

MINUTES



Financial Accounting
Standards Board

To: Board Members

From: Leases Team (Martin, ext. 354)

Subject: Minutes of the June 17, 2009 Board Meeting: Sale and Leaseback Transactions, Impairment of the Right-of-use Asset, Revaluation of the Right-of-use asset, Initial direct costs, and Transition. **Date:** June 24, 2009

cc: FASB: Bielstein, Golden, Lott, Stoklosa, Proestakes, Zeyher, Nickell, Homant, Helmus, C. Smith, Brickman, Hood, Sutay, Glotzer, Mechanick, Gabriele, McGarity, Klimek, Willis, FASB Intranet; FASAC: Chookaszian, Posta; IASB: Leisenring, Teixeira, Knubley, Kim, Vatrenejak

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Sale and Leaseback Transactions, Impairment of the Right-of-use Asset, Revaluation of the Right-of-use asset, Initial direct costs, and Transition.

Basis for Discussion: Memorandum #30 (IASB Agenda Paper 11)
Memorandum #31 (IASB Agenda Paper 11A)
Memorandum #31A (IASB Agenda Paper 11B)
Memorandum #32 (IASB Agenda Paper 11C)
Memorandum #33 (IASB Agenda Paper 11D)
Memorandum #34 (IASB Agenda Paper 11E)

Length of Discussion: 8:30 a.m. to 9:35 a.m.

Attendance:

Board members present: Herz, Linsmeier, Seidman, Siegel, and Smith

Board members absent: None

Staff in charge of topic: Zeyher

Other staff at Board table: Golden, Stoklosa, Helmus, and Martin

Outside participants (IASB

staff participating by phone): Knubley, Vatrenejak, and Kim

Summary of Decisions Reached

The Board discussed several lessee accounting issues that were not addressed in the March 19, 2009 Discussion Paper, *Leases: Preliminary Views*. The Board reached the following tentative decisions:

Sale and leaseback transactions

1. In a sale and leaseback transaction, a seller/lessee would consider whether the entire leased asset qualifies for derecognition. If the entity determines, after applying the applicable guidance for the underlying asset, that the transaction qualifies as a sale, it would derecognize the leased item and recognize a right-of-use asset and an obligation to make rental payments for the leaseback. The Board will consider whether additional criteria are needed to help entities determine whether a sale and leaseback transaction represents a sale and how to account for a sale and leaseback transaction when the sales prices or rental payments are not at market rates.

Impairment of the right-of-use asset

2. A lessee preparing financial statements in accordance with international financial reporting standards would follow the guidance in IAS 36, *Impairment of Assets*, to determine whether its right-of-use asset is

impaired and a loss should be recognized. A lessee applying U.S. generally accepted accounting principles would follow FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to determine whether its right-of-use asset is impaired and a loss should be recognized.

Revaluation of the right-of-use asset

3. A lessee would subsequently report a right-of-use asset at cost adjusted for amortization and impairment losses, if any. A lessee would not be permitted to subsequently remeasure its right-of-use asset to fair value unless required to do so to recognize an impairment loss.

Initial direct costs

4. A lessee would expense any initial direct costs as incurred.

Transition

5. A lessee would apply the new lease standard by recognizing an obligation to pay rentals and a right-of-use asset for all outstanding leases at the transition date. The obligation and the asset would be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date.

Objective of the Meeting:

1. The objective of the meeting was for the Board to discuss several lessee accounting issues that were not addressed in the FASB Discussion Paper, *Leases: Preliminary Views*, specifically (a) sale and leaseback transactions, (b) impairment of the right-of-use asset, (c) revaluation of the right-of-use asset, (d) initial direct costs, and (e) the transition to a new accounting model for lessees. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1: Sale and Leaseback Transactions

Identifying the Asset

1. Ms. Knuble presented two approaches in determining the asset to be derecognized in a sale and leaseback transaction identified by the staff:
 - a. An entire asset approach—The seller/lessee evaluates whether the entire asset qualifies for derecognition.
 - b. A partial derecognition approach—The seller/lessee considers only the bundle of rights and obligations that are transferred to the buyer/lessor for derecognition.
2. **Staff recommendation:** The staff recommended the entire asset approach.
3. **Board vote:** The Board unanimously agreed with the staff recommendation.
4. **Board comments:** Messrs. Smith and Siegel stated that the entire asset approach is more consistent with the right-of-use model.
5. Mr. Linsmeier observed that the entire asset approach better represents the economics of the transaction as it reflects who holds the property rights after the transaction occurred.
6. Mr. Smith expressed concern regarding gain recognition issues in a sale and leaseback transaction, particularly when the term of the lease covers a significant portion of the asset's useful life. Messrs. Smith and Linsmeier suggested that gain recognition in a sale and leaseback transaction should be discussed by the Board as a separate issue at a future meeting.
7. Ms. Seidman stated that the entire asset approach is consistent with how the assessment of whether a transaction involving tangible assets represents a sale or financing arrangement is made. Ms. Seidman further stated that the issue of derecognition of the asset in a sale and leaseback transaction should be viewed separately from the issue of presentation of the leased asset by the lessor, for which some Board members favoured a net presentation option, as discussed in the May 18th, 2009 Board meeting (see the [meeting minutes](#)). Ms. Seidman noted that the whole asset approach is also consistent with the notion supported by some

Board members that certain leases represent in-substance purchases of the leased assets.

8. Mr. Linsmeier supported Ms. Seidman's view that derecognition of the asset by a seller/lessee in a sale and leaseback transaction and presentation of the leased asset by lessor should be viewed as separate issues.
9. Ms. Seidman stated that if the Board decides that some gains on sale and leaseback transactions would be deferred, the Board should note that amortization of the deferred gain would conflict with preliminary decisions reached in the Revenue Recognition project, which rejects the notion of earnings process. Consequently, the gain should be recognized at a point in time (that is, at the time the sale occurs), rather than over time.
10. Mr. Smith noted that derecognition of a leased asset by a sublessor is a different issue from derecognition of leased asset in a sale and leaseback transaction because a sublease involves a different asset: a right to use the leased asset.

Derecognition of the Asset by the Seller/Lessee

11. Ms. Knuble presented two approaches to derecognition in a sale and leaseback transaction identified by the staff:
 - a. Always derecognize the leased asset
 - b. Develop criteria to differentiate between transactions that qualify for derecognition and those that do not.
12. **Staff recommendation:** The FASB staff recommended an approach in which the leased asset is always derecognized and the rights and obligations arising in the leaseback are recognized. Any gains or losses arising in such a transaction would be recognized immediately. The IASB staff recommended that the Boards develop criteria to differentiate between transactions that qualify for derecognition and those that do not.
13. **Board vote:** The Board unanimously decided that the lessor would look to the existing applicable guidance to determine whether the sale and leaseback transaction meets the criteria of a sale; if it does, the lessor would derecognize the leased item and recognize a right-of-use asset and an obligation to make rental

payments for the leaseback. Additionally, the Board decided to discuss at a future meeting whether additional criteria are needed to help entities determine whether a sale and leaseback transaction represents a sale and how to account for a sale and leaseback transaction when the sales prices or rental payments are not at market rates.

14. **Board comments:** Ms. Seidman stated that the approach to determining whether or not an asset has been sold should be consistent for all transactions involving tangible assets, regardless of whether the transaction involves a leaseback.
15. Mr. Herz suggested the Board needs to discuss whether certain leases represent in-substance purchases. If the Board decides that certain leases are in-substance purchases, then a sale and leaseback transaction under which the leaseback represents an in-substance purchase would not qualify as a sale.
16. Ms. Knuble observed that while the scope of the Discussion Paper, *Leases: Preliminary Views* includes leases that are in-substance purchases, the staff acknowledges that a number of Board members would like to discuss the issue of in-substance purchases further and will bring the matter for the Board's deliberation at a future meeting.
17. Mr. Linsmeier stated that if the sale and leaseback transaction transfers property rights to the purchaser, the transaction is likely to represent a sale. Mr. Linsmeier expressed concern that the terms of a sale and leaseback transaction can be structured to create an inflated gain on sale for the seller/lessee (for example, through lease payments that are not at market rates) and suggested the Board needs to discuss this issue further.
18. Mr. Linsmeier noted an additional issue related to comparability of return on asset metrics for companies that purchase assets and dispose of them before the end of the assets' useful lives and the companies that lease assets only for the portion of their useful lives. Mr. Linsmeier suggested it would be useful for the Board to receive user feedback on how helpful the proposed model is in making return on asset metrics more comparable.

Issue 2: Impairment of the Right-of-use Asset

19. Ms. Vatrenejak presented four options identified by the staff for impairment accounting for right-of-use assets:
- a. Require all entities to use the International Financial Reporting Standards (IFRS) approach
 - b. Require all entities to use the U.S. generally accepted accounting principles (GAAP) approach
 - c. Develop a specific approach for right-of-use assets
 - d. Require entities to refer to existing applicable standards (IAS 36, *Impairment of Assets*, for IFRS preparers, FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, for U.S. GAAP preparers).
20. **Staff recommendation:** The staff recommended option (d), requiring entities to refer to existing applicable standards.
21. **Board vote:** Messrs. Herz, Smith and Linsmeier, and Ms. Seidman agreed with the staff recommendation. Mr. Siegel supported option (a), requiring all entities to use IFRS approach.
22. **Board comments:** Mr. Siegel stated that he supports option (a) because this option would converge the accounting for impairment of the right-of-use assets under U.S. GAAP and IFRS.
23. Ms. Seidman observed that option (d) provides more consistency within companies' financial statements.
24. Mr. Linsmeier noted that changing impairment guidance only for the right-of-use assets would create difficulties in impairment testing under U.S. GAAP in other instances; for example, when the entity evaluates for impairment an asset group that consists of both leased and owned assets.

Issue 3: Revaluation of the Right-of-use Asset

25. **Staff recommendation:** The IASB staff recommended that revaluation of right-of-use assets should be permitted; the FASB staff recommended that revaluation of right-of-use assets should not be permitted.

26. **Board vote:** The Board unanimously agreed with the FASB staff recommendation.
27. **Board comments:** Mr. Herz noted that the progress made in Phase C: Measurement, of the Conceptual Framework project will inform the decisions on this subject in the future. However, the guidance on this issue should remain unchanged at present.

Issue 4: Initial Direct Costs

28. Ms. Kim presented three approaches to addressing how initial direct costs should be accounted for:
- a. Add initial direct costs to the carrying amount of the right-of-use asset
 - b. Allocate initial direct costs between debt issuance costs and asset acquisition costs
 - c. Recognize such costs as an expense as incurred.
29. **Staff recommendation:** The staff recommended approach (a), adding initial direct costs to the carrying amount of the right-of-use asset recognized by the lessee.
30. **Board vote:** The Board unanimously decided to adopt approach (b) to require expensing of initial direct costs as incurred.
31. **Board comments:** Ms. Seidman noted that valid reasons for adopting either of the options exist. Capitalizing initial direct costs of a lease would be consistent with accounting for the costs incurred in acquiring an asset. On the other hand, measurement of the right-of-use asset is based on the lease liability, and transaction costs for liabilities are expensed. Ms. Seidman noted that if the Board receives feedback from financial statement users indicating that they would prefer capitalization of initial direct costs of a lease, she would not object to this option.
32. Mr. Herz observed that some leases can be compared with the purchase of an asset that involves financing, in which case the costs related to the purchase would be capitalized, and the costs related to financing would be expensed. However, bifurcating initial direct costs of a lease is not likely to be practicable.

33. Mr. Smith indicated that the latest thinking in this area is to expense these costs and therefore does not think the decision should be to capitalize these costs just because that is what is done in other purchases.

Issue 5: Transition

34. Ms. Kim presented four transition options for the new lease standard:
- a. Option A: retrospective application
 - b. Option B: prospective application to new lease contracts entered into after the effective date
 - c. Option C: measure all leases at fair value on the transition date
 - d. Option D: measure all leases at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date.
35. **Staff recommendation:** The staff recommended Option D. That is, on the date of transition the lessee would be required to:
- a. Recognize an obligation to pay rentals measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date
 - b. Recognize a right-of-use asset measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date with an impairment review of the right-of-use asset.
36. **Board vote:** The Board unanimously agreed with the staff recommendation.
37. Mr. Golden clarified that at the time of the transition, the lessee may need to re-evaluate the lease term and contingent rents in accordance with the new guidance. Consequently, the right-of-use asset recognized by the lessee at transition would not necessarily be equal to the present value of the remaining lease payments as disclosed by the entity under the current guidance.
38. Mr. Linsmeier supported Option D for leases that are currently accounted for as operating leases. However, he thought leases that are currently accounted for as

capital leases could transition to the new leases standard by recording a cumulative effect.

Follow-up Items:

- 39. Ms. Zeyher noted that the IASB is likely to reach different conclusions on some of the questions discussed at this meeting and asked the Board how they would like to address the resulting differences.
- 40. Mr. Golden suggested the staff bring for the Board's discussion a sweep issue covering all differences between decisions reached by the IASB and the FASB at a later date.
- 41. The Board agreed with Mr. Golden's suggestion.

General Announcements:

None.