

### FASB AND IASB ISSUE PROPOSED ACCOUNTING STANDARDS UPDATE (ASU) EXPOSURE DRAFT (ED): LEASES

On August 17, 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) published a joint proposal for comment that fundamentally changes the current accounting model for leases under both US GAAP and IFRS. The proposed requirements would supercede the guidance in Topic 840 on leases in US GAAP and IAS 17, *Leases*, in IFRS. The proposal is open for comment until December 15, 2010.

The proposal focuses on a consistent approach to lease accounting for both lessees and lessors – a “right-of-use” approach. This will result in most leases being recorded on the face of the financial statements. Leases of 12 months or less would be able to apply simplified requirements.

#### Right-of-Use model

For leases within the scope of the proposal (certain leases, such as leases of intangibles, leases of certain extractive activities, and leases of biological assets are not included in the scope):

- a. A lessee would recognize an asset representing its right to use the leased (‘underlying’) asset for the lease term (the ‘right-of-use’ asset) and a liability to make lease payments.
- b. A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:
  - Recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach, or
  - Derecognize the rights in the underlying asset at the end of the lease term (a derecognition approach)

#### Measurement: Lessees

At the date of the inception of the lease, a lessee shall measure:

- a. The liability to make lease payments at the present value of the lease payments, discounted using the lessee’s incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee
- b. The right-of-use asset at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee

Subsequent to initial inception, a lessee shall measure:

- a. The liability to make lease payments at amortized cost using the interest method (interest expense)
- b. The right-of-use asset at amortized cost, amortized on a systematic basis (amortization expense)

#### Measurement: Lessors

The proposal includes two accounting models for lessors. A lessor that retains exposure to significant risks or benefits associated with the underlying asset would apply the performance obligation approach, otherwise, the derecognition approach is applied.

Performance obligation approach:

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At the date of inception of the lease, a lessor shall measure:

- a. 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, and any initial direct costs incurred by the lessor
- b. The lease liability at the amount of the right to receive lease payments

Subsequent to initial inception, a lessor shall measure:

- a. The right to receive lease payments at amortized cost using the interest method
- b. The remaining lease liability determined on the basis of the pattern of use of the underlying asset by the lessee. If the lessor cannot reliably determine the remaining lease liability on that basis, it shall use the straight-line method

Decrecognition approach:

At the date of inception of the lease, a lessor shall measure:

- a. 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 and any initial direct costs incurred by the lessor
- b. The residual asset at an allocated amount of the carrying amount of the underlying asset

Subsequent to initial inception, a lessor shall measure:

- a. The right to receive lease payments at amortized cost using the interest method
- b. The residual asset will generally not be remeasured

Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

- a. Assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease
- b. Uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified in the lease
- c. Is updated when changes in facts and circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period

For contracts that combine service and lease components, the right to receive lease payments and the liability to make lease payments would exclude payments arising from distinct service components and for the draft IFRS, non-distinct service components for lessors that apply the derecognition approach.

### **Disclosure Requirements**

The proposal includes significantly increased disclosures associated with leases. It requires companies to disclose quantitative and qualitative information that:

- a. Identifies and explains the amounts recognized in the financial statements arising from leases
- b. Describes how leases may affect the amount, timing, and uncertainty of the entities future cash flows

This would include disclosures of terms of the lease including contingent rentals, renewal options, residual guarantees, information about changes in assumptions and judgments related to options, contingent rentals, residual guarantees, lease terms and discount rates. A reconciliation between opening and closing balances for assets and liabilities related to leases will also be required.

### **Transition**

Leases outstanding at the date of initial application will be subject to the proposed lease accounting. The proposal provides for a simplified retrospective approach. A lessee will recognize an obligation and a right-to-

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use asset for each lease outstanding at the date of initial application measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate on the date of initial application. The right-of-use asset would need to be adjusted to reflect recognized prepaid or accrued lease payments when payments are not straightlined over the lease term. No adjustment would be required for existing capital leases that do not have options, contingent rentals, or residual value guarantees.

Lessors would recognize a right to receive lease payments and a performance obligation measured at the present value of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease, and would reinstate any previously derecognized underlying asset at depreciated cost, under the performance obligation approach. For leases under the derecognition approach, the lessor would recognize an asset for the right to receive lease payments measured at present value of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease, and would also recognize a residual asset measured at fair value as of the date of initial application.

### **Effective Date**

There was no effective date in the proposals. Given the significant amount of proposed changes in US GAAP and IFRS that are expected as a result of current joint convergence topics, the boards will solicit feedback on appropriate effective dates.

### **How Resources Can Help**

We provide strong technical accounting, project management, internal controls and information systems expertise and can help businesses with all aspects of financial reporting, including assessing the impact of this proposal on your business. Please contact your client service director for more information.

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**As of March 2010, Resources is now aligned with IASeminars, which allows us to provide CPAs and other financial professionals with a comprehensive range of training solutions around IFRS and other key finance and accounting initiatives.**

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