



Exposure Draft - Leases

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Agenda



- Introduction
- Background
- Overview
- Lessee Accounting
- Lessor Accounting
- Other
- Q & A

Background



- Potential Converged Lease Standard
 - Why change?
 - Discussion Paper (DP) issued on lease accounting by FASB and IASB in March 2009 with certain preliminary views and request for comments
 - 290 comments received, 50% supported overall principles and objectives in DP and 33% did not support the boards preliminary views
 - DP only covered Lessees Accounting
 - Exposure draft (ED) issued August 17, 2010 with comment period ending December 15, 2010. ED covers both Lessees and Lessors Accounting

Overview



- Covers contracts that meet the definition of a lease
 - Right to use a specific asset is conveyed for a period of time in exchange for consideration
- Scope
 - Includes leases of PP&E, land, equipment, property
 - Excludes leases of intangible assets, natural resources and biological assets
 - Covers Sale – Leasebacks and Subleases

Overview cont'd



- Contracts that represent a purchase or sale of the underlying asset are accounted for as purchase and sale
 - At the end of the contract transfers to another entity control of the entire underlying asset (i.e. leased asset) and all but a trivial amount of risk and benefit associated with the entire underlying asset
 - Bargain purchase options
 - Automatic transfer of title to underlying asset at the end of the lease term

Overview cont'd



- Investment properties

- Under IFRS if investment properties are accounted for at fair value then the properties are not covered by the lease standard
- FASB plans on issuing an exposure draft expected to be final in the 3rd quarter of 2011 that would require investment properties to be carried at fair value
 - Current efforts are focused on defining which entities will be included in scope (real estate investment companies?)
 - If issued as proposed then investment properties are not expected to be covered by the lease standard

Overview cont'd



- Lessee
 - All leases will be recorded on the statement of financial position (Balance Sheet)
 - Recognize a “right-of-use” asset and a liability to make estimated future lease payments (lease liability) separately on the Balance Sheet
 - Difference in accounting for Capital vs. Operating lease will no longer apply
- Lessor
 - Apply one of two models, the Performance Obligation Approach or the Derecognition Approach

Overview cont'd



- Inception date is date agreed to terms of the lease
 - For lessees determines right-of-use asset and liability to make lease payments
 - For lessor determines if performance obligation model or derecognition model applies
 - Commencement date is the date the asset is available for use
 - Record balances at the commencement date

Overview cont'd



- Impact on financial statements
 - Lessee
 - Increase assets and liabilities
 - Impact balance sheet ratios and covenants
 - Decrease net income but increase EBITDA
 - Lessor
 - Performance obligation: accelerate income
 - Derecognition: upfront gain/loss
 - More volatility
 - More complexity and costly to maintain?

Lessee Accounting

- Lease liability is equal to Present Value (PV) of estimated future lease payments which includes estimate of
 - Lease term – the longest possible term that is more likely than not to occur. Consider all factors contractual, non contractual, business and lessee's intentions and past practice.
 - Contingent rentals using probability weighted estimate using a reasonable number of outcomes. If based on changes in index or rate, use prevailing rates unless there are readily available forward rates or index, then use these rates
 - Residual value guarantees and term option penalties
 - Exclude purchase option

Lessee Accounting cont'd

- Example of Lease Term

- Company has a lease for rental of space in a building. The lease is for 5 years with two 5-year renewal options at a fair market value rental. The Company has incurred significant tenant improvement costs that have an estimated useful life of 8 years. Given these facts the Company determines the longest possible lease term that is more likely than not to occur is 10 years and this is the lease term used to calculate the lease liability. If the Company's past practice is to always exercise the lease option this would need to be considered and the lease term could be 15 years.

Lessee Accounting cont'd

- Example of Contingent Rents

Company has a lease which requires minimum lease payments plus contingent rents based on percentage of it's sales. To determine the contingent rents to consider in the calculation of the lease liability the Company estimates the following possibilities:

Probability	Amount
5%	\$ 5,000
15%	\$ 10,000
40%	\$ 15,000
20%	\$ 20,000
15%	\$ 25,000
5%	\$ 30,000

Eliminating the high and low probabilities the contingent rents included in the lease liability would be \$15,250

$$(\$10,000 \times 15\%) + (\$15,000 \times 40\%) + (\$20,000 \times 20\%) + (25,000 \times 15\%)$$

Lessee Accounting cont'd

- Lease liability is discounted at the lessee's incremental borrowing rate or the rate that the lessor charges the lessee if that rate can be readily determined, the discount rate is not subsequently adjusted except in limited circumstances
- Right-of-use asset equals at inception the initial lease liability plus direct costs and prepaid rents
 - Examples of direct costs are commissions, legal fees, closing costs, other costs that are incremental and directly attributed to the lease
 - Direct costs do not include overhead, advertising costs, cost to service the lease, etc...

Lessee Accounting, cont'd

- Subsequent to initial recognition
 - Amortize lease liability using the effective interest method, results in interest expense being recorded
 - Amortize right-of-use asset over the shorter of lease term and economic life of leased asset (typically straight line pattern), record cost as amortization and not rent expense
 - Reassess lease term, contingent rents, residual value guarantee and term option penalties if facts and circumstances indicate there would be a significant change in the lease liability
 - For changes related to reassessment of lease term adjust lease liability and right-of-use asset
 - For changes related to reassessment of contingent rents, residual value guarantee and term option penalties adjust lease liability and for changes related to future periods adjust right-of-use asset and for changes related to current or prior periods recognize in P&L

Lessee Accounting, cont'd

- For balance sheet purposes present right-of-use asset separately within PP&E from other owned assets and present lease liability separately. For P/L show amortization expense and interest expense separately from other amortization and interest expense (also could present in notes). For cash flow payments of principal and interest are financing activities shown separately.

Lessor Accounting

- Two approaches
 - Performance obligation approach is used when lessor retains exposure to significant risks and benefits associated with leased asset
 - Derecognition approach is used when lessor does not retain exposure to significant risk or benefit associated with leased property

Lessor Accounting cont'd

- Risk and benefit analysis
 - Lease contains significant contingent rents based on use of property
 - Options to extend or terminate lease
 - Material non-distinct services
 - Lease term compared to useful life of leased asset
 - Significant change in value of leased asset at end of the lease

Lessor Accounting cont'd

- Lessor's Receivable (lease asset) is recorded under both the performance obligation or derecognition approach and is equal to the present value of the estimated future lease payments which includes estimate of:
 - Lease term – similar to lessee assessment, but could be different periods
 - Contingent rents, residual value guarantee and term option penalties – similar to lessee assessment, but only include amounts the lessor “can measure reliably” and could differ from lessee

Lessor Accounting cont'd

- Exclude purchase option
- Lease receivable is discounted at rate lessor charges the lessee
 - Lessee incremental borrowing rate
 - Rate implicit in lease
 - Capitalization rate
- Lease receivable is increased for direct costs

Lessor Accounting cont'd

- Under Performance Obligation Approach
 - Leased property remains on the balance sheet and continues to be depreciated
 - Lease receivable recorded as discussed above
 - Lease liability (performance obligation) recorded equal to present value of estimated future lease payments (same as lease receivable) plus prepaid rents

Lessor Accounting cont'd

- Subsequent to initial recognition
 - Lease receivable amortized using effective interest method results in interest income
 - Lease liability is amortized to P/L based on pattern of use of leased property (typically straight line)
 - Reassessment of lease receivable (similar to lessee) is required if facts and circumstances indicate there would be a significant change in the receivable
 - Changes from reassessment would be an adjustment of the lease liability (performance obligation) if due to lease term or future periods or recognized in P/L if related to the current or prior periods
- For balance sheet purposes the leased property, lease receivable and lease liability (performance obligation) presented separately totally to a net lease asset or liability. For P/L purposes record depreciation expense, interest income, income from satisfaction of lease liability (rental income), for cash flow show as operating activity

Lessor Accounting cont'd

- Under Derecognition Approach
 - Leased property is derecognized except for an allocation of the carrying amount to the residual asset (allocation of the derecognized asset is based upon estimates of fair value of right to receivable lease payments over the fair value of the leased property), residual asset is not depreciated
 - Lease receivable is recorded as discussed above under performance obligation approach and recognize a gain or loss in P/L at initial measurement

Lessor Accounting cont'd

- Subsequent to initial recognition
 - Lease receivable is amortized using the effective interest method resulting in interest income
 - Reassessment of lease receivable for change in estimated future lease payments if facts and circumstances indicate a significant change in lease receivable, effects of reassessment are recorded in P/L
- For balance sheet purposed show lease receivable separately from other receivables and residual asset presented separately within PP&E. For P/L record interest income, net lease income (if used for financing) or lease income and expense (if used for selling purposes). Cash receipts are operating activity

Other



- **Agreements with lease/service components**
 - If service component is distinct and payments can be allocated than account for lease component in accordance with ED and service component in accordance with applicable GAAP, otherwise account for whole contract as a lease
 - Service component is distinct if either:
 - An identical or similar service is sold separately by any entity
 - The service has both:
 - a distinct function and
 - a distinct profit margin

Other cont'd



- **Short term leases**
 - Contract for which the longest possible term is less than 12 months
 - Lessee may recognize right-of-use asset and lease liability at undiscounted amounts of the lease payments, recognize lease payment in P/L over term of lease
 - Lessor accounts for lease income as earned
- **Sublease**
 - Account for assets and liabilities arising from head lease (original lease) in accordance with lessee accounting model
 - Account for assets and liabilities arising from subleases in accordance with lessor accounting model
 - Present all item gross in balance sheet together except liability for payments for estimated future lease payments on head lease

Other cont'd



- Presentation of information from a sublease

Property, plant and equipment		X
Cash		X
<i>Right-of-use asset</i>	X	
<i>Lease receivables</i>	X	
<i>Lease liability</i>	(X)	
<i>Net sublease asset</i>		<u>X</u>
Total assets		<u><u>X</u></u>
Trade and other payables		X
<i>Liability to make lease payments</i>		<u>X</u>
Total liabilities		<u><u>(X)</u></u>

Other cont'd



- **Sale-Leasebacks**

- Seller-Lessee – if transaction qualifies as a sale, then
 - derecognize the leased property;
 - recognize a right-to-use asset; and
 - recognize a liability to make estimated future lease payments
- Buyer-Lessor – if transaction qualifies as a sale for seller-lessee, then
 - Recognize the lease property;
 - Recognize a liability to permit lessee to use leased property; and
 - recognize an asset for estimated future lease payments
- If does not qualify as a sale then account for the transaction as a financing arrangement

- **Disclosures**

- Extensive disclosures required for both lessees and lessors including certain reconciliation/roll forward analysis and disclosure of contractual lease obligation/receivable and total lease obligation/receivable

Other cont'd



- Transition

- Lessee

- At date of initial application which is the beginning of the earliest comparable period presented after the effective date, recognize an obligation to make estimated future payments (based on PV of remaining lease payments) and right-of-use asset for all outstanding leases, except simple capital leases
 - Simple capital lease have no options, contingent rents or residual guarantees and are grandfathered
 - Eliminate any prepaid or accrued rents with offset to right-of-use asset

- Lessor

- At date of initial application (same as lessee) recognize and measure all leases using a simplified retrospective approach
 - Record lease receivable at PV of estimated remaining lease payments
 - If use performance obligation model record performance obligation (lease liability) at amount equal to lease receivable
 - If use derecognition model the residual asset is measured at fair value at date of application

Other cont'd



- Reinstatement of any previously derecognized asset if using the performance obligation model (recognize at cost adjusted for depreciation)
- Effective date
 - Expect to finalize standard in Q2 of 2011
 - Effective date to be determined

Questions



- Contact info

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LEASE AGREEMENT

THIS LEASE AGREEMENT (hereinafter referred to as the "Agreement") made and entered into this ____ day of _____, 20____, by and between _____, whose address is _____ (hereinafter referred to as "Lessor") and _____ (hereinafter referred to as "Lessee").

WITNESSETH:

WHEREAS, Lessor is the owner of certain real property being, lying and situate in _____ County, _____, such real property having a street address of _____.

WHEREAS, Lessor is desirous of leasing the Premises to Lessee upon the terms and conditions as contained herein; and

WHEREAS, Lessee is desirous of leasing the Premises from Lessor on the terms and conditions as contained herein;

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Real Estate Team



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