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Proposed Lease Accounting Model

Listen to a brief discussion about the lease accounting model proposed in the FASB's and IASB's new exposure draft.

It's the Lease We Can Do

Boards Issue Exposure Drafts on Leases

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On May 16, 2013, the FASB and IASB issued a revised exposure draft (ED), *Leases*. The ED, released by the FASB as a proposed Accounting Standards Update (ASU), proposes a new accounting model to address off-balance-sheet financing arrangements for lessees. If finalized, the proposed ASU would converge most significant aspects of the FASB's and IASB's accounting for lease contracts.

Comments on the proposed ASU are due by September 13, 2013. A final standard is likely to be issued in 2014 and would be effective no earlier than annual reporting periods beginning on January 1, 2017.

Editor's Note: We expect that on the basis of the comments they receive on the ED, the boards may decide to reexamine the definition of a lease, the accounting for variable lease payments, the expense recognition patterns for lessees, and the accounting by lessors.

A Snapshot of the ED's Provisions

The table below highlights the ED's most significant provisions and is followed by a more detailed discussion of these and other aspects of the proposed lease accounting model.

Topic	Decisions
Lessee accounting — right-of-use (ROU) model	• The lessee recognizes an ROU asset and liability for all lease contracts (other than short-term leases). • The ROU asset represents the lessee's right to use the leased asset for the lease term; the liability represents the lessee's obligation to make lease payments.
Scope	• Similar overall to scope in current U.S. GAAP.
Definition of a lease	• A leased asset must be specifically identifiable either explicitly (e.g., by a specific serial number) or implicitly (e.g., the only asset available to satisfy the lease contract). • A physically distinct portion of a larger asset could represent a specified asset (e.g., one floor of a building). • A lease contract would convey the right to control the use of the specified asset. The concept of control would be similar to that in the proposed revenue recognition standard (i.e., the customer has the ability to direct, and derive benefits from, the use of the asset). • Obtaining all the output from an asset is, in isolation, no longer determinative of control.

Topic	Decisions
Lease term	• Noncancelable term that takes into account renewal options and termination options if there is a significant economic incentive for an entity to exercise or not exercise the option. • Entities should consider contract-based, asset-based, market-based, and entity-specific factors when assessing whether there is a significant economic incentive to exercise or not exercise the option. • Reassessment of lease term is required when relevant factors change (i.e., lessee would have, or no longer have, a significant economic incentive to renew or not terminate). Market-based factors should not, in isolation, result in a reassessment.
Lease payments	• Measurement of the ROU asset and lease liability would include fixed payments and only those variable payments that are: o Based on an index or rate. o In-substance fixed lease payments (e.g., the lease contains disguised fixed lease payments). • Amounts expected to be paid under residual value guarantees for lessees and certain residual value guarantees for lessors. • Renewal options or termination penalties when there is a significant economic incentive to exercise or not exercise the option. • The index or rate that exists at the end of each reporting period (i.e., the spot rate) would be used to adjust lease payments that are based on an index or rate.
Subsequent measurement for lessees — profit and loss recognition	• Two approaches are used for amortizing the ROU asset: (1) Type A ("financing") and (2) Type B ("straight-line"). • The amortization approach would be based on the nature of the underlying asset — that is, whether the underlying asset is "property" — and the terms and conditions of the lease.
Lessor accounting	• The lessor would account for a lease under either the Type A approach ("receivable and residual") or the Type B approach ("operating lease") on the basis of the nature of the underlying asset and the terms and conditions of the lease. • For leases accounted for under the receivable and residual model, a lessor would derecognize the underlying asset and would recognize a receivable for lease payments and a residual asset in its place. The effective-interest method would be used to amortize the receivable, and the residual would be accreted at the rate the lessor charges the lessee. • For leases accounted for under the operating lease approach, a lessor would continue to recognize the underlying asset and record periodic lease revenue.

The scope of the proposed lease guidance would be similar to that of existing lease accounting requirements.

Scope

The scope of the proposed lease guidance would be similar to that of existing lease accounting requirements. However, because the proposed scope would encompass all assets in addition to property, plant, and equipment, the boards agreed that entities would not be required to account for leases of intangible assets in accordance with the proposed lease guidance. The following would also be outside the scope of the guidance:

- Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources.
- Leases of biological assets.

ROU assets in a sublease are within the scope of the proposed guidance, as are assets that are often treated like inventory (e.g., spare parts, supplies).

Short-Term Leases

Entities would have the option of excluding leases that have a maximum possible lease term of 12 months or less, including any options to renew, from the ED's recognition, measurement, and presentation requirements. A lessee electing this option would not recognize an ROU asset or lease liability for the short-term lease. Rather, the lessee would recognize lease payments in profit or loss on a straight-line basis over the lease term (i.e., a short-term lease could essentially be treated similarly to an operating lease). A lessor electing this option would recognize the lease payments as rental income over the lease term either on a straight-line basis or by using another systematic basis that is representative of how the income is earned from the underlying asset. The election would be made on an asset-class basis and would not exempt entities from providing certain required disclosures for their short-term leases. In addition, the election would not be available for leases that contain a purchase option.

Editor's Note: On the basis of the ED, we believe that month-to-month leases — in which the lessee has the unilateral right to continue using the leased asset indefinitely on a month-to-month basis at the end of the contractual lease term — would not qualify as short-term leases.

The ED proposes that when determining whether a contract contains a lease, entities should assess whether (1) the contract is based on an identified asset and (2) the lessee obtains the right to control the use of the asset for a particular period.

Definition of a Lease

The ED defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration." The ED proposes that when determining whether a contract contains a lease, entities should assess whether (1) the contract is based on an identified asset and (2) the lessee obtains the right to control the use of the asset for a particular period.

The concept of identifying the asset is consistent with current GAAP. Under the proposal, a leased asset must be specifically identifiable either explicitly (e.g., by a specific serial number) or implicitly (e.g., the only asset available to satisfy the lease contract). The evaluation should take into account substantive rights held by the lessor to substitute the underlying asset. Substitution rights are considered substantive if the lessor can substitute the leased asset without the customer's consent and no barriers would prevent substitution (e.g., high costs or alternative assets are not available).

Editor's Note: Example 3 (ASC 842-10-55-23 through 55-26) in the ED describes a customer that enters into a contract for medical equipment for three years. The supplier carries out repairs and maintenance of the monitoring equipment when needed and can replace the equipment without the customer's consent. The example concludes that the supplier's substitution rights are not substantive because the costs of replacing the equipment prevent the supplier from replacing the equipment unless it is not operating properly. Because the FASB does not explain this conclusion, it is unclear when such costs should be considered prohibitive; however, the FASB may believe that it is a low threshold to consider substitute rights nonsubstantive.

The ED also proposes that a specified asset could be a physically distinct portion of a larger asset (e.g., one floor of a building). However, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) would not be a specified asset under the proposal.

The ED would align the assessment of whether a contract gives the lessee the right to control the specified asset with the concept of control developed as part of the project on revenue recognition. Accordingly, a contract would convey the right to control the use of an identified asset if the customer has the ability to direct, and derive benefits from, the use of that asset. The ability to direct the use of the specified asset includes the determination of when and how the asset is used. Benefits from use would include direct economic gain stemming from use of the asset (e.g., renewable energy credits and secondary physical output).

Under the ED, when a customer can specify the output from the use of the asset but is unable to make decisions about the input or process that results in that output, the customer may not necessarily have the ability to direct the use of the asset. This decision is likely to affect whether gas supply contracts and power purchase arrangements constitute leases.

Further, the ED proposes that when an asset is used to perform services for a customer, the customer and supplier must assess whether the asset is incidental to the delivery of services (i.e., whether the asset will only function when the additional services are supplied). If the asset will only function when the supplier provides additional goods and services and the customer cannot obtain benefits from the asset without additional goods or services that are not separately obtainable, the arrangement may ultimately not contain a lease.

Editor's Note: When discussing the separation of assets that are used to deliver a service, the boards referred to an example[1] in which (1) a customer contracts with a supplier of digital television satellite services for certain television channels and (2) the supplier has the ability to determine the specific equipment (cable box) that the customer will be given to view those television channels. The boards indicated that such a contract would not contain a lease for the equipment provided because use of the cable box is incidental to the services requested by the customer and therefore the customer does not have the ability to derive benefits from its use. The boards also discussed a number of additional examples at their April 2011 meeting (e.g., season tickets for sporting events, oil rigs in the energy industry). Constituents should monitor the boards' redeliberations related to the definition of a lease because the definition could affect an entity's determination of whether an arrangement contains a lease.

The ED would align the assessment of whether a contract gives the lessee the right to control the specified asset with the concept of control developed as part of the project on revenue recognition.

The ED includes guidance on contracts that contain multiple lease components (e.g., a contract that includes a building and an equipment lease). In these situations, an entity would need to consider whether (1) "the lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee" and (2) "the underlying asset is neither dependent on nor highly interrelated with the other underlying assets in the contract." If both of these criteria are met, the lease components would be accounted for separately. Otherwise, the lease components would be combined.

Lease Term

The ED defines "lease term" as "[t]he noncancellable period of the lease, together with both of the following: (a) periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; and (b) periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option."

In evaluating whether the lessee has a significant economic incentive to renew a lease or not to terminate a lease, an entity would consider the following:

- *Contract-based factors* — The terms of the lease agreement (e.g., a bargain renewal option, a contractual requirement for the lessee to incur substantial costs to restore the asset before returning it to the lessor).
- *Asset-based factors* — Specific characteristics of the underlying asset (e.g., the lessee has installed significant leasehold improvements that would still have economic value when the option becomes exercisable or the facility is in a geographically desirable location with no other viable locations).
- *Market-based factors* — Market rentals for comparable assets.
- *Entity-specific factors* — The historical practice of the entity, management's intent, and common industry practice.

[1] Paragraph A6 in the boards' agenda paper (IASB 5C/FASB 131).

Lease Payments

The ED proposes that a lessee's calculation of its ROU asset and lease obligation or a lessor's calculation of its receivable and residual asset would include fixed lease payments (net of any incentives payable by the lessor to the lessee). However, variable lease payments would generally not be included. Accordingly, entities would recognize lease payments that are based on performance or usage of an underlying asset (e.g., lease payments based on a retailer's revenues) as an expense (lessees) or income (lessors) when they are incurred rather than include them in the initial measurement. Only variable payments that are (1) based on an index or rate or (2) in-substance fixed lease payments (e.g., the lease contains disguised fixed lease payments) should be included in the measurement.

In addition, the ED proposes that entities should use the spot rate, rather than a forward rate, to measure variable payments related to an index or rate. Such payments should be remeasured at the end of each reporting period. To the extent that the changes are related to the current period, a lessee would recognize them through current income. Any changes related to future periods would result in a change to the ROU asset and lease obligation. Conversely, a lessor would recognize in current income all changes in lease payments that depend on an index or rate. See the Other Lease Considerations section in Appendix A for an example.

Lessees and lessors would also need to evaluate residual value guarantees and the exercise price for options to extend the lease or penalties incurred to terminate the lease to determine whether they are lease payments. See the Other Lease Considerations section in Appendix A for additional details.

The ED proposes that entities should use the spot rate, rather than a forward rate, to measure variable payments related to an index or rate.

Editor's Note: Some entities have expressed concerns about how to determine the payments for leases with related parties. Specifically, they have questioned whether an ROU asset and obligation to make lease payments would need to be recognized in the financial statements of a subsidiary when the arrangement to occupy a portion of a building that is owned or leased by its parent company is part of an operating agreement rather than a formal lease agreement.

The FASB decided to eliminate the guidance in ASC 840-10-25-26[2] that requires entities to evaluate related-party leases on the basis of their substance. Rather, the ED requires entities to account for a related-party lease on the basis of its legal terms and conditions, acknowledging that some related-party leases are not documented or at arm's length. In making this decision, the FASB also discussed whether related-party leases would be considered cancelable or noncancelable leases (which could affect how such leases are accounted for under the proposed lease guidance). Ultimately, the Board decided against a presumption that related-party leases would be considered noncancelable. Entities would be required to provide the disclosures in U.S. GAAP for such related-party transactions.

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Contracts That Contain Lease and Nonlease Components

If contracts contain lease and nonlease components, entities would be required to separate and account for the various elements separately. For example, real estate leases often contain certain nonlease elements (e.g., property taxes, insurance, and maintenance) that would need to be separated from the lease elements of the contract. Lessees would need to first consider whether the stand-alone prices of the various components are observable. If each component has an observable stand-alone price, the lessee would base its allocation on the relative stand-alone price of each component. If only certain components have observable stand-alone prices, the lessee would base its allocation on the residual method. If there are no observable stand-alone prices, the lessee would account for the entire contract as a lease. A lessor would consider the guidance in the proposed revenue recognition standard to determine how to allocate the payments between the lease and nonlease components. That guidance allows a lessor to use an estimated selling price when no observable price exists.

Editor's Note: When the stand-alone price of the lease component of a contract is not observable and only certain of the nonlease components have observable stand-alone prices, a lessee would account, on a stand-alone basis, for only those nonlease components that have an observable purchase price. Components without observable prices would be combined with the lease component and accounted for as a single lease component.

For example, consider a multiple-element arrangement containing two separate lease components (Building A and Machine B) and three separate nonlease components (property taxes and insurance on the building and maintenance on the machine). The stand-alone prices of the building components (including the property taxes and insurance) are observable; however, there are no observable stand-alone prices for the lease or maintenance of the machine. Because one of the components without an observable price is a lease component (the lease of the machine), the lessee would allocate the monthly payment to the building components on the basis of their observable prices and would allocate the residual to the combined remaining components (the lease and maintenance of the machine). The lessee would account for the combined remaining lease components as a single lease component.

If contracts contain lease and nonlease components, entities would be required to separate and account for the various elements separately.

Discount Rate

The discount rate used for lessees should be the rate the lessor charges the lessee if this rate is available. If that rate is not available, which is generally expected to be the case, the lessee should use its incremental borrowing rate as of the date of lease commencement. Lessors should use the rate they charge the lessee — the rate implicit in the lease or the yield on the property. The ED also discusses circumstances in which an entity should reassess the discount rate. Specifically, an entity should perform such a reassessment when there is a change in the (1) lease term, (2) conclusion about whether a lessee has a significant incentive to exercise an option to purchase the underlying leased asset, or (3) referenced rate, if variable lease payments are based on that rate. Nonpublic entities would be allowed to make an accounting policy election to use the risk-free discount rate for all leases.

Lessee Accounting

The proposed accounting model for lessees is based on an ROU approach, which would be applied to all leases within the scope of the proposal unless the lease meets the definition of a short-term lease and the lessee elects short-term lease accounting. Under this approach, a lessee would recognize (1) an asset for the right to use the underlying asset and (2) a liability to make lease payments. Both would be initially measured at the present value of the future lease payments. Any initial costs (e.g., legal fees, consultant fees, commissions paid) that are directly attributable to negotiating and arranging the lease, as well as any lease payments to the lessor before or at the commencement of the lease, would be included in the ROU asset. A lessee would also include lease incentives in the initial measurement of the ROU asset (i.e., receipts from the lessor would reduce the ROU asset).

A lessee would use the effective-interest method to subsequently measure the liability to make lease payments. Regarding the ROU asset, respondents to the August 2010 ED noted that the proposal's subsequent-measurement requirements for ROU assets did not reflect the economics of all types of leases. They indicated that a straight-line expense recognition pattern would more appropriately reflect the economic substance of certain types of leases (e.g., leases of real estate). Accordingly, the ED proposes two different approaches for lessees: the Type A approach ("financing") and the Type B approach ("straight-line"). A lessee would determine which method to apply on the basis of the underlying asset — that is, whether the underlying asset is "property," which is defined as "land or a building, or part of a building, or both." As part of this evaluation,the lessee would consider the terms and conditions of the lease as follows:

The proposed accounting model for lessees is based on an ROU approach, which would be applied to all leases within the scope of the proposal unless the lease meets the definition of a short-term lease and the lessee elects short-term lease accounting.

Property	Other Than Property
A lessee will classify a lease of property as a Type B ("straight-line") lease unless:	A lessee will classify a lease of other than property as a Type A lease ("financing lease") unless*:
(1) "the lease term is for the major part of the **remaining** economic life of the underlying asset" (emphasis added); or	(1) "the lease term is for an insignificant part of the **total** economic life of the underlying asset" (emphasis added); or
(2) "the present value of the lease payments accounts for substantially all of the fair value of the underlying asset"; or	(2) "the present value of the lease payments is insignificant relative to the fair value of the underlying asset."
(3) "[the] lessee has a significant economic incentive to exercise an option to purchase the underlying asset."	* If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as a financing lease regardless of whether it meets the exceptions.

The ED states that an entity would determine the lease classification at lease commencement. The entity would not be required to reassess its classification unless the lease is subsequently modified and accounted for as a new lease. For example, a lessee may initially determine that a property qualifies for the straight-line lease approach because the lease term is not considered a major portion of the asset's remaining economic useful life and the present value of the fixed lease payments is not equal to substantially all of the fair value of the asset. If circumstances change so that the lessee has a significant economic incentive to renew the lease, the lessee would not need to reconsider the lease classification.

Editor's Note: The classification of a lease component would be based on the primary asset in the arrangement rather than the current U.S. GAAP guidance on integral equipment. For example, a lease of a turbine housed in a building would be considered a lease of "other than property" under the proposal because the turbine is the primary asset. An entity may need to use judgment in assessing arrangements in which the location of the leased assets is a significant component of the arrangement.

Further, leases of real estate that include both land and buildings would be assessed as one unit of account and the life of the building would be used in the assessment of the lease classification.

For leases accounted for under the financing approach, the ROU asset would be amortized in the same manner as other nonfinancial assets; that is, it would generally be depreciated on a straight-line basis. Entities would present the interest and amortization expenses separately in the income statement.

For leases accounted for under the straight-line approach, the amortization of the ROU asset would be calculated as the difference between the total straight-line lease expense (total undiscounted lease payments — subject to certain adjustments — divided by the lease term) and the interest expense related to the lease liability for the period. The amortization of the ROU asset and the interest expense would be combined and presented as a single amount within the income statement. In addition, the expense recognition pattern for leases accounted for under the straight-line approach must be straight-line, regardless of whether this is the pattern of consumption for the underlying asset.

The following example illustrates the application of the two subsequent-measurement models for lessees:

Example 1: Lessee Accounting — Profit and Loss Recognition

A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: $10,000 in year 1, $15,000 in year 2, and $20,000 in year 3. The initial measurement of the ROU asset and liability to make lease payments is $38,000 at a discount rate of 8 percent.

This table highlights the differences in accounting for the lease under the financing and straight-line approaches:

	Both Methods	Financing Approach (Type A)				Straight-Line Approach (Type B)		
Year	Lease Liability[a]	Interest Expense <X>	Amortization Expense <Y>[c]	Total Lease Expense <X + Y>	ROU Asset	Lease Expense <Z>	Reduction in ROU Asset <Z − X>[b]	ROU Asset
0	$ 38,000				$ 38,000			$ 38,000
1	31,038	$ 3,038	$ 12,666	$ 15,704	25,334	$ 15,000	$ 11,962	26,038
2	18,520	2,481	12,667	15,148	12,667	15,000	12,519	13,519
3	–	1,481	12,667	14,148	–	15,000	13,519	–
Total		$ 7,000	$ 38,000	$ 45,000		$ 45,000	$ 38,000	

(a) The effective-interest method is used to calculate the lease liability, regardless of the expense recognition pattern.

(b) Under the straight-line method, amortization expense is calculated as the difference between lease expense and interest expense.

(c) Under the financing approach, the ROU asset would be amortized in the same manner as other nonfinancial assets.

Under both the financing and straight-line approaches, the ROU asset would be subject to impairment testing in a manner similar to other long-lived assets. If the ROU asset for a lease accounted for under the straight-line approach is impaired, the lessee would adjust the subsequent amortization of the ROU asset to ensure that a straight-line expense is maintained throughout the remainder of the lease term unless, because of the impairment, the total lease expense for any subsequent period would be lower than the interest expense on the lease obligation. In such situations, rather than continuing a straight-line expense approach (albeit at a reduced amount), the subsequent amortization of the ROU asset would be consistent with the financing approach. Accordingly, if the ROU asset is fully impaired under the straight-line approach, the lessee would subsequently recognize lease expense in a manner consistent with the unwinding of the liability to make lease payments.

Lessor Accounting

The ED proposes that for those leases that are not considered short-term and for short-term leases for which the lessor has not elected to apply the short-term lease option, lessors would be required to classify leases similarly to how lessees classify them. Accordingly, the appropriate accounting model (receivable and residual method or operating lease method) to be applied by lessors depends on the nature of the underlying asset and the terms and conditions of the lease as follows:

Property	Other Than Property
A lessor will classify a lease of property as a Type B lease ("operating lease") unless: (1) "the lease term is for the major part of the **remaining** economic life of the underlying asset" (emphasis added); or (2) "the present value of the lease payments accounts for substantially all of the fair value of the underlying asset"; or (3) "[the] lessee has a significant economic incentive to exercise an option to purchase the underlying asset."	A lessor will classify a lease of other than property as a Type A lease ("receivable and residual") unless*: (1) "the lease term is for an insignificant part of the **total** economic life of the underlying asset" (emphasis added); or (2) "the present value of the lease payments is insignificant relative to the fair value of the underlying asset." * If a lessee has a significant economic incentive to exercise a purchase option to purchase the underlying asset, the lease would be classified as a receivable and residual lease regardless of whether it meets the exceptions.

Under the receivable and residual model, a lessor would derecognize the leased asset at lease commencement and would instead recognize a lease receivable and a residual asset.

Receivable and Residual Model

Under the receivable and residual model, a lessor would derecognize the leased asset at lease commencement and would instead recognize a lease receivable and a residual asset. The lease receivable would represent the lessor's right to lease payments and would initially be measured at an amount equal to the present value of future lease payments determined by using the rate the lessor charges the lessee plus any initial direct costs incurred. The lessor would recognize profit related to the receivable (i.e., a proportionate amount of the difference between the fair value and the carrying value of the leased asset), if any, when the asset is transferred to the lessee. The residual asset would represent the lessor's claim to the residual value of the leased asset at the end of the lease term and would be measured as the net amount of (1) the gross residual asset and (2) the deferred profit, if any. The gross residual asset would initially be measured at an amount equal to the present value of the expected residual value of the leased asset at the end of the lease term. The deferred profit component represents the portion of profit, if any, related to the residual asset. Although the two components of the net residual asset would be presented as a single amount, entities must calculate the two components to apply the subsequent accounting requirements.

The lessor would subsequently account for the lease receivable at amortized cost under the effective-interest method, recognizing interest income at the rate implicit in the lease at lease commencement. In addition, the lessor would subsequently accrete the gross residual asset over the lease term to an amount equal to the expected residual value of the leased asset at the end of the lease by using the rate the lessor charges the lessee. The deferred profit would not be recognized until the residual is sold or leased. The lessor would also adjust the residual asset in situations in which it receives variable lease payments related to the usage of a leased asset and expected to receive such payments when it initially determined the rate it charges the lessee.

Under the receivable and residual model, both the lease receivable and the residual asset would be subject to impairment testing. The lease receivable would be tested for impairment in a manner similar to other receivables under ASC 310. The residual asset would be tested for impairment in a manner similar to other long-lived assets under ASC 360.

Operating Lease Model

If a lessor determines that the lease should be accounted for under the operating lease model, the lessor would account for the lease contract by using a model similar to the operating lease treatment for lessors under current U.S. GAAP. That is, at lease commencement, the lessor would continue to recognize the leased asset in its statement of financial position and, in subsequent periods, would recognize (1) lease income by using a straight-line approach (or other systematic basis) and (2) depreciation expense for the leased asset by using an appropriate method of depreciation.

The following example illustrates how a lessor would account for a lease under the receivable and residual model compared with how it would account for it under the operating lease model:

Example 2: Lessor Accounting

A lessor leases an asset to a lessee. The leased asset has a carrying amount of $20,000 and a fair value of $24,000 at lease commencement. The terms of the lease are as follows:

Terms	
Lease term	5 years
Annual lease payments	$4,500, due at the end of each year
Estimated useful life of underlying asset	9 years
Rate the lessor charges the lessee (implicit rate in the lease)	6.2%
Present value of lease receivable at lease commencement	$ 18,829
Estimated residual value at the end of the lease term	$ 7,000

Under the receivable and residual model, the lessor will record the following entry on the lease commencement date (no entry would be recorded under the operating lease model):

Journal Entry	Debit	Credit
Lease receivable	$ 18,829	
Net residual asset	4,309[(b)]	
Underlying asset		$ 20,000
Profit		3,138[(c)]

	Receivable and Residual Model (Type A)					Operating Lease Model (Type B)	
		Net Residual Asset					
Year	Lease Receivable	Gross Residual[(a)]	Deferred Profit	Net[(b)]	Profit[(c)]	Underlying Asset	Profit[(d)]
0	$ 18,829	$ 5,171	$ (862)	$ 4,309	$ 3,138	$ 20,000	
1	15,506	5,493	(862)	4,631	1,499	17,400	$ 1,900
2	11,974	5,837	(862)	4,975	1,312	14,800	1,900
3	8,222	6,201	(862)	5,339	1,112	12,200	1,900
4	4,235	6,588	(862)	5,726	901	9,600	1,900
5	–	7,000	(862)	6,138	676	7,000	1,900
Total					$ 8,638		$ 9,500

(a) The gross residual asset is the present value of the estimated residual asset at the end of the lease term (the present value of $7,000 at a 6.2% discount rate). The gross residual amount is subsequently accreted at the rate the lessor charges the lessee.

(b) The residual asset initially equals $4,309 [carrying amount of underlying asset – (carrying amount of underlying asset × [lease receivable ÷ fair value of underlying asset)]] [($20,000 – ($20,000 × [$18,829 ÷ $24,000]))].

(c) The year-0 profit of $3,138 represents profit recognized at lease commencement when the leased asset is transferred to the lessee. It is calculated as (1) the difference between the fair value and the carrying amount of the leased asset at inception ($24,000 – $20,000 = $4,000) multiplied by (2) the lease receivable divided by the fair value of the leased asset at lease commencement ($18,829 ÷ $24,000 = 78%). In all other periods, profit equals periodic interest income on the lease receivable plus periodic accretion of the gross residual asset.

(d) Profit under the operating lease accounting model is equal to the annual lease payment ($4,500) less the annual depreciation expense of the leased asset ([$20,000 – $7,000] ÷ 5 = $2,600). That is, $1,900 = $4,500 – $2,600.

Appendix A — Other Lease Considerations

Reassessment of Lease Term

Under the ED, reassessment of the lease term would be required if relevant factors change so that a lessee would have, or no longer have, a significant economic incentive to renew or terminate the lease. When reassessing the lease term, an entity should consider factors that are similar to those it considered at lease commencement (i.e., contract-based, asset-based, market-based, and entity-specific factors). However, a change in market-based factors (such as a change in rental rates) would not in isolation trigger a reassessment.

When the lease term changes as a result of a reassessment, the entity would need to reassess the lease payments **and** the discount rate it applies to the lease payments. A reassessment would result in an adjustment to the lessee's ROU asset and obligation to make lease payments. A lessor would adjust the residual asset and lease receivable (using a revised discount rate), with an offset to net income.

The following example illustrates the proposed accounting under the financing and straight-line approaches for a lessee (1) on the lease commencement date and (2) upon a subsequent change in the lessee's expectations about whether there is a significant incentive to exercise a renewal option:

Example 3: Lessee Accounting, Including Reassessment of Renewal Options

Terms	
Lease term	10 years (5-year renewal option)
Payment years 1–5	$ 2,000,000
Payment years 6–10	$ 2,500,000
Renewal option years 11–15	$ 3,000,000
Concessions	None
Guaranteed residual value	None
Lessee's incremental borrowing rate[a] at lease commencement	7%
Lessee's incremental borrowing rate[a] on reassessment date	8%

Lessee Accounting for the Initial Lease Term (When the Renewal Option Will Not Be Exercised)

The lessee originally concluded that the lease term would be 10 years because it did not have a significant economic incentive to renew.

	Both Methods			Financing Approach (Type A)			Straight-Line Approach (Type B)		
Year	Payment	End-of-Year Lease Liability[b]	Interest Expense at 7% <X>	End-of-Year ROU Asset	Amortization Expense <Y>[d]	Lease Expense <X + Y>	End-of-Year ROU Asset	Amortization Expense[c] <Z − X>	Lease Expense <Z>
0		$15,508,855		$15,508,855			$15,508,855		
1	$ 2,000,000	14,594,475	$ 1,085,620	13,957,969	$ 1,550,886	$ 2,636,506	14,344,475	$ 1,164,380	$ 2,250,000
2	2,000,000	13,616,088	1,021,613	12,407,083	1,550,886	2,572,499	13,116,088	1,228,387	2,250,000
3	2,000,000	12,569,214	953,126	10,856,197	1,550,886	2,504,012	11,819,214	1,296,874	2,250,000
4	2,000,000	11,449,059	879,845	9,305,311	1,550,886	2,430,731	10,449,059	1,370,155	2,250,000
5	2,000,000	10,250,493	801,434	7,754,425	1,550,886	2,352,320	9,000,493	1,448,566	2,250,000
6	2,500,000	**8,468,028**	717,535	**6,203,539**	1,550,886	2,268,421	**7,468,028**	1,532,465	2,250,000
7–9	7,500,000	2,336,448	1,368,421	1,550,882	4,652,657	6,021,078	2,086,449	5,381,579	6,750,000
10	2,500,000	–	163,551	–	1,550,882	1,714,433	–	2,086,449	2,250,000
Total	$22,500,000		$ 6,991,145		$15,508,855	$22,500,000		$15,508,855	$22,500,000

The lessee made significant leasehold improvements at the end of year 6 and therefore reassessed the lease term. As a result of the reassessment, the lessee determined that there is now a significant economic incentive to exercise the renewal option at the end of year 10. The calculation below illustrates the accounting for the extended lease term.

Example 3 (continued): Lessee Accounting, Including Reassessment of Renewal Options

At the end of year 6:

Carrying amount of lease liability: $8,468,028

New present value of lease liability given the revised lease term: $17,084,600

The accounting entry on the reassessment date is as follows for both the financing approach and the straight-line approach:

Journal Entry	Debit	Credit
Leased asset	$ 8,616,572	
Leased liability		$ 8,616,572[e]

Lessee Accounting After Reassessment and Inclusion of Additional Renewal Option

	Both Methods			Financing Approach (Type A)			Straight-Line Approach (Type B)		
Year	Payment	End-of-Year Lease Liability[b]	Interest Expense at 8% <X>	End-of-Year ROU Asset	Amortization Expense[d] <Y>	Lease Expense <X + Y>	End-of-Year ROU Asset	Amortization Expense[c] <Z − X>	Lease Expense[f] <Z>
1–6	$12,500,000	$17,084,600		$14,820,114		$14,764,486	$16,084,600		$13,500,000
7	2,500,000	15,951,368	$ 1,366,768	13,173,435	$ 1,646,679	3,013,447	14,784,701	$ 1,299,899	2,666,667
8	2,500,000	14,727,477	1,276,109	11,526,756	1,646,679	2,922,788	13,394,143	1,390,558	2,666,667
9	2,500,000	13,405,676	1,178,198	9,880,077	1,646,679	2,824,877	11,905,674	1,488,469	2,666,667
10–12	8,500,000	7,731,292	2,825,616	4,940,039	4,940,038	7,765,654	6,731,292	5,174,382	7,999,998
13	3,000,000	5,349,795	618,503	3,293,360	1,646,679	2,265,182	4,683,128	2,048,164	2,666,667
14	3,000,000	2,777,778	427,984	1,646,680	1,646,680	2,074,664	2,444,445	2,238,683	2,666,667
15	3,000,000	–	222,222	–	1,646,680	1,868,902	–	2,444,445	2,666,667
Total	$37,500,000		$ 7,915,400		$14,820,114	$37,500,000		$16,084,600	$37,500,000

(a) Incremental borrowing rate is used because the rate the lessor charges the lessee is not known.

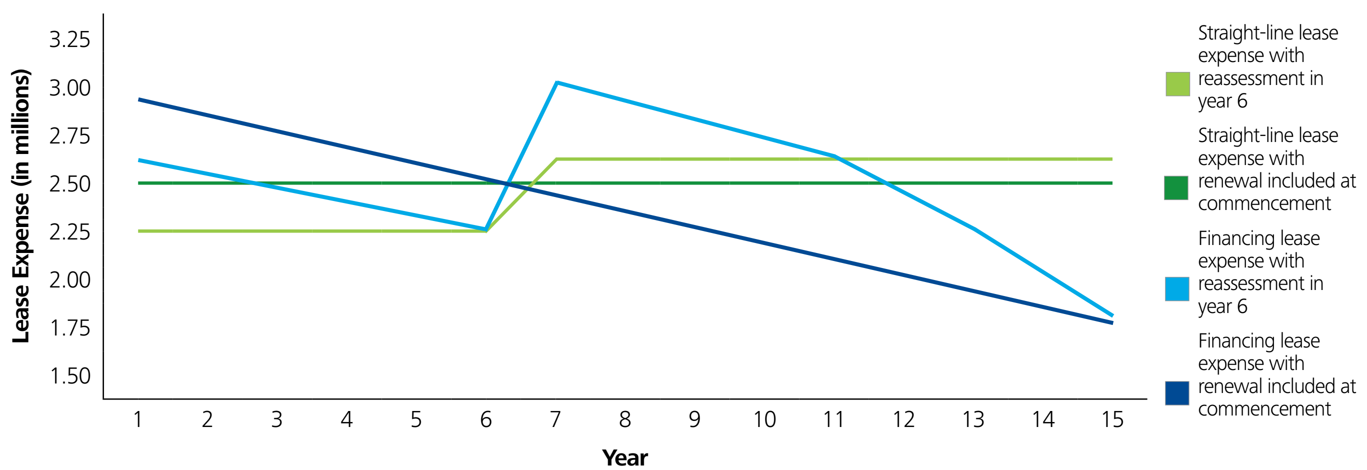
(b) The effective-interest method is used to calculate the lease liability, regardless of the expense recognition pattern.

(c) Under the straight-line method, amortization expense is calculated as the difference between lease expense and interest expense.

(d) Under the financing approach, the ROU asset would be amortized in the same manner as other nonfinancial assets.

(e) Amount calculated as the difference between the new present value of the lease liability and the carrying amount of the lease liability ($17,084,600 – 8,468,028).

(f) The revised straight-line expense is calculated as the total lease payments ($37,500,000) adjusted for the lease expense to date ($13,500,000) divided by the remaining lease terms (9 years). That is, $2,666,667 = ($37,500,000 – $13,500,000) ÷ 9.



Variable Lease Payments Based on an Index

As indicated in the lease payments section above, variable lease payments that are based on an index or rate would be included in the measurement of a lessee's ROU asset and lease obligation. In addition, entities would use the spot rate, rather than a forward rate, to measure such payments and the payments would be remeasured at the end of each reporting period. Lessees would recognize changes in the rate that relate to the current period through current income and any changes related to future periods would result in a change to the ROU asset and lease obligation. The lessee would not need to revise the discount rate as a result of a change in the consumer price index (CPI).

The following example illustrates the proposed accounting for a lessee when the lease payments increase on the basis of increases in the CPI:

Example 4: CPI Lease Payments

Terms	
Lease term	5 years (no renewal options)
Rate the lessor charges the lessee	7%
Lease type	Straight-line lease (Type B)
Annual lease payments	$2,000 (base amount) — adjusted for changes in the CPI (CPI adjustment)
The first lease payment was made on January 1. Each subsequent payment is made on December 31.	

Year	CPI	Payment	Liability[a]	Interest <A>	ROU Asset[b]	Amortization Expense <A − B>	Lease Expense[c] <B>
0	172	$ 2,000	$ 6,774		$ 8,774		
1	174	2,023	5,310	$ 474	7,333	$ 1,526	$ 2,000
2	175	2,035	3,679	371	5,714	1,652	2,023
3	177	2,058	1,923	258	3,982	1,777	2,035
4	178	2,070	–	135	2,070	1,923	2,058
5	180	–	–	–	–	2,070	2,070
Total		$ 10,186		$ 1,238		$ 8,948	$ 10,186

(a) The liability is measured at the present value of the remaining expected future lease payments (by using the CPI spot rate). At the end of year 1, the liability is adjusted by $85 ($7,333 – $7,248) to equal the present value of the four remaining lease payments of $2,023 each (with an offsetting adjustment to the ROU asset). Subsequently, the liability is adjusted for the payment made on December 31.

(b) The ROU asset is initially measured at the present value of the expected lease payments at the commencement of the lease (the present value of 5 payments of $2,000 (advanced lease payments)). In subsequent years, the ROU asset is adjusted for (1) changes in the lease liability that result from a change in CPI and (2) amortization expense. In year 1, the adjustment to the lease liability (and, accordingly, the ROU asset) as a result of the change in CPI is an increase of $85. That is, $7,333 = $8,774 – $1,526 + $85.

(c) The lease expense equals a pro rata portion of the undiscounted sum of total expected lease payments (adjusted for changes in the spot CPI rate) less the lease expense already recognized. These amounts are calculated at the beginning of each year. For year 2, the lease expense is calculated as a pro rata portion of the $10,092 expected total lease payments (1 payment of $2,000 and 4 payments of $2,023) less the amount of lease expense previously recognized ($2,000). That is, $2,023 = ($10,092 – $2,000) ÷ 4.

Purchase Options

Purchase options with a "significant economic incentive to exercise" would be included in lease payments. The expectation of whether a purchase option will be exercised should be reassessed in a manner consistent with the guidance on reevaluating renewal options. If the expectation changes, the lease payments and the discount rate must be revised. In addition, leases that include a purchase option with a significant economic incentive to exercise at lease commencement would be accounted for as a financing lease (lessees) or under the receivable and residual method (lessors).

Term Option Penalties

The boards concluded that the accounting for term option penalties should be consistent with the accounting for options to extend or terminate a lease. If a lessee would be required to pay a penalty for failure to renew the lease and the renewal period has not been included in the lease term, that penalty should be included in the recognized lease payments.

Subleases

The proposal would apply to leases of ROU assets in a sublease. When determining which lessor accounting model to apply to a sublease arrangement, an intermediate lessor should evaluate the transaction on the basis of the underlying leased asset, not the ROU asset. Similarly, the sublessee would determine whether to apply the financing or straight-line approach on the basis of the underlying leased asset. The assessment of which model the intermediate lessor and the sublessee should apply will therefore focus on the economic useful life and fair value of the underlying leased asset.

Editor's Note: Entity A (head lease lessee) enters into an agreement with a property lessor, Prop Co (head lease lessor), to lease property — consisting of land and a building with a remaining economic useful life of 20 years — for a 10-year period. Two years later, A enters into a sublease arrangement with Entity B (sublease lessee) to lease the entire property for the remaining eight-year period of the head lease. In the determination of which lessor accounting model to apply, the assessment will focus on the property (rather than on the ROU asset). In this case, because the sublease is not for a major portion of the property's remaining estimated useful life and the present value of the sublease payments does not account for substantially all of the fair value of the property, A would account for the sublease under the operating lease approach. Entity A would also continue to account for the head lease under the straight-line approach.

Residual Value Guarantees

Under the ED, the lessee should include the amounts expected to be paid under residual value guarantees, other than those provided by an unrelated third party, as lease payments. The lessor would only recognize amounts receivable under residual value guarantees as lease payments when the counterparty to the residual value guarantee also receives the benefits of the residual asset at the end of the lease term. In all other situations, the lessor would not recognize amounts expected to be paid under residual value guarantees until they are received; however, the lessor should consider residual value guarantees when assessing the residual asset for impairment.

Editor's Note: The accounting for residual value guarantees would be a significant change from current GAAP. For example, under current GAAP, a lessee must include the stated amount of a residual value guarantee, rather than the estimate of the deficiency, in the determination of its minimum lease payments. Accordingly, the amount of the lease payments (and therefore the lease asset and liability) may be less under the proposal than under the current capital lease requirements.

In addressing subsequent measurement, the ED proposes that the amounts expected to be payable under residual value guarantees included in the lessee's lease liability should be reassessed when events or circumstances indicate that there has been a change in the amounts expected to be payable. The change to the lessee's lease liability as a result of changes in estimates of residual value guarantees should be recognized as an adjustment to the ROU asset.

Embedded Derivatives

Lease contracts would be assessed for potential embedded derivatives in accordance with applicable U.S. GAAP on the bifurcation of embedded derivatives.

Foreign Exchange Differences

Foreign exchange differences related to the liability to make lease payments for leases denominated in a foreign currency would be recognized in profit or loss. This is consistent with the foreign exchange guidance in existing U.S. GAAP (ASC 830).

Build-to-Suit Leases

In build-to-suit lease arrangements, the lessee typically is involved with the construction of the asset. Under current guidance on accounting for build-to-suit arrangements, the lessee is sometimes deemed the accounting owner of the leased property. However, the ED would not retain the current guidance; rather, payments made by the lessee in connection with the construction of the asset would be accounted for in accordance with other applicable U.S. GAAP (e.g., inventories). In contrast, any payments made by the lessee for the right to use the asset (regardless of whether they are made during the construction period) would be accounted for as lease payments. In situations in which the lessee controls the underlying asset (e.g., the land on which the leased property will be constructed) before lease commencement, sale-and-leaseback accounting should be applied.

Sale-and-Leaseback Transactions

Because the ED eliminates off-balance-sheet accounting for leases, the boards believe that the structuring opportunities afforded by sale-and-leaseback transactions are minimized. Therefore, the ED proposes that entities should consult the guidance on revenue recognition to determine whether the conditions of a sale are met. When applying the proposed revenue recognition guidance to determine whether the underlying asset has been sold in a sale-and-leaseback transaction, an entity should evaluate the entire transaction. That is, the entity should consider that it will retain physical possession of the asset under the lease. However, the existence of the lease may not prevent the entity from accounting for the entire transaction as a sale and leaseback. Therefore, provided that the seller/lessee does not have "the ability to direct the use of and obtain substantially all of the remaining benefits from the asset," the transaction may qualify for sale-and-leaseback accounting rather than as a financing arrangement. If such conditions are met, the seller/lessee would use a "whole asset approach" in accounting for the transaction — derecognizing the entire underlying asset and recognizing the ROU asset associated with the leaseback. In addition, the ED proposes that if the consideration is at fair value, gains or losses would not be deferred.

Editor's Note: To address concerns related to sale-and-leaseback transactions that include a forward or a call or put option on the underlying asset, the boards decided as part of the revenue project that if the seller/lessee must or can repurchase the asset (forward or call option), the entity would conclude that a sale has not occurred and the transaction would be treated as a financing or lease. Similarly, if the purchaser/lessor has the option to put the asset back to the seller/lessee at a price lower than the original selling price (put option), and at the contract inception the purchaser/lessor has a significant economic incentive to exercise that right, the entity would also conclude that a sale has not occurred and the transaction would be treated as a lease. The boards indicated during their discussions on the revenue project that only substantive terms should be considered in the evaluation of the forward or the call or put option.

Lease Commencement Date

The ED proposes that at inception of a contract, both lessees and lessors would evaluate whether the contract contains a lease and identify the lease components. However, the initial measurement and recognition will be as of the lease commencement date rather than at lease inception. Any lease payments made by the lessee for the right to use the asset before the asset is available for use (commencement date) should be accounted for as prepayments for the ROU asset. These prepayments would then be added to the ROU asset on the commencement date.

In addition, the ED proposes that an entity would determine the lease classification at lease commencement. The entity would not be required to reassess its classification unless the lease is subsequently modified and accounted for as a new lease.

Modifications

Modifications that result in substantive changes would result in the derecognition of the existing contract and the recognition of a new lease as of the effective date of the modification. The difference in carrying amounts of the ROU asset and lease liability would be recognized through profit and loss.

Lease Termination

When a lease is terminated, the lessor would test the lease receivable for impairment in accordance with ASC 310. The lessor would reclassify the lease receivable and residual asset on the basis of the nature of the underlying asset (e.g., property, plant, and equipment).

Borrowing Costs

Entities would include interest expense incurred in a lease to determine the borrowing costs to be capitalized for qualifying assets. Accordingly, in calculating the "capitalization rate" applied to a qualifying asset, entities would include the interest expense recognized for finance leases. Because no interest expense is recorded for straight-line leases, these leases would not affect the capitalization rate.

Appendix B — Presentation and Disclosure Requirements

Presentation — Lessee

Under the ED, ROU assets and lease liabilities would be presented separately from other assets and liabilities in the statement of financial position or disclosed separately in the notes. An entity should separate the ROU assets and lease liabilities for leases that it accounts for as a finance lease from those it accounts for as a straight-line lease. If a lessee opts not to present the ROU assets and lease liabilities separately in the statement of financial position, the ROU asset should be classified consistently with owned assets that are similar to the underlying asset associated with the lease and the lessee should disclose the line item that includes these amounts.

For leases accounted for under the financing approach, the entity would present interest and amortization separately in the statement of comprehensive income. Conversely, if the entity accounts for a lease under the straight-line approach, the entity would present a single-line expense (including both the interest and amortization).

A lessee's presentation in the statement of cash flows is also based on the lease classification. For leases classified under the financing approach, the payment of cash toward principal would be treated as a financing activity and the payment of cash toward interest would be treated as an operating activity in accordance with applicable U.S. GAAP. Cash paid for (1) leases under the straight-line approach, (2) variable payments, and (3) short-term leases would be classified as operating activities in the statement of cash flows. In addition, ROU assets that are acquired in exchange for lease liabilities would be disclosed as a supplemental noncash transaction.

Editor's Note: Constituents have expressed concerns about the potential effect of the two different approaches on the presentation of leases in the financial statements. Specifically, questions have arisen about whether the use of different approaches would ultimately simplify current lease accounting. For example, a lessee may be required to use two different approaches (i.e., financing and straight-line) to account for leases of similar underlying assets (e.g., two different real estate properties). Depending on the lease classification, some leases would be presented as a single-line expense in the statement of comprehensive income (i.e., straight-line leases) while others would be presented as a separate interest and amortization expense (i.e., financing leases). In addition, the classification would affect how the lease is presented in the statement of cash flows, which could be confusing to financial statement users. We expect that constituents will raise these concerns in comment letters to the boards on the ED.

Disclosure — Lessee

Lessees would be required to disclose certain information, including:

- A reconciliation of the beginning and ending balances of the lease liability under both the finance and the straight-line approaches (i.e., a separate rollforward of the lease liability under each approach). Private companies would be exempt from disclosing this information.
- A single maturity analysis of the liabilities to make lease payments. The analysis should include the undiscounted cash flows for all leases and should be reconciled to the total lease liability.
- The maturity of contractual commitments associated with services and other nonlease components.
- Expenses related to variable lease payments (those not included in the lease liability).

Presentation — Lessor

Under the receivable and residual approach, lease receivables and residual assets would be presented separately in the statement of financial position or disclosed in the notes. Both amortization of the lease receivable under the effective-interest method and accretion of the residual asset would be presented as interest income in the statement of comprehensive income. These amounts would be presented separately from nonlease income in the statement of comprehensive income or disclosed in the notes. Cash inflows from a lease would be classified as an operating activity in the statement of cash flows.

Disclosure — Lessor

The more significant disclosure requirements for lessors include:

- A tabular disclosure of lease-related income, including (1) profit recognized at lease commencement, (2) interest income on the lease receivable, (3) interest income on the residual asset, (4) variable lease income, (5) short-term lease income, and (6) income resulting from operating lease payments.

- Information about the basis and terms on which variable lease payments are determined.
- Information about the existence and terms of options, including renewal and termination options.
- A qualitative description of purchase options in leasing arrangements, including information about the extent to which the entity is subject to such agreements.
- A maturity analysis of the undiscounted cash flows separately for receivable and residual leases and operating leases. The maturity analysis should show, at a minimum, the undiscounted cash flows to be received in each of the first five years after the reporting date and a total of the amounts for the years thereafter.
- Information about how the entity manages its exposure to the underlying asset, including (1) its risk management strategy, (2) the carrying amount of the residual asset that is covered by residual value guarantees, and (3) whether the lessor has any other means of reducing its exposure to residual asset risk (e.g., buyback agreements with the manufacturer from whom the lessor purchased the underlying asset or options to put the underlying asset back to the manufacturer) for receivable and residual leases.
- For receivable and residual leases, a lessor should disclose a reconciliation of the opening and closing balances of the lease receivable and residual asset.

Appendix C — Transition

Lessees

The ED proposes that lessees with existing capital leases could either carry forward the amounts recorded as of the date of initial application (amounts would be reclassified as ROU assets and obligations to make lease payments) or apply a full retrospective approach to those leases. Lessees who carry forward the amounts recorded as of the date of initial application would still be subject to the ED's presentation and disclosure requirements (i.e., the lessee would be required to classify its former capital leases as a financing lease and apply all of the applicable presentation and disclosure guidance).

Editor's Note: Any modifications that result in substantive changes to the contractual terms or conditions of a lease, when the lessee has elected to carry forward the amounts recorded for a capital lease under the transition requirements, might cause the contract to be considered a new lease. In such cases, the lessee would need to account for the revised lease under the new lease guidance.

For operating leases, a lessee would first need to determine which approach it will subsequently apply when accounting for the lease. If it applies the financing approach, the lessee may use a full retrospective approach or the following modified retrospective approach at the beginning of the earliest comparative period presented:

- Recognize a liability to make lease payments, measured as the present value of the remaining lease payments and discounted by the lessee's incremental borrowing rate as of the transition date (nonpublic entities would be allowed to make an accounting policy election to use the risk-free discount rate).
- Recognize an ROU asset calculated as if the remaining lease payments represent the lease payments throughout the life of the lease and then weighted for the remaining term of the lease.
- Apply any asset or liability resulting from uneven lease payments to the ROU asset.
- Record any difference to retained earnings.

For operating leases that would be subject to the straight-line approach, the lessee could apply a full retrospective approach or apply the following modified retrospective approach at the beginning of the earliest comparative period presented:

- Recognize a liability to make lease payments, measured as the present value of the remaining lease payments discounted by the lessee's incremental borrowing rate as of the transition date.
- Recognize an ROU asset equal to the related liability to make lease payments.
- Apply any asset or liability resulting from uneven lease payments to the ROU asset.

The following example demonstrates how a lessee would calculate the ROU asset and lease liability under the financing and straight-line approaches in accordance with the boards' proposed transition provisions:

Example 5: Lessee Transition

A lease with the following terms was previously accounted for as an operating lease:

Terms	
Lease term	10 years
Adoption date	Beginning of year 7 (4 years remaining)
Lease payments	$100: years 1 through 5; $120: years 6 through 10 (payments occur at the end of the year)
Discount rate	10% (at both lease inception and adoption of the proposed guidance)

	Financing Approach				Straight-Line Approach			
	Lease Liability[a]	ROU Asset	Reversal of the Straight-Line Accrual[f]	Retained Earnings	Lease Liability[a]	ROU Asset	Reversal of the Straight-Line Accrual[f]	Retained Earnings
Full retrospective	$ 380	$ 265[b]	$ 40	$ 75	$ 380	$ 340[d]	$ 40	–
Modified retrospective	380	255[c]	40	85	380	340[e]	40	–

(a) The lease liability is calculated at the present value of the remaining lease payments ($120 for 4 years discounted at 10%).

(b) The ROU asset under the full retrospective approach (financing) is calculated in proportion (4 of 10 years remaining) to the initial ROU asset (present value of actual payments or $662). That is, $265 = $662 × 4/10.

(c) The ROU asset under the modified retrospective approach (financing) is calculated in proportion (4 of 10 years remaining) to the "hypothetical" initial ROU asset. The "hypothetical" initial ROU asset is the present value of the lease payments for the entire lease term (10 years) provided that future payments were in place for the entire lease term (i.e., present value of $120 lease payments for 10 years discounted at 10% or $737). The lessee would also need to adjust the ROU asset for any previously recognized prepaid or accrued lease payments (in this case, a reduction to the ROU asset for the straight-line accrual of $40). That is, $255 = ($737 × 4/10) – $40.

(d) The ROU asset under the full retrospective approach (straight-line) is calculated by taking the initial ROU asset (present value of the actual lease payments or $662) and adjusting the asset for the 6 years of amortization ($321) to record an straight-line expense of $110 per year.

(e) The ROU asset under the modified retrospective approach (straight-line) is set at an amount equal to the lease liability. The lessee would adjust the ROU asset for any previously recognized prepaid or accrued lease payments (in this case, a reduction to the ROU asset for the straight-line accrual of $40). That is, $340 = $380 – $40.

(f) This amount represents the liability created as a result of the increasing lease payments over the lease term for leases accounted for as an operating lease under the current provisions in ASC 840. The amount is calculated as the difference between the annual lease expense of $110 (total lease payments of $1,100 for 10 years) for 6 years or $660 and the total lease payments for 6 years of $620.

Lessors

Lessors may apply a full retrospective approach. Alternatively, for leases previously classified as sales-type and direct financing leases, lessors can reclassify as a lease receivable the carrying amount of the lease investment just before the earliest presented period. A lessor would also still need to apply the ED's presentation requirements.

For prior operating leases that are now determined to be a receivable and residual lease, lessors would:

- Recognize a lease receivable asset, measured as the present value of the remaining lease payments discounted by the rate the lessor charges the lessee at lease commencement (adjusted for any previously recognized impairment charges).
- Recognize a residual asset measured under the proposed measurement provisions of the lessor receivable and residual model on the basis of information available for the earliest comparative period presented.
- Derecognize the leased asset and any asset or liability resulting from uneven lease payments.

The ED does not carry forward the existing guidance on leveraged leases. Lessors would apply a full retrospective approach to leveraged leases.

Sale-and-Leaseback Transactions

For a sale-and-leaseback transaction that resulted in a capital lease, a seller/lessee would:

- Not reevaluate the sale recognition conclusion previously reached.
- Not remeasure lease assets and lease liabilities previously recognized on the balance sheet.
- Continue to amortize any deferred gain or loss on the sale over the lease term in the income statement.

A seller/lessee would do the following for a sale-and-leaseback transaction that resulted in operating lease classification or if the sale recognition criteria previously were not met:

- Reevaluate the sale conclusion previously reached on the basis of the criteria in the proposed revenue recognition standard. If the sale criteria are met, a seller/lessee would measure lease assets and lease liabilities in accordance with the proposed lessee model and recognize any deferred gain or loss in opening retained earnings upon transition to the new lease guidance.
- If, as a result of the reevaluation, the sale criteria are not met, the entire transaction would be accounted for as a financing.

The seller/lessee could also elect to apply a full retrospective approach.

Other Transition Requirements

The ED does not provide transition guidance on short-term leases, subleases, useful lives of leasehold improvements, build-to-suit leases, and in-substance purchases and sales.

Lessors that had previously securitized lease receivables from operating leases would continue to account for the securitization as a secured borrowing.

The ED also does not retain the transition exception in ASC 840-10 (formerly EITF Issue 01-8[3]), under which certain transactions are grandfathered and are not subject to an evaluation pursuant to the Issue 01-8 framework unless they were subsequently modified. Accordingly, an entity will need to evaluate arrangements that previously may not have been analyzed under the guidance on the definition of a lease.

For existing favorable and unfavorable operating leases acquired through business combinations, lessees would, upon transition, derecognize the associated assets and liabilities and book an offsetting adjustment to the ROU asset. Lessors applying the receivable and residual model would record the offsetting adjustment to retained earnings.

Transition Relief

To ease the burden of an entity's adoption of the new standard, the ED allows some transition relief, including:

- Not requiring inclusion of initial direct costs in the measurement of the ROU asset (from the lessee's perspective) or the lease receivable (from the lessor's perspective) for leases commencing before the final standard's effective date.
- Allowing the use of hindsight in the preparation of comparative information, including the determination of whether a contract is or contains a lease.

[3] EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."

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