair value" is the price for which an asset could be bought or sold in an arm's-length transaction between unrelated parties (e.g., between a willing buyer and a willing seller). (adapted from Kohler's Dictionary for Accountants)] of the leased property.

    The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property.

29. The cost of general PP&E acquired under a **capital lease** shall be equal to the amount recognized as a liability for the capital lease at its inception (i.e., the net present value of the lease payments calculated as specified in the liability standard [footnote 21: See Statement of Recommended Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*.] unless the net present value exceeds the fair value of the asset).

OMB Circular A-11 *Preparation, Submission, And Execution Of The Budget*
Appendix A – Scorekeeping Guidelines

11. Scoring purchases

When a law provides the authority for an agency to enter into a contract for the purchase, lease-purchase, capital lease, or operating lease of an asset, budget authority and outlays will be scored as follows: For lease-purchases and capital leases, budget authority will be scored against the legislation in the year in which the budget authority is first made available in the amount of the estimated net present value of the Government's total estimated legal obligations over the life of the contract, except for imputed interest costs calculated at Treasury rates for marketable debt instruments of similar maturity to the lease period and identifiable annual operating expenses that would be paid by the Government as owner (such as utilities, maintenance, and insurance). Property taxes will not be considered to be an operating cost. Imputed interest costs will be classified as mandatory and will not be scored against the legislation or for current level but will count for other purposes.

For operating leases, budget authority will be scored against the legislation in the year in which the budget authority is first made available in the amount necessary to cover the Government's legal obligations. The amount scored will include the estimated total payments expected to arise under the full term of a lease contract or, if the contract will include a cancellation clause, an amount sufficient to cover the lease payments for the first fiscal year during which the contract is in effect, plus an amount sufficient to cover the costs associated with cancellation of the contract. For funds that are self-insuring under existing authority, only budget authority to cover the annual lease payment is required to be scored.

Outlays for a lease-purchase in which the Federal government assumes substantial risk (for example, through an explicit Government guarantee of third party financing) will be spread across the period during which the contractor constructs, manufactures, or purchases the asset. Outlays for an operating lease, a capital lease, or a lease-purchase in which the private sector retains substantial risk will be spread across the lease period. In all cases, the total amount of outlays scored over time against legislation will equal the amount of budget authority scored against that legislation.

No special rules apply to scoring purchases of assets (whether the asset is existing or is to be manufactured or constructed). Budget authority is scored in the year in which the authority to purchase is first made available in the amount of the Government's estimated legal obligations. Outlays scored will equal the estimated disbursements by the Government based on the particular purchase arrangement, and over time will equal the amount of budget authority scored against that legislation.

Existing contracts will not be rescored.

To distinguish lease purchases and capital leases from operating leases, the following criteria will be used for defining an operating lease:
-- Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease period.
-- The lease does not contain a bargain-price purchase option.
-- The lease term does not exceed 75 percent of the estimated economic lifetime of the asset.
-- The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of the fair market value of the asset at the inception of the lease.

-- The asset is a general purpose asset rather than being for a special purpose of the Government and is not built to unique specification for the Government as lessee.
-- There is a private-sector market for the asset.

Risks of ownership of the asset should remain with the lessor.

Risk is defined in terms of how governmental in nature the project is. If a project is less governmental in nature, the private-sector risk is considered to be higher. To evaluate the level of private-sector risk associated with a lease-purchase, legislation and lease-purchase contracts will be considered against the following type of illustrative criteria, which indicate ways in which the project is less governmental:

-- There should be no provision of Government financing and no explicit Government guarantee of third party financing.
-- Risks of ownership of the asset should remain with the lessor unless the Government was at fault for such losses.
-- The asset should be a general purpose asset rather than for a special purpose of the Government and should not be built to unique specification for the Government as lessee.
-- There should be a private-sector market for the asset.
-- The project should not be constructed on Government land.

Language that attempts to waive the Anti-Deficiency Act, or to limit the amount or timing of obligations recorded, does not change the Government's obligations or obligational authority, and so will not affect the scoring of budget authority or outlays.

Unless language that authorizes a project clearly states that no obligations are allowed unless budget authority is provided specifically for that project in an appropriations bill in advance of the obligation, the legislation will be interpreted as providing obligation authority, in an amount to be estimated by the scorekeepers.

OMB Circular A-11 Preparation, Submission, And Execution Of The Budget

Appendix B—Budgetary Treatment of Lease-Purchases and Leases of Capital Assets

This Appendix provides instructions on the budgetary treatment of lease-purchases and leases of capital assets consistent with the scorekeeping rule developed by the executive and legislative branches in connection with the Budget Enforcement Act of 1990 (BEA), as revised pursuant to the Balanced Budget Act of 1997 (see Appendix A). The scorekeeping rule focuses on leases and lease-purchases specifically authorized by law. However, these requirements apply to all lease-purchase arrangements and capital leases, including those arrangements that agencies may enter into under existing general legal authorities and arrangements that are financed through the Federal Financing Bank. The only exception is that leases between Federal agencies generally will not be treated this way if the lessor recorded the full cost of the asset when it was acquired.

Agencies are required to submit to their OMB representatives the following types of leasing and other non-routine financing proposals for review of the scoring impact:

-- Any proposed lease of a capital asset where total Government payments over the full term of the lease would exceed $50 million. It should be assumed that options to renew will be exercised.

-- All financing proposals that are non-routine in nature and involve unique or unusual concepts or characteristics such as those listed below:

-- Outlease-leaseback mechanisms;

-- Establishment of public-private partnerships or limited liability corporations;

-- Issuance of debt by a third party that includes an explicit "full faith and credit" guarantee of debt repayment by the Government or an implicit guarantee of repayment from Federal funds that removes a substantial amount of the investor's risk;

-- Special purpose assets for which there is no real private sector market;

-- Enhanced-use leases with leasebacks with annual payments above the following threshold levels:

- 2010—$2,790,000
- 2011—$2,790,000
- 2012—$2,790,000

-- Projects constructed or located on Government land;

-- Service contracts that require the contractor to acquire or construct assets valued over $50 million;

-- Share in savings proposals that result in the acquisition of real property;

-- Proposals that raise issues about the governmental/non-governmental status of the asset or the entity that holds the title to the asset;

-- Any financing proposal for which a statute requires OMB approval of the scoring (or of the proposal) or compliance with Circular No. A–11. Where compliance with Circular No. A–11 or other specified scoring rules is required by statute, the agency submission must be accompanied by a memorandum from the agency General Counsel explaining how the statutory criteria are satisfied;

-- Arrangements that convey special tax status to the project by virtue of the Government's participation; and

-- Leasing arrangements that involve options that can be conveyed to a third party in exchange for future considerations.

Agencies should submit these proposals to OMB during the conceptual, developmental stage. Subsequent changes that could substantially change the scope of the proposal or affect the scoring impact (e.g., change from an operating lease to a lease-purchase) must be resubmitted to OMB.

1. Basic requirements

(a) ***General.***

When an agency is authorized to enter into a ***lease-purchase*** or ***capital lease*** contract, budget authority will be scored in the year in which the authority is first made available in the amount of the net present value of the Government's total estimated legal obligations over the life of the contract, as described in section 2(b) below. Outlays for lease-purchases in which the Federal Government assumes substantial risk will be spread across the period during which the contractor constructs, manufactures, or purchases the asset. Outlays for a capital lease or a lease-purchase in which the private sector retains substantial risk will be spread across the lease term. The scorekeeping requirements are summarized below.

For ***operating leases***, budget authority is required for the first year of the contract in the amount necessary to cover the Government's legal obligations, consistent with the requirements of the Antideficiency Act. This will include the estimated total payments expected to arise under the full term of the contract or, if the contract includes a cancellation clause, an amount sufficient to cover the lease payments for the first year plus an amount sufficient to cover the costs associated with cancellation of the contract. (For each subsequent year, sufficient budget authority is required to cover the annual lease payment plus any additional cancellation costs.) In a limited number of instances, where funds are self-insuring under existing authority, only the amount of budget authority needed to cover the annual lease payment is required to be scored. OMB will advise agencies if funds may be considered self-insuring for this purpose.

(b) ***Making annual lease payments after the BA expires.***

Unless otherwise specified by law, budget authority is available for liquidating obligations (i.e., outlays) for only five fiscal years after the authority expires. For leases financed by annual or multi-year budget authority, agencies should ensure that the appropriations language allows the budget authority to remain available for lease payments over the full term of the lease. If this period is expected to be longer than five fiscal years after the authority expires, the appropriations language should include the provision described in section 95.8.

(c) ***Changes to existing contracts.***

When an agency modifies or amends an existing capital lease or lease-purchase contract, any remaining budgetary resources prior to modification should be used to offset the cost of the new contract. The amount scored will be the difference in the net present value of the Government's total estimated legal obligations between the new contract and the remaining term of the original contract. (Both net present values should be calculated using the Treasury borrowing rates published in the annual update to Appendix C of OMB Circular No. A-94 at the time the contract is amended (see section 4)). There would be no remaining budgetary resources if funds equal to the lease payments or the present value of the lease payments were not scored up front at the time the lease was signed. In this case, the full cost of the new contract should be scored, consistent with the rules for scoring lease-purchases and capital leases. Similarly, when an agency modifies or amends an existing operating lease contract, the impact of the changes needs to be evaluated. If the lease no longer meets the criteria for an operating lease, the modified lease should be rescored.

(d) ***Options to renew or purchase.***
When the lease agreement contains an option to renew that can be exercised without additional legislation, it will be presumed that the option will be exercised for purposes of calculating the term of the lease and scoring budget authority. When the lease agreement contains an option to purchase at less than fair market value (at the time the option is to be exercised), and the option can be exercised without additional legislation, it will be presumed that the option will be exercised for purposes of classifying the type of lease and scoring budget authority.

SUMMARY OF BUDGET REQUIREMENTS

Transaction	Budget Authority	Outlays
Lease-purchase without substantial private risk	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease period.	Amount equal to asset cost scored over the construction period in proportion to the distribution of the contractor's costs; amount equal to imputed interest costs recorded on an annual basis over lease term.
Lease-purchase with substantial private risk	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease term.	Scored over lease term in an amount equal to the annual lease payments.
Capital lease	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease term.	Scored over lease term in an amount equal to the annual lease payments.
Operating lease	Amount equal to total payments under the full term of the lease or amount sufficient to cover first year lease payments plus cancellation costs recorded up front	Scored over lease term in an amount equal to the annual lease payments.

2. Budget presentation

(a) ***General.***

For the purposes of scorekeeping transactions that involve lease-purchases and capital leases, the costs are separated into the following components:

-- Asset cost (which equals the present value of the lease payments); and

-- Imputed interest cost (which equals the financing cost Treasury would have incurred if it had financed the project by borrowing).

These concepts are defined more fully in section 3. The amounts can be determined from the amortization tables developed in accordance with the instructions in section 4. Budget authority and outlays attributable to asset costs will be classified as investment-type activities (physical assets), and budget authority and outlays attributable to imputed interest costs will be classified as non-investment activities (see section 84.4).

(b) ***Budget authority.***

-- ***Amounts.*** The up-front budget authority required for both lease-purchases and capital leases is called the asset cost. This equals the present value of the minimum lease payments excluding payments for identifiable annual operating expenses that would be paid by the Government as owner, such as utilities, maintenance, and insurance. Property taxes will not be considered to be an operating expense and will be included in the calculation of the up-front budget authority. (See section 3 for the treatment of property taxes for purposes of distinguishing operating leases from capital leases.) The present value of the lease payments is discounted as of the date of the first payment (or the beginning of the lease term, whichever is earlier) using the appropriate interest rate (see section 4 for a more detailed explanation and the treatment of multiple deliveries).

Additional budget authority equal to Treasury's cost of financing (i.e., the imputed interest cost) plus any annual operating expenses will be recorded on an annual basis over the lease term.

-- ***Typ***e ***of authority***. When an agency enters into a capital lease or lease-purchase under general authorities available to the agency, it must do so within the limits of the budgetary resources available to it and the constraints of the scorekeeping requirements.

If Congress enacts legislation that enables an agency to enter into a lease-purchase or capital lease for a specific project without further congressional action (e.g., appropriations action), it will be assumed that Congress has provided the budget authority required for the transaction. If Congress does not provide the budget authority in the form of an appropriation, then authority to borrow or contract authority will be recorded as follows:

-- ***Authority to borrow*** will be recorded if the transaction is a lease-purchase without substantial private risk, in which case outlays need to be scored up-front in advance of appropriations for the annual lease payment (or offsetting collections). A portion of the amount subsequently appropriated (or collected, if the agency receives offsetting collections) will be applied to retire outstanding agency debt attributable to the lease-purchase. (See sections 2(c) and 2(d) for more information on how that portion is determined and presented in the Budget.)

-- ***Contract authority*** will be recorded if the transaction is a lease-purchase with substantial private risk or a capital lease, in which case outlays will be scored over the lease term and financed by appropriations for the annual lease payment (or offsetting collections). A portion of the amount appropriated (or collected, if the agency receives offsetting collections) will be applied to liquidate contract authority. (See sections 2(c) and 2(d) for more information on how that portion is determined and presented in the Budget.)

-- ***Timing.*** When Congress enacts legislation that specifically enables an agency to enter into a lease-purchase or capital lease, the budget authority required for the transaction will be recorded when the authority first becomes available for obligation. Obligations will be recorded when the lease agreement is signed. When the authority stems from general authority available to the agency, obligations are recorded, and sufficient budgetary resources must be available, when the lease agreement is signed.

(c) ***Outlays.***

-- ***Lease-purchases without substantial private risk***. Outlays are not equal to the annual lease payments.

-- Outlays are scored over the period during which the contractor constructs, manufactures, or purchases the asset, in an amount equal to the asset cost. This amount will equal the up-front budget authority. Amounts of the asset cost in excess of the contractor's actual construction or manufacturing costs should be distributed in proportion to the distribution of the construction or manufacturing costs. If the asset already exists, the outlays will be recorded in the year in which the lease-purchase contract is signed.

-- Outlays equal to the imputed interest costs are reported on an annual basis over the lease term.

-- ***Lease-purchases with substantial private risk and capital leases***. Outlays are scored annually equal to the annual lease payments.

-- Over the life of the lease agreement, a portion of the outlays (equivalent to the asset cost) will come from the balances obligated when the lease agreement was signed, and a portion (equivalent to the imputed interest cost) will come from new budget authority. The appropriate amounts can be determined from amortization tables developed in accordance with the instructions in section 4.

(d) ***Annual appropriations for lease financed by contract authority or borrowing authority.***

Lease-purchases and capital leases that are financed by contract authority or borrowing authority will generally require annual appropriations in an amount equal to the annual lease payment. Since budget authority equal to the asset cost is scored up front, the portion of the annual appropriation that corresponds to the amortization of the asset cost is not scored as new budget authority. If it were, total budget authority would be overstated over the life of the lease. The budget authority that is recorded on an annual basis will equal the imputed interest cost. The required adjustments are explained below:

-- ***For lease-purchases without substantial private risk that are financed by borrowing authority.*** An amount equal to the amortization of the asset cost component of the annual lease payment will be treated as redemption of debt and deducted from the new budget authority totals. On the program and financing schedule, this amount will be reported as a negative entry on line 1135 or 1236 (see section 82.3). If offsetting collections are used to make the annual lease payment in lieu of an appropriation, the amount will be reported as a negative entry on line 1726 or 1825.

-- For capital leases and lease-purchases with substantial private risk that are financed by contract authority. An amount equal to the amortization of the asset cost component of the annual lease payment will be treated as liquidating cash and deducted from the new budget authority totals. On the program and financing schedule, this amount will be reported as a negative entry on line 1137 or 1238 (see section 82.3). (If offsetting collections are used to make the annual lease payment in lieu of an appropriation, the amount will be reported as a negative entry on line 1727 or 1826.)

(e) ***Agency debt.***
For lease-purchases without substantial private risk, agency borrowing must be recorded to finance the outlays scored for the construction, manufacture, or purchase of the asset. The agency debt that accumulates over this period is equal to the asset cost; this debt is subsequently redeemed over the lease payment period in an amount equal to a portion of the annual lease payment. The appropriate amounts of debt and debt redemption can be

determined from the amortization tables developed in accordance with the instructions in section 4, Step 5. Interest on agency debt can be determined in accordance with Steps 3, 4, and 5.

If the account has a balance sheet, the amount of such agency debt should be included as a separate item (and separate from other agency debt) under liabilities and identified as having been incurred to finance lease-purchases. All other accounts should include the amount of agency debt in the narrative statement for the account that is published in the ***Budget Appendix***.

3. Definitions and concepts

For the purposes of scoring lease-purchases and capital leases, the following definitions and concepts apply. Agencies should consult with OMB in cases where enhanced use leases and public-private partnerships are involved. Public-private partnerships should not be used solely or primarily as a vehicle for obtaining private financing of Federal construction or renovation projects. Such transactions should be used only when they are the least expensive method, in present value terms, to finance construction or repair.

Lease-purchase means a type of lease in which ownership of the asset is transferred to the Government at or shortly after the end of the lease term. Such a lease may or may not contain a bargain-price purchase option.

Capital lease means any lease other than a lease-purchase that does not meet the criteria of an operating lease.

Operating lease means a lease that meets all the criteria listed below. If the criteria are not met, the lease will be considered to be a capital lease or a lease-purchase, as appropriate. Multi-year service contracts (e.g., grounds maintenance) and multi-year purchase contracts for expendable commodities (e.g., aspirin) will be considered to be operating leases. Agencies should consult with OMB in cases where a service contract requires a private contractor to construct or acquire a capital asset solely or primarily to provide the service to the government.

-- Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease term;

-- The lease does not contain a bargain-price purchase option;

-- The lease term does not exceed 75 percent of the estimated economic life of the asset;

-- The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of the fair market value of the asset at the beginning of the lease term;

-- The asset is a general purpose asset rather than being for a special purpose of the Government and is not built to the unique specification of the Government as lessee; and

-- There is a private sector market for the asset.

The following guidelines will be used in distinguishing between operating leases, capital leases, and lease purchases. They should be used in calculating the ***term of the lease*** and the value of the ***minimum lease payments***:

-- ***Estimate of fair market value.*** In the case of real property, the fair market value should be based on current market appraisals. If no asset exists, the fair market value of the proposed asset should be based on the Government's estimate of the private developer's cost to construct the leased facility. The estimate should only include the costs the Government would normally pay the private sector for such a facility. These costs include the total direct and indirect costs of constructing the facility, including land purchase, design, site improvements, and management costs. Fair market value should not include the value of features or enhancements that were built or added for the Government's unique needs or special purposes or features or enhancements that will be paid for by the Government in lump sum. If the Government proposes to lease only a portion of a facility, then the estimate of fair market value should be adjusted accordingly to reflect the portion that will be leased by the Government.

-- ***Special features or enhancements.*** Assets that have special features or enhancements that were built or added for the Government's unique needs or special purposes need to be evaluated on a case-by-case basis to ascertain whether they can be considered to be general purpose assets. If the asset is considered to be a general purpose asset, then, as a general rule, such special features or enhancements should be financed up-front, separate from the lease.

-- ***Upfront, lump sum payments.*** If the terms of a lease contain an upfront, lump sum payment, only the amounts associated with special features or enhancements to meet the Government's unique needs or specifications and the amounts associated with agency specific customizations can be removed from the agency scoring calculation. Any payment in excess of that amount will be factored into the net present value scoring calculation. The rental stream over the life of the lease must be adequate to provide functional space.

-- ***Projects on Government land***. If the project is constructed or located on Government land, it will be presumed to be for a special purpose of the Government.

-- ***Renewal and purchase options***. If the lease agreement contains an option to renew that can be exercised without additional legislation, it will be presumed that the option will be exercised. If the lease agreement contains an option to purchase at less than fair market value (at the time the option is to be exercised), and the option can be exercised without additional legislation, it will be presumed that the option will be exercised.

-- ***Cancellation clauses***. It will be presumed that the lease will run for the full term of the contract, and the minimum lease payments will be calculated on the basis of the lease payments that will be made over the full term of the lease (including options to renew).

-- ***Lease-backs from public/private partnerships.*** If an agency leases from a public/private partnership that has substantial private participation, the lease will be treated as a capital lease. The term "public/private partnership" includes special purpose entities for which the Government is a beneficiary. Substantial private participation means (1) the non-Federal partner has a majority ownership share of the partnership and its revenues; (2) the non-Federal partner has contributed at least 20 percent of the total value of the assets owned by the partnership; and (3) the Government has not provided indirect guarantees of the project, such as a rental guarantee or a requirement to pay higher rent if it reduces its use of space. Total value includes the value of assets contributed by the Government (but not the value of land) and all improvements made to the asset. Contributions by the non-Federal partner of cash, real assets, and loans for which the non-Federal partner is responsible for repayment will count towards meeting the 20 percent threshold. Direct loans from the Government or guarantees by the Government of loans made to the non-Federal partner or to the partnership will not count towards the 20 percent threshold.

If a public/private partnership fails to meet the test of substantial private participation, the partnership will be considered governmental for purposes of the budget, and the lease-back will be scored against the agency that enters into the partnership. If the Government ground-leases property to a non-Federal party and subsequently leases back the improvements, the lease will not be considered a lease-back from a public/private partnership, as long as the lessor is a totally non-Federal entity. Such lease-backs may be treated as operating leases if they meet the criteria for an operating lease.

-- ***Bargain-price purchase option***. A bargain-price purchase option is a provision allowing the Government to purchase the leased property for a price that is lower than the expected fair market value of the property at the date the option can be exercised. The purchase price includes the value of any rebates or income to the agency or Government resulting from its purchase of the asset.

-- ***Property taxes***. Property taxes, along with other operating expenses, will be excluded from the lease payments for purposes of comparing the present value of the minimum lease payments with the fair market value of the asset. (Note: Property taxes will be included in the calculation of the net present value of the lease payments for purposes of scoring budget authority under the BEA. See section 2(b) above.)

-- ***Interest rates***. The present value of the minimum lease payments will be calculated on the basis of Treasury rates for marketable debt instruments of similar maturity to the lease term (see section 4).

Risk means the level of private-sector risk. Lease-purchase agreements are scored as with or without substantial private risk depending on the level of private-sector risk. Substantial private risk means the absence of substantial government risk. Risk is defined in terms of how governmental in nature the project is. That is, if the project is less governmental in nature, the private sector risk is considered to be higher.

The following types of illustrative criteria indicate ways in which the project is ***less governmental***:

-- There is no provision of Government financing and no explicit Government guarantee of third-party financing;

-- Risks incident to ownership of the asset (e.g., financial responsibility for destruction or loss of the asset) remain with the lessor unless the Government was at fault for such losses;

-- The asset is a general purpose asset rather than being for a special purpose of the Government and is not built to the unique specification of the Government as lessee;

-- There is a private-sector market for the asset; or

-- The project is not constructed on Government land.

Imputed interest cost means the financing costs that Treasury would have incurred if it had sold debt to the public equal to the total project cost. The difference between the total estimated legal obligations (excluding obligations for annual operating expenses as described in section 2(b)) and their estimated net present value represents imputed interest costs. Imputed interest costs will be calculated at Treasury rates for marketable debt instruments of similar maturity to the lease term on the date the contract is signed. These costs will be considered mandatory under the BEA and will be shown in the same function as interest on agency debt, that is, in the function that provided the obligational authority to enter into the contract.

Differential cost of financing means the total annual interest payments on any debt sold to the public less the interest payments that would have been made on the same amount of debt at the Treasury rate (i.e., less the imputed interest costs). Simply stated, this corresponds to any interest above Treasury's interest rate.

Asset cost means the present value of the agency's minimum lease payments discounted from the date of the first payment (or the beginning of the lease term, whichever is earlier) using the Treasury interest rate for marketable debt instruments of similar maturity to the lease term on the date the contract is signed and excluding obligations for identifiable annual operating expenses as described in section 2(b). Asset cost corresponds to the total construction or acquisition costs, plus property taxes and any interest above Treasury's cost of financing (i.e., the differential cost of financing). See section 4 for more detailed explanation and the treatment of multiple deliveries.

4. Guidance on calculations

A schedule of lease payments or an amortization schedule is required to calculate budget authority, outlays, and debt. The correct Treasury rate to use for discounting to present value and for calculating imputed interest costs will be based on the economic assumptions in the most recent budget, which, for the current year, are published in the annual update to Appendix C of OMB Circular No. A–94. Revised forecasts of these Treasury interest rates are released whenever economic assumptions for the budget are updated. Use Treasury rates for marketable debt instruments of similar maturity to the lease term on the date the contract is signed. Discount from the date of the first payment (or the beginning of the lease term, whichever is earlier). The term selected for the Treasury rate should be comparable to the term of the capital lease or lease-purchase.

All assumptions required to perform the lease analysis are subject to OMB approval.

Step 1—Calculate up-front BA.

For lease-purchase without substantial private risk; lease-purchase with substantial private risk; and capital lease (including lease-back from public/private partnership with substantial private sector participation): To determine up-front BA (i.e., asset cost), calculate the present value of the lease payments, discounting from the date of the first payment or the beginning of the lease term, whichever is earlier, using the appropriate Treasury interest rate as the discount factor and excluding obligations for identifiable annual operating expenses as described in section 2(b). This BA is scored when the authority to enter into a contract for the lease-purchase or capital lease first becomes available for obligation.

However, if the lease contract provides for multiple deliveries of assets, the up-front BA is sum of the present values of the lease payments for each asset discounted back to the date that the asset is delivered. For example, if the lease contract provides for the delivery of one machine in each of the next five years, the lease payments for the machine acquired in the first year would be discounted back to the first year, while the lease payments for the machine acquired in the fifth year would be discounted back to the fifth year, and the total BA recorded up front would be the sum of the present values calculated for each of the five deliveries.

Step 2—Calculate outlays over the period during which the contractor constructs, manufactures, or purchases the asset.

For lease-purchase without substantial private risk: Score outlays in proportion to the distribution of the contractor's costs. For example, assume a contractor's costs on a $50 million project are estimated to be $7.5 million the first year, $27.5 million the second year, and $15 million the third year. The analyst should apply spendout rates of 15 percent, 55 percent, and 30 percent to the BA calculated in Step 1 for the first, second, and third years, respectively. Total outlays at the end of the construction, manufacture, or purchase period should equal the BA calculated in Step 1. (Note that total outlays will ordinarily exceed the contractor's costs.)

For lease-purchase with substantial private risk and capital lease (including lease-back from public/private partnership with substantial private sector participation): Outlays are not scored during this period. Refer to Step 4 for outlay scoring.

Step 3—Calculate annual BA for the lease payment period.

For lease-purchase without substantial private risk; lease-purchase with substantial private risk; and capital lease: Annual BA will equal the imputed interest costs calculated using the same Treasury interest rate used to discount the lease payments in Step 1. The interest portion of each periodic payment is the imputed interest cost. In the case of a lease-purchase without substantial private risk, the interest rate should be applied to debt that is initially equal to the up-front BA calculated in Step 1 and that is then amortized over the lease term in accordance with Step 5.

Step 4—Calculate outlays over the lease payment period.

For lease-purchase without substantial private risk: Annual outlays are equal to the annual BA (i.e., the imputed interest costs).

For lease-purchase with substantial private risk and capital lease (including lease-back from public/private partnership with substantial private sector participation): Annual outlays are equal to the lease payments.

Step 5—Calculate agency debt (applies only to lease-purchases without substantial private risk).

Agency debt accumulates during the period of construction, manufacture, or purchase of the asset. The increase in debt each year equals the amount of outlays calculated in Step 2. Agency debt is subsequently redeemed over the lease payment period according to an amortization schedule. The amount of debt redemption each year is equal to the lease payment less the imputed interest cost as defined in Step 3. (Debt redemption is not scored as BA or outlays.) Imputed interest costs are scored as BA and outlays and are also scored as interest on agency debt.

5. Reporting to OMB and Treasury

Budget execution reports and apportionment requests will reflect budget amounts in accordance with these requirements. Amounts (e.g., budget authority and outlays) will be reported to Treasury on the same basis.

Joint Project of the FASB and the IASB — Leases

PROJECT OBJECTIVE AND SUMMARY OF THE PROPOSED MODEL

- Leasing is an important source of finance. Therefore, it is important that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities. The existing accounting models for leases require lessees to classify their leases as either capital leases or operating leases. However, those models have been criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular, they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual framework. The models also lead to a lack of comparability and undue complexity because of the sharp bright-line distinction between capital leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

- Accordingly, the FASB and the IASB initiated a joint project to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position.

- To meet that objective, the FASB and the IASB have jointly developed draft guidance on leases and, hence, are proposing an International Financial Reporting Standard (IFRS) and amendments to the *FASB Accounting Standards Codification*™. The Boards developed the proposals after considering responses to their Discussion Paper, *Leases: Preliminary Views,* which was published in March 2009.

- Although many of the problems associated with existing lease guidance relate to the treatment of operating leases in the financial statements of lessees, keeping the existing lease guidance for lessors would be inconsistent with the proposed approach to lessee accounting. It also would be inconsistent with the Boards' proposed approach to revenue recognition, which is described in the proposed FASB Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers.* Consequently, the Exposure Draft on leases deals with both lessee accounting and lessor accounting.

NEWS RELEASE 08/17/10

IASB and US FASB Publish Proposals to Improve the Financial Reporting of Leases

Norwalk, CT, August 17, 2010—The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) today published for public comment joint proposals to improve the financial reporting of lease contracts. The proposals are one of the main projects included in the boards' Memorandum of Understanding. The proposals, if adopted, will greatly improve the financial reporting information available to investors about the financial effects of lease contracts.

The accounting under existing requirements depends on the classification of a lease. Classification as an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position (balance sheet) under either International Financial Reporting Standards or US standards (generally accepted accounting principles). This results in many investors having to adjust the financial statements (using disclosures and other available information) to estimate the effects of lessees' operating leases for the purpose of investment analysis.

The proposals would result in a consistent approach to lease accounting for both lessees and lessors—a 'right-of-use' approach. Among other changes, this approach would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, thus providing more complete and useful information to investors and other users of financial statements.

The boards developed the proposals after considering responses to their discussion paper, Leases: Preliminary Views, published in March 2009. In developing the proposals, the boards also considered extensive input from constituents, including more than 300 comment letters. The proposals are set out in the exposure draft Leases, which is open for comment until 15 December 2010 and can be accessed via the 'Comment on a Proposal' section of **www.ifrs.org** or on **www.fasb.org**. During the exposure draft's comment period the boards will undertake further outreach activities, including public round-table meetings, to ensure that the views of all interested parties are taken into consideration before the new standard is completed.

Commenting on the exposure draft, Sir David Tweedie, chairman of the IASB, said:

The leasing industry plays an important role in many economies by helping companies manage cash flow and working capital. However, much of the estimated annual $640 billion of lease commitments fails to appear on the balance sheet of lessees, thereby giving a false impression of companies' liabilities and gearing.

Our proposals would result in better and more complete financial reporting information about lease contracts being available to investors and others.

Bob Herz, chairman of the FASB, said:

This proposal continues the progress both boards are making to improve and converge our standards in significant areas of accounting. The proposal is intended to improve the transparency of lease accounting and also decrease its current complexity. I encourage all constituents that engage in leasing transactions to provide us with your views on this important proposal.

As part of their additional outreach, the boards are seeking entities that would be willing to take part, on a confidential basis, in field work to discuss and test the provisions of their proposals for lease accounting. The purpose of the field work is to assess the operationality and the costs and benefits of the proposed new standard. This exercise will be conducted during the exposure draft's comment period.

IASB/FASB Meeting January 2011

Leases - Comment letter summary — main issues

Purpose of this paper

1. This paper summarises the feedback received in response to the boards' exposure draft Leases (ED), which was published for public comment in August 2010.

2. Before and after the publication of the ED, both IASB and FASB project staff and board members have reached out to several thousand organisations and professionals to explain the proposals and to obtain feedback. Detailed feedback about these activities to date was provided during the October 2010 Board meeting (Agenda Paper 15). These activities included:

(a) seven roundtables in London, Hong Kong, Chicago and Norwalk held in December 2010 and January 2011. These were attended by representatives from over 80 interested parties and included one roundtable focused on private and not for profit entities;

(b) fifteen preparer workshops in London, Tokyo, Seoul, Melbourne, São Paulo, Toronto and Norwalk held in November and December 2010 and attended by representatives from over 90 organisations;

(c) outreach meetings in which the staff and boards met globally with over 1500 organisations in over 200 meetings since publication of the ED. In doing so we have engaged with around 2300 individuals, including over 500 users. These meetings included:

(i) presentations during accounting conferences;

(ii) keynote presentations at industry forums;

(iii) investor calls; and

(iv) meetings with individual organisations or groups;

(d) preparer questionnaires completed by over 250 lessors and over 400 lessees relating to their use of leases;

(e) project webcasts and podcasts which each attracted between 500 and 1000 participants; and

(f) publication of articles in professional journals and on the IASB and FASB websites.

3. The project pages on the boards' websites contain further details about these activities.

4. The summary feedback included in this paper is based on the staff's preliminary analysis of respondents' comment letters as well as on feedback received from these outreach activities undertaken by board and staff members.

5. A detailed analysis of feedback received on specific proposals in the ED will be presented to the boards when redeliberations on those proposals begin. This paper does not include any staff recommendations and the boards will not be asked to make any technical decisions at this meeting.

6. This paper should be read in conjunction with agenda paper 5B / FASB memo 124, which proposes a plan to achieve the boards' stated objective of issuing a joint leases standard for US GAAP and IFRSs during 2011.

Overview of the comment letters

7. The four-month comment period on the exposure draft ended on 15 December 2010. As of 12 January 2011, the boards have received 760 comment letters. Appendix A provides a summary by type of respondent and geographical region.

8. The response rate to this ED was very high, firstly because many entities are involved, either as a lessee or lessor, in lease transactions. Consequently, it is not surprising that a diverse range of industries are well represented in the responses, including retail, financial services, real estate, transportation, power and utilities, tourism and hospitality. Some of the concerns raised by those respondents were specific to their industry (eg interpreting whether a specific contract is a lease or a service arrangement), but many concerns expressed were shared by respondents from a range of different industries.

9. The relevance of the proposals—in terms of their application across industries and geographical regions —is also evident from the high response rate from preparers as well as from the substantial number of responses from auditors, accounting professional bodies, national standard-setters, industry organisations and other interested parties including academics. Although responses from users were limited, board members and staff focused much of their outreach efforts on those groups to ensure that their views could be included in the boards' redeliberations on the project.

10. The very high response rate can be attributed to the leases project being an IFRS-US GAAP convergence project. This has also resulted in the comment letters being received from a geographically diverse range of respondents. In addition to the responses received from the FASB's constituents and the IASB's constituents from jurisdictions that have been using IFRSs since 2005 (such as Europe and Australia), responses were also received from:

(a) jurisdictions that are adopting IFRSs for the first time in 2010 or 2011, including Brazil, Canada and South Korea, or have that have plans to adopt IFRSs from 2012, such as India; and

(b) other jurisdictions that are in the process of making a decision on whether to adopt IFRSs in the future, including Japan.

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Overall views

12. Most respondents supported the boards' efforts in jointly developing a single, comprehensive and converged lease accounting model for US GAAP and IFRSs.

13. There was general support for the boards' efforts to address criticisms of the current 'bright-lines' that exist in the current lease accounting guidance and the objective of improving information provided to users of the financial statements by providing greater transparency and comparability. In this regard, most respondents supported the recognition of lease obligations and related assets on the lessee's statement of financial position.

14. However, significant concerns were expressed relating to the:

(a) complexity and cost of implementing the proposals, specifically the initial and subsequent measurement of lease assets and liabilities;

(b) reduced comparability arising from the level of estimation and judgement required by the proposals (eg determination of lease term and calculation of variable lease payments);

(c) definition of a lease, and whether all arrangements meeting the proposed definition should be accounted for in accordance with the proposals; and

(d) direction and objectives of the proposals on lessor accounting.

15. These concerns included observations on the interaction between these issues, the risk of creating new bright-lines to replace existing bright-lines and the pervasive implications that simplifying the guidance on these matters would have on the overall proposals.

16. Many respondents and participants in round tables and workshops urged the boards to focus on providing a high quality standard, rather than focusing on meeting specific project time lines. They communicated that significant changes are needed to the ED if the boards are to proceed with a comprehensive standard on leases.

17. A number of respondents also recommended that further field-testing should be performed on elements of the proposals, assessing the cost/benefit of changes that the boards may make in the final standard, specifically relating to:

(a) the criteria for differentiating between a service and a lease;

(b) revisions to the current lessor accounting model; and

(c) which elements of lease contracts should be recognised rather than disclosed.

18. Finally, several respondents applauded the boards and staffs for their efforts to reach out and engage with preparers, users and auditors, specifically after the publication of the ED.

User views

19. Although comment letters from users have been received, the staff obtained a considerable amount of additional feedback from users during their outreach activities. A summary of this feedback has been included below:

<u>Simple lease—lessee accounting</u>

20. Almost all users already make adjustments to capitalise operating leases on the statement of financial position and so they support the right-of-use model in principle. Some think that this

would provide better information than the broad assumptions used today (eg those that apply multiples to disclosed lease payments may use numbers such as 6 to 8, which are often carried over from past calculations that may not accurately reflect an entity's lease term or discount rate). This is particularly important for users when calculating leverage ratios because operating leases are taken into account when assessing leverage.

21. However, some users say that they will still adjust the statement of financial position if a right-of-use model is implemented because they support a whole asset approach, or because they want to measure liabilities or assets that would result from cash flows over the life of an entity (on a going concern basis). Other users commented that they would find improved information on entities' long-term contract commitments useful, regardless of whether they arise from leases or from other contractual arrangements.

22. At present, some users separate rental expense on operating leases into an interest and depreciation component and therefore support the proposal to that effect which was included in the ED. However, they do not calculate the interest expense from a mortgage-type liability; instead, they split the straight-line rent expense that has already been recorded. This does not have the same profit or loss effect as the proposals would. Other users prefer all expense to be treated as rental expense, with many users commenting that they see lease cash flows as operating, not financing, in nature. The users that support interest plus amortisation expense support the proposals in the ED because they agree that the lease is a source of financing of the right-of-use asset.

23. Some users do not make adjustments to the amounts recognised in the profit or loss for operating leases and are they are therefore concerned about the proposed approach which results in a higher lease expenses in earlier periods compared to later periods.

<u>Simple lease—lessor accounting</u>

24. Many users did not report any adjustments being made to current lessors' ccounting. Users are still considering the proposed lessor approach. To date, reactions have been mixed, with some users preferring two different approaches, while some are calling for a single approach consistent with lessee accounting. Those who support a dual approach think that it makes sense because there are two different business models associated with leasing. When asked about statement of financial position and profit or loss treatment for specific scenarios, almost all users that we met with supported different approaches to the underlying asset, depending on the characteristics of the lease.

25. As in the case of lessee comments, some users prefer profit or loss to be more similar to actual cash flows. Many users are uncomfortable with the lessor recognising higher lease expenses in earlier periods compared to later periods, although some users said they supported the removal of straight-line rents because, in the past, they think that some lessors have manipulated rents to achieve the highest possible GAAP income.

26. This profit or loss pattern proposed was a particular concern with long-term property leases as it suggests that most of the economic value of the lease is gained early in the lease which some users in their view do not think reflect the economics of the transactions. This distortion is further magnified the longer the lease term. Some users asked for these property leases to be scoped out entirely.

27. In their analysis, users focus on exposure to residual assets and the impairment analysis of the underlying asset of the lessor and they note that this is not disclosed in current accounting.

28. Users are also often very interested in the residual value of the asset. Almost all users commented that, if the derecognition model is to be used, the residual asset should be accreted or measured at fair value so that entire income can be recognised over the lease term and not be deferred until the end of the lease.

Complex features

29. Users had mixed views on the treatment of complex features. They have not had significant information in the past about variable lease payments or options to extend or cancel leases, unlike the information that the proposed model would provide. They welcome better access to this information, but disagree on how best to provide it.

30. Some think that estimates are a part of business and that including them in measurement, similar to other accounting estimates, provides the best possible information on the statement of financial position, as long as users can understand the assumptions that were made about these features (ie via disclosure). They argue that statement of financial position presentation and footnote disclosure have different weights and that footnotes are not audited as robustly.

31. Users also cited the difference in timeliness of information provided in the financial statements and information provided in the notes. They identified that information presented in the financial statements is usually available earlier (typically in an earnings release) that information included in footnote disclosures.

32. Others would prefer to see only the minimum contractual on the statement of financial position and see additional, detailed information disclosed about options to renew or cancel and contingent lease payments in the footnotes, because of the uncertainly in estimating such amounts. Some industry-focused users (eg retail) are particularly uncomfortable with including optional lease terms in the statement of financial position, because they think that options to extend are negotiated to provide the lessee with flexibility and do not represent obligations of the lessee.

33. Some think that economic compulsion should be reflected in the recognition of renewal terms. Those users did not think that an expectation of renewal without some economic incentive to do so (eg the existence of significant leasehold improvements) is enough.

34. Many users did not think that performance-based and usage-based contingencies were liabilities and thought that only index-based contingencies should be recognised. Some users did think that accounting should reflect constructive obligations and support expected value measurement, which could be on a portfolio, rather than lease-by-lease basis.

35. When asked about leases with 100 per cent contingent lease payments (eg based on sales), users also had mixed reactions. Some want to estimate these amounts themselves and think that management is too biased or uses too much judgement in making future estimates. Others think that management has the best information about the future contingent lease payments linked to sales and would like those amounts to be included in the statement of financial position, as long as users can understand how the amounts are calculated when looking at the notes.

Summary of feedback on the main elements of the proposals

Lessee right-of-use model

36. Many respondents expressed support for recognising a right-of-use asset and a liability to make lease payments as a result of a contract that meets the definition of a lease, although some respondents struggled with applying one model to all leases (eg because of concerns about viewing all lease contracts as defined in the ED, such as real estate leases, as a financing of a right-of-use asset).

37. However, there were mixed views on the pattern of profit or loss recognition for lessees with:

(a) some respondents, specifically those from accounting firms and standard-setter respondents supporting the proposals in the ED; and

(b) Other respondents, specifically those from the leasing industry, some users and preparers, supporting an annuity-based or mortgage-based amortisation of the right-of-use asset to create a straight-line profit or loss pattern similar to current operating lease accounting.

38. Almost all respondents supported providing a simplified lessee accounting approach for short-term leases. However, many of them proposed that this simplified approach should be consistent with current operating lease accounting, rather than the approach proposed in the ED.

Lessor accounting model

39. Many respondents observed that the lessor accounting proposals in the ED were less developed than those for lessee accounting. They believe that the boards need to perform significant additional work as part of their due process, including field-testing, before finalising any amendments to lessor accounting.

40. A significant number of respondents questioned whether the lessor accounting proposals were an improvement to current financial reporting, noting that the:

(a) current lessor accounting model is not ‘broken’.

(b) cost / benefits of any proposed changes should be carefully evaluated and considered because the financial reporting outcomes may not be significantly different from the application of current US GAAP or IFRS.

(c) complexity of lessor accounting is increased, rather than simplified.

41. Consequently, respondents offered a variety of proposals for the path forward for lessor accounting, with significant support expressed for developing a:

(a) single lessor accounting model, consistent with the lessee accounting model; or

(b) lessor accounting model that would be consistent with the Revenue from Contracts with Customers exposure draft (the Revenue Recognition ED); or

(c) business model approach to lessor accounting that would more closely reflects the economics of lease transactions (which may lead to retaining, or substantively retaining, the guidance in current IFRS/US GAAP).

42. Overall, respondents had mixed views on whether the boards should proceed with:

(a) proposals to change the lessee accounting model, acknowledging that the main objective of the proposals should focus on lessee accounting, and address lessor accounting later; or

(b) a complete project analysing both lessee and lessor accounting because only by looking at both together can the boards resolve issues about proposals relating to either lessee or lessor accounting.

Definition of a lease

43. The majority of respondents recommended that the boards need to perform additional work to develop the definition of a lease in the ED because the definition is based on interpretations in IFRS and US GAAP to address a very narrow set of circumstances rather than the broad range of contracts that may be affected by the ED. They suggested that the definition should be narrowed and they identified examples in which the assessment of whether a contract should be accounted for as a lease or a service is difficult.

44. Many respondents agreed with the principle of separating the service and lease components of a contract but were concerned that when the service and lease components are not distinct, both lessees and lessors are required (always in the FASB ED, and for (a) lessees and (b) lessors applying the performance obligation approach in the IASB ED) to apply lease accounting to the combined contract.

45. The majority of respondents:

(a) commented that if the boards appropriately defined a leases contract in the Leases project and appropriately defined a sale in the Revenue recognition project that additional guidance on distinguishing a lease from a purchase or sale contract would not be needed; and

(b) supported the scope proposed in the ED, although significant concerns were raised relating to the:

(i) requests by the US real estate industry to enable them to apply guidance similar to IAS 40 Investment Property; and

(ii) proposal to scope out leases of intangible assets.

Lease term

46. Almost all respondents disagreed with the definition of the lease term as the longest possible term that is more likely than not to occur.

47. As an alternative to the proposals in the ED, many respondents supported either:

(a) increasing the threshold for taking into account options to renewal from ‘longest possible lease term that is more likely than not to occur’ to either ‘reasonably assured’ (current US GAAP), or ‘reasonably certain’ (current IFRSs), with respondents noting that current practice generally works well, or ‘virtually certain’ (which would nearly equate to including only contractual minimum lease payments); or

(b) the Alternative View to reflect options to cancel and extend leases in measurement of lease assets and liabilities only when the lease contract includes incentives for the lessee or lessor to exercise the options.

Lease payments

48. Many respondents disagreed with the proposal to estimate lease payments, term option penalties and residual value guarantees using an expected outcome technique. These respondents commented that estimating variable lease payments would:

(a) be costly and challenging to reliably estimate; and

(b) create significant volatility in profit or loss.

49. Users supported additional disclosure relating to contingent lease payments but were mixed in their views on whether amounts recognised in the financial statements should reflect:

(a) only contractual minimum lease payments (allowing users to apply their own judgement to estimate contingent lease payments, based on disclosures of non-contractual lease payments);

(b) in-substance contractual lease payments; or

(c) the proposals in the ED (noting that management estimates are useful and would not prevent users from making further revisions from management estimates, based on information disclosed in the notes).

50. Many respondents suggested alternative approaches such as:

(a) those proposed in the Alternative View, which advocated including only contingent lease payments based upon indices or rates and excluding contingent lease payments that vary with usage or performance (noting that similar guidance in current US GAAP works well in practice);

(b) including only those contingent lease payments which that are outside of an entity’s control and are therefore unavoidable; or

(c) changing the estimation approach from ‘expected value’ to an alternative estimation technique (eg to be consistent with the threshold for recognising options to renew or cancel leases).

Other matters

Purchase options

51. Respondents had mixed views on the proposal to only account for purchase options when they are exercised. Some respondents agreed with the proposals, although others proposed that the accounting for purchase options should be consistent with the accounting for options to cancel or extend a lease.

Sale and leaseback

52. Many respondents are concerned that the threshold for recognising a transaction as a sale and leaseback is set too high and is inconsistent with the Revenue recognition ED.

Presentation

53. Many respondents proposed that entities should be allowed to apply judgement in determining which leases line items should be presented separately in the income statement or statement of financial position, rather than being required to do so.

Disclosures

54. Respondents expressed concern about balancing the objective of providing useful information to users with the burden created for preparers by requiring potentially voluminous, boiler-plate disclosures.

Transition

55. Many respondents recommended permitting, but not requiring, entities to apply the guidance on a fully retrospective basis, specifically as a way of overcoming the profit or loss ‘front-loading’ effect of the simplified retrospective transition approach proposed in the ED.

Effective date

56. Many respondents recommended an extended lead-time before entities are required to apply the proposals. This is because of the:

(a) significant burden of assessing a significant number of contracts to determine whether they meet the definition of a lease, and

(b) complexity of the requirements for recognition and measurement for those contracts that meet the definition of a lease.

Private companies that apply US GAAP

57. Feedback from private companies that apply US GAAP was consistent with the feedback from public companies. This included support for the proposals to be applied consistently by both public and private companies that apply US GAAP and concerns with the complexity and cost of implementing the proposals. However, private companies that apply US GAAP requested that the effective date be later than for public companies applying US GAAP.

Other

58. Additional concerns were noted relating to:

(a) discount rates;

(b) accounting for transactions (eg build-to-suit leases) between the inception and commencement dates; and

(c) other issues that respondents highlighted should be addressed in the final standard.

NEWS RELEASE 07/21/11

IASB and FASB Announce Intention to Re-Expose Leasing Proposals

Norwalk, CT, July 21, 2011—The International Accounting Standards Board (IASB) and the US-based Financial Accounting Standards Board (FASB) announced today their intention to re-expose their revised proposals for a common leasing standard. Re-exposing the revised proposals will provide interested parties with an opportunity to comment on revisions the boards have undertaken since the publication of an exposure draft on leasing in August 2010.

Even through the boards have not completed all of their deliberations, the decisions taken to date were sufficiently different from those published in the exposure draft to warrant re-exposure of the revised proposals. The boards intend to complete their deliberations, including consideration of the comment period, during Q3 2011 with a view to publishing a revised exposure draft shortly afterwards.

Commenting on the decision, Hans Hoogervorst, Chairman of the IASB said:

Although we have yet to conclude our deliberations on this project, the direction of travel indicates that there are aspects of our revised proposals that would benefit from additional input from interested parties.

Leslie F Seidman, Chairman of the FASB, said:
During our discussions of the extensive comments we received on the exposure draft, the boards have reaffirmed the major change to lease accounting, which is to report lease obligations and the related right-to-use on the balance sheet.

However, the boards decided to make many other changes to address the comments made by stakeholders. The boards decided that, while we still have other matters to discuss, stakeholders would appreciate the opportunity to comment on the revised package of conclusions.

Further details will be available shortly from the leases project sections of the IASB and FASB websites.

DECISIONS REACHED AT THE LAST MEETING (July 20-21, 2011)

Leases Reexposure Announcement

The Boards agreed unanimously to reexpose their revised proposals for a leases standard. Reexposing the revised proposals will provide interested parties with an opportunity to comment on revisions that the Boards have undertaken since the publication of the Exposure Draft on leases in August 2010.

At the July 21 joint meeting, the Boards discussed the presentation and disclosure requirements for lessees. Decisions resulting from those discussions will be posted shortly.

At the July 20 joint meeting, the Boards discussed lessor accounting, the accounting for lease payments that depend on an index or a rate, and the accounting for embedded derivatives in lease contracts.

Lessor Accounting

The Boards tentatively decided that a lessor should apply a “receivable and residual” accounting approach as follows:

1. The lessor would recognize a right to receive lease payments and a residual asset at the date of the commencement of the lease.

2. The lessor would initially measure the right to receive lease payments at the sum of the present value of the lease payments, discounted using the rate the lessor charges the lessee.

3. The lessor would initially measure the residual asset as an allocation of the carrying amount of the underlying asset and would subsequently measure the residual asset by accreting it over the lease term using the rate the lessor charges the lessee.

4. If profit on the right-of-use asset transferred to the lessee is reasonably assured, the lessor would recognize that profit at the date of the commencement of the lease. The profit would be measured as the difference between (a) the carrying amount of the underlying asset and (b) the sum of the initial measurement of the right to receive lease payments and the residual asset.

5. If profit on the right-of-use asset transferred to the lessee is not reasonably assured, the lessor would recognize that profit over the lease term. In that case, the lessor would initially measure the residual asset as the difference between the carrying amount of the underlying asset and the right to receive lease payments. The lessor would subsequently accrete the residual asset, using a constant rate of return, to an amount equivalent to the underlying asset’s carrying amount at the end of the lease term as if the underlying asset had been subject to depreciation.

6. If the right to receive lease payments is greater than the carrying amount of the underlying asset at the date of the commencement of the lease, the lessor would

recognize, as a minimum, the difference between those two amounts as profit at that date.

The Boards also tentatively decided that the following should be excluded from the scope of the "receivable and residual" approach to lessor accounting:

1. Leases of investment property measured at fair value
2. Short-term leases.

For those excluded leases, a lessor should (1) continue to recognize and depreciate the underlying asset and (2) recognize lease income over the lease term on a systematic basis.

Lease Payments That Depend on an Index or a Rate

The Boards discussed the measurement of lease payments that depend on an index or a rate included in the lessee's liability to make lease payments and the lessor's right to receive lease payments and tentatively decided that:

1. Lease payments that depend on an index or a rate should be initially measured using the index or rate that exists at the date of commencement of the lease.
2. Lease payments that depend on an index or a rate should be reassessed using the index or rate that exists at the end of each reporting period.
3. Lessees should reflect changes in the measurement of lease payments that depend on an index or a rate (a) in net income to the extent that those changes relate to the current reporting period and (b) as an adjustment to the right-of-use asset to the extent that those changes relate to future reporting periods.

The Boards will discuss at a future meeting how a lessor should reflect changes in the measurement of lease payments that depend on an index or a rate.

Embedded Derivatives in Lease Contracts

The Boards tentatively decided that an entity should assess whether a lease contract includes embedded derivatives that should be bifurcated and accounted for in accordance with applicable U.S. GAAP and IFRS guidance on derivatives.

***SUMMARY OF TENTATIVE DECISIONS REACHED TO DATE (As of July 2011)**

During the redeliberation process, the Boards considered a summary of:

1. The feedback received in response to the Exposure Draft, *Leases*, which was published for public comment in August 2010
2. Outreach activities undertaken after the publication of the Exposure Draft to explain the proposals in the Exposure Draft and to obtain feedback on the proposals.

Definition of a Lease

In the *Leases* Exposure Draft, the Boards defined a lease as 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 tentatively decided the following in relation to applying that definition, having considered feedback received from targeted outreach meetings held during March 2011 as well as feedback received in comment letters and through other outreach:

1. An entity would determine whether a contract contains a lease on the basis of the substance of the contract, by assessing whether:

    a. The fulfilment of the contract depends on the use of a specified asset; and

    b. The contract conveys the right to control the use of a specified asset for a period of time.

2. A contract would convey that right to control the use if the customer has the ability to direct the use, and receive the benefit from use, of a specified asset throughout the lease term. Guidance on separating the use of a specified asset from other services should be aligned with the Boards' tentative decisions in March 2011 relating to the separation of lease and non-lease components.

3. A "specified asset" refers to an asset that is explicitly or implicitly identifiable.

4. A physically distinct portion of a larger asset of which a customer has exclusive use is a specified asset. A capacity portion of a larger asset that is not physically distinct (for example, a capacity portion of a pipeline) is not a specified asset.

Scope

Leases of intangibles are not required to be accounted for in accordance with the leases standard.

The following are within the scope of the leases standard:

1. Right-of-use assets in a sublease

2. Leases of non-core assets

3. Long-term leases of land.

The following are not within the scope of the leases standard:

1. Leases for the right to explore for or use minerals, oil, natural gas and similar non-regenerative resources

2. Leases of biological assets, including (U.S. GAAP only) timber

3. (IFRSs only) Leases of service concession arrangements within the scope of IFRIC 12, Service Concession Arrangements.

The Boards directed the staff to perform additional research and present an analysis at a future meeting of whether the following are within the scope of the leases standard:

1. Leases of internal-use software in accordance with Subtopic 350-40, Intangibles–Goodwill and Other Internal-Use Software, of the FASB Accounting Standards Codification®

2. Leases of inventory.

Confirmation of the Right-of-Use Model

The Boards affirmed the decision in the leases Exposure Draft to apply a right-of-use model to all lease arrangements. Under that model, a lessee in an arrangement that is, or contains, a lease would recognize an asset representing its right to use an underlying asset during the lease term and a liability representing its obligation to make lease payments during the lease term. Application of the right-of-use model by a lessor will be discussed at a future meeting.

Lessee Accounting

The Boards tentatively decided that lessees should apply a single accounting approach for all leases consistently with the approach proposed in the Leases Exposure Draft. This accounting approach would require a lessee to:

1. Initially recognize a liability to make lease payments and a right-of-use asset, both measured at the present value of the lease payments.

2. Subsequently measure the liability to make lease payments using the effective interest method.

3. Amortize the right-of-use asset on a systematic basis that reflects the pattern of consumption of the expected future economic benefits.

Lessor Accounting

The Boards tentatively decided that a lessor should apply a “receivable and residual” accounting approach as follows:

1. The lessor would recognize a right to receive lease payments and a residual asset at the date of the commencement of the lease.

2. The lessor would initially measure the right to receive lease payments at the sum of the present value of the lease payments, discounted using the rate the lessor charges the lessee.

3. The lessor would initially measure the residual asset as an allocation of the carrying amount of the underlying asset and would subsequently measure the residual asset by accreting it over the lease term using the rate the lessor charges the lessee.

4. If profit on the right-of-use asset transferred to the lessee is reasonably assured, the lessor would recognize that profit at the date of the commencement of the lease. The

profit would be measured as the difference between (a) the carrying amount of the underlying asset and (b) the sum of the initial measurement of the right to receive lease payments and the residual asset.

5. If profit on the right-of-use asset transferred to the lessee is not reasonably assured, the lessor would recognize that profit over the lease term. In that case, the lessor would initially measure the residual asset as the difference between the carrying amount of the underlying asset and the right to receive lease payments. The lessor would subsequently accrete the residual asset, using a constant rate of return, to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if the underlying asset had been subject to depreciation.

6. If the right to receive lease payments is greater than the carrying amount of the underlying asset at the date of the commencement of the lease, the lessor would recognize, as a minimum, the difference between those two amounts as profit at that date.

The Boards also tentatively decided that the following should be excluded from the scope of the "receivable and residual" approach to lessor accounting:

1. Leases of investment property measured at fair value

2. Short-term leases.

For those excluded leases, a lessor should (1) continue to recognize and depreciate the underlying asset and (2) recognize lease income over the lease term on a systematic basis.

Accounting for the right to receive lease payments

The Boards indicated a tentative preference for measuring a lessor's right to receive lease payments in accordance with the requirements for other similar financial assets. The Boards nevertheless requested the staff to analyze whether this would create any unintended consequences, specifically if the Boards were to specify two approaches for lessor accounting.

Presentation of the lessor's right to receive lease payments and the residual asset

The Boards tentatively decided that a lessor should present its right to receive lease payments separately from any residual asset. The Boards will discuss the presentation of the residual asset at a future meeting.

Leveraged Leases

The Board discussed lessor accounting for leveraged lease transactions and tentatively decided that:

1. A lessor would account for leveraged leases under the proposed new leases guidance. There would not be a different lessor approach for leveraged leases.

2. A lessor would apply the same transition guidance to current leveraged leases as required for all other leases; that is, existing leveraged lease transactions would not be grandfathered.

Subleases

The Boards discussed the accounting for subleases under the proposed leases requirements for lessees and lessors and tentatively decided the following:

1. A head lease and a sublease should be accounted for as separate transactions.

2. An intermediate lessor, as a lessee in a head lease arrangement, should account for its assets and liabilities arising from the head lease in accordance with the decisions-to-date for all lessees.

3. An intermediate lessor, as a lessor in a sublease arrangement, should account for its assets and liabilities arising from the sublease in accordance with the decisions-to-date for all lessors.

4. If the Boards decide that there should be more than one approach to lessor accounting, an intermediate lessor, as a lessor in a sublease, should evaluate its right-of-use asset, not the underlying asset, to determine the appropriate lessor accounting approach to apply to the sublease.

Lease Term

The lease term is defined, for both lessees and lessors, as follows:

> The lease term is the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is 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.

A lessee and a lessor should reassess the lease term only when there is a significant change in relevant factors such that the lessee would then either have, or no longer have, a significant economic incentive to exercise any options to extend or terminate the lease.

Contract Modifications or Changes in Circumstances after the Date of Inception of the Lease

The Boards tentatively decided to provide guidance on accounting for changes after the date of inception of the lease as follows:

1. A modification to the contractual terms of a contract that is a substantive change to the existing contract should result in the modified contract being accounted for as a new contract. The change is a substantive change if it results in a different determination of whether the contract is, or contains, a lease.

2. A change in circumstances other than a modification to the contractual terms of the contract that would affect the assessment of whether a contract is, or contains, a lease should result in a reassessment as to whether the contract is, or contains, a lease.

Variable Lease Payments and Other Lease Payment Considerations

Variable lease payments include any lease payments that arise under the contractual terms of a lease because of changes in facts or circumstances occurring after the date of inception of the lease, other than the passage of time.

Recognition of variable lease payments by a lessee and lessor should be subject to the same reliable measurement threshold. However, the need for such a threshold will depend on the basis for recognizing variable lease payments.

Variable lease payments that are in-substance fixed lease payments

The lessee’s liability and lessor’s receivable should include lease payments that are in-substance fixed lease payments, but are structured as variable lease payments in form.

Variable lease payments that depend on an index or a rate

The Boards discussed the measurement of lease payments that depend on an index or a rate included in the lessee’s liability to make lease payments and the lessor’s right to receive lease payments and tentatively decided that:

1. Lease payments that depend on an index or a rate should be initially measured using the index or rate that exists at the date of commencement of the lease.

2. Lease payments that depend on an index or a rate should be reassessed using the index or rate that exists at the end of each reporting period.

3. Lessees should reflect changes in the measurement of lease payments that depend on an index or a rate (a) in net income to the extent that those changes relate to the current reporting period and (b) as an adjustment to the right-of-use asset to the extent that those changes relate to future reporting periods.

The Boards will discuss at a future meeting how a lessor should reflect changes in the measurement of lease payments that depend on an index or a rate.

Embedded Derivatives in Lease Contracts

The Boards tentatively decided that an entity should assess whether a lease contract includes embedded derivatives that should be bifurcated and accounted for in accordance with applicable U.S. GAAP and IFRS guidance on derivatives.

Residual value guarantees

Lease payments should include amounts expected to be payable under residual value guarantees, except for amounts payable under guarantees provided by an unrelated third party.

The Boards discussed the subsequent measurement of residual value guarantees by lessees (excluding guarantees provided by an unrelated third party) and tentatively decided that:

1. The amounts expected to be payable under residual value guarantees included in the measurement of the lessee's right-of-use asset should be amortized consistently with how other lease payments that are included in the measurement of a right-of-use asset are amortized. That is, amortization should be on a systematic basis from the date of commencement of the lease to the end of the lease term, or over the useful life of the underlying asset, if this is shorter. The method of amortization should reflect the pattern in which the economic benefits of the right-of-use asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method should be used.

2. The amounts expected to be payable under residual value guarantees that are included in the measurement of the lessee's liability to make lease payments should be reassessed when events or circumstances indicate that there has been a significant change in the amounts expected to be payable under residual value guarantees. An entity would be required to consider all relevant factors to determine whether events or circumstances indicate that there has been a significant change.

3. The amount of the change to the lessee's liability to make lease payments arising from changes in estimates of residual value guarantees should be recognized (a) in net income to the extent that those changes relate to current or prior periods and (b) as an adjustment to the right-of-use asset to the extent those changes relate to future periods. The allocation for changes in estimates of residual value guarantees should reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or were consumed. If that pattern cannot be reliably determined, an entity should allocate changes in estimates of residual value guarantees to future periods.

Term option penalties

The accounting for term option penalties should be consistent with the accounting for options to extend or terminate a lease. That is, if a lessee would be required to pay a penalty if it does not renew the lease and the renewal period has not been included in the lease term, then that penalty should be included in the recognized lease payments.

Foreign exchange differences

The Boards discussed the accounting by lessees for leases denominated in a foreign currency. The Boards tentatively decided that foreign exchange differences related to the liability to make lease payments should be recognized in profit or loss, consistently with foreign exchange guidance in existing IFRSs and U.S. GAAP.

Impairment

The Boards discussed impairment of the lessee's right-of-use asset. The Boards tentatively decided to affirm the proposal in the Leases Exposure Draft to refer to existing guidance in IFRSs and U.S. GAAP for impairment of the right-of-use asset.

Revaluation (IASB only)

The IASB discussed revaluation of the lessee's right-of-use asset. The IASB tentatively decided to affirm the proposals in the Leases Exposure Draft allowing revaluation of the right-of-use asset.

Distinguishing between a Lease and a Purchase or a Sale

Guidance should not be provided in the leases standard for distinguishing a lease of an underlying asset from a purchase or a sale of an underlying asset. That is, if an arrangement does not contain a lease, it should be accounted for in accordance with other applicable standards (for example, property, plant, and equipment or revenue recognition).

Accounting for Purchase Options

Lessees and lessors should include the exercise price of a purchase option (including bargain purchase options) in the measurement of the lessee's liability to make lease payments and the lessor's right to receive lease payments, if the lessee has a significant economic incentive to exercise the purchase option. If it is determined that the lessee has a significant economic incentive to exercise the purchase option, the right-of-use asset recognized by the lessee should be amortized over the economic life of the underlying asset, rather than over the lease term.

Reassessment of Options in a Lease

The Boards discussed how lessees and lessors should reassess whether a lessee has a significant economic incentive to exercise:

1. An option to extend or terminate a lease, and

2. An option to purchase the underlying asset.

The Boards tentatively decided that a lessee and a lessor should consider contract-based, asset based, and entity-based factors in reassessing whether a lessee has a significant economic incentive to exercise an option. The boards noted that all these factors should be considered together and the existence of only one factor does not necessarily, by itself, signify a significant economic incentive to exercise the option.

The Boards tentatively decided that the thresholds for evaluating a lessee's economic incentive to exercise options to extend or terminate a lease and options to purchase the underlying asset should be the same for both initial and subsequent evaluation, except that a lessee and lessor should not consider changes in market rates after lease commencement when evaluating whether a lessee has a significant economic incentive to exercise an option.

The Boards tentatively decided that changes in lease payments that is due to a reassessment in the lease term should result in:

1. A lessee adjusting its obligation to make lease payments and its right-of-use asset; and

2. A lessor adjusting its right to receive lease payments and any residual asset, and recognizing any corresponding profit or loss (pending the Boards' decision on lessor accounting).

Short-Term Leases

The Boards discussed the accounting for short-term leases by lessees. A short-term lease is defined as follows:

> A lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less.

The Boards tentatively decided that for short-term leases a lessee need not recognize lease assets or lease liabilities. For those leases, the lessee should recognize lease payments in profit or loss on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

The Boards also tentatively decided that a lessee may elect to apply the recognition and measurement requirements in the leases guidance to short-term leases.

The Boards expressed support for requiring disclosure of the rental expense recognized in the current period and a statement about the extent to which that expense is expected to be representative of rental expense in future periods. The Boards will continue to discuss disclosures for short-term leases, as well as lessor accounting for short-term leases, at a future meeting.

A short-term lease, for lessors, is defined as:

> A lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less.

Lessors may elect, as an accounting policy for a class of underlying asset(s), to account for all short-term leases by not recognizing lease assets or lease liabilities and by recognizing lease payments in profit or loss on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

Inception versus Commencement

The leases standard would:

1. Require a lessee and a lessor to recognize and initially measure lease assets and lease liabilities (and derecognize any corresponding assets and liabilities) at the date of commencement of the lease.

2. Require a lessee and a lessor to use a discount rate calculated at the date of commencement when initially measuring lease assets and lease liabilities.

3. Include application guidance on the accounting for costs incurred by the lessee before the date of commencement of a lease.

4. Include application guidance on the accounting for lease payments made by the lessee before the date of commencement of a lease.

5. Include application guidance on the accounting for incentives provided by the lessor to the lessee. This would clarify that a lessee will deduct all lease incentives from the initial measurement of the right-of-use asset.

The Boards also discussed the accounting for a lease contract between the date of inception and the date of commencement of a lease when the contract meets the definition of an onerous contract. The IASB affirmed the leases Exposure Draft proposal to exclude from the scope of the leases standard leases between the date of inception and the date of commencement if they meet the definition of an onerous contract. Such leases would be accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* until the date of commencement. The FASB also indicated support for applying Topic 450, Contingencies, to those contracts that meet the definition of an onerous contract before the date of commencement but noted that this issue would be reviewed when the Board considers impairment at a future meeting.

Initial Direct Costs

Initial direct costs is defined as follows:

> Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

Lessees and lessors should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively.

Discount Rate

The discount rate to be used by lessees and lessors should be as follows:

1. The lessee would use the rate the lessor charges the lessee when that rate is available; otherwise, the lessee would use its incremental borrowing rate.

2. The lessor would use the rate the lessor charges the lessee.

3. The rate the lessor charges the lessee could be the lessee's incremental borrowing rate, the rate implicit in the lease or, for property leases, the yield on the property. When more than one indicator of the rate that the lessor charges the lessee is available, the rate implicit in the lease should be used.

The Boards also tentatively decided to provide application guidance for the determination of the discount rate when considering the use of a group discount rate and determining the yield on property.

Reassessment of the Discount Rate

The Boards discussed whether there are circumstances that would require a lessee or a lessor to reassess the discount rate that is used to measure the present value of lease payments.

The Boards tentatively decided that the discount rate should not be reassessed if there is no change in the lease payments.

The Boards tentatively decided that the discount rate should be reassessed when the changes below are not reflected in the initial measurement of the discount rate:

1. When there is a change in lease payments that is due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease or to purchase the underlying asset.

2. When there is a change in lease payments that is due to the exercise of an option that the lessee did not have a significant economic incentive to exercise.

The Boards also decided that a lessee or lessor should determine a revised discount rate using the spot rate at the reassessment date and should then apply that rate to the remaining lease payments (i.e. to the remaining payments due in the initial lease plus the payments due during the extension period or upon exercise of a purchase option).

Separating Lease and Non-lease Components of a Contract

An entity should be required to identify and separately account for the lease and the non-lease components of a contract.

In allocating payments in a contract between the lease and non-lease components of the contract:

1. The lessor should allocate payments in accordance with the guidance on revenue recognition.

2. The lessee should allocate payments as follows:

    a. If the purchase price of each component is observable, the lessee would allocate the payments on the basis of the relative purchase prices of individual components;

    b. If the purchase price of one or more, but not all, of the components is observable, the lessee would allocate the payments on the basis of a residual method; or

    c. If there are no observable purchase prices, the lessee would account for all the payments required by the contract as a lease.

The Boards directed the staff to include application guidance on how a lessee should determine what would be an observable price, considering the relevance of guidance in other projects such as revenue recognition.

Sale and Leaseback Transactions

When a sale has occurred, the transaction would be accounted for as a sale and then a leaseback. If a sale has not occurred, the entire transaction would be accounted for as a financing.

An entity should apply the control criteria described in the revenue recognition project to determine whether a sale has occurred.

The Boards affirmed the decision in the leases Exposure Draft that in a transaction accounted for as a sale and leaseback:

1. When the consideration is at fair value, the gains and losses arising from the transaction should be recognized when the sale occurs.

2. When the consideration is not established at fair value, the assets, liabilities, gains and losses recognized should be adjusted to reflect current market rentals.

The seller/lessee would adopt the "whole asset" approach in a sale and leaseback transaction. The "whole asset" approach deems that in a sale and leaseback transaction, the seller/lessee sells the entire underlying asset and leases back a right-of-use asset relating to part of the underlying asset.

The leases guidance would not prescribe a particular type of lessee accounting model for entities that are accounting for the leaseback part of a sale and leaseback transaction.

***NEXT STEPS**

The Boards agreed unanimously to reexpose their revised proposals for a leases standard. Reexposing the revised proposals will provide interested parties with an opportunity to comment on revisions that the Boards have undertaken since the publication of the Exposure Draft on leases in August 2010. Please see the **Current Technical Plan** for more information about the project timeline.

ABBREVIATIONS

FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
IASB	International Accounting Standards Board
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standards

KEY TERMS

Enhanced Use Lease – A long-term lease agreement with public and private entities for the use of federal property, resulting in cash and/or in-kind consideration for the agency—or to retain the proceeds from the sale of real property.

Lessee – An entity which has the right to use property owned or otherwise controlled by another entity. Such use is usually limited both as to its nature and time by the terms specified in a lease. [*Kohler's Dictionary for Accountants* sixth edition]

Lessor – An entity which contracts for another entity to use property it owns or controls in accordance with a lease. [*Kohler's Dictionary for Accountants* sixth edition]