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Heads Up

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Path of Lease Resistance? Recap of Lease Redeliberation Results

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In August 2010, the IASB and FASB (the "boards") issued an exposure draft (ED) that would fundamentally change the accounting for lease arrangements. On the basis of feedback received from comment letters, roundtables, and outreach sessions, the boards have made many significant changes to the proposals in the ED and therefore have decided to reexpose the proposed lease accounting guidance for comment.

Although the boards have not discussed a potential effective date for the final lease standard, they did discuss effective dates pertaining to the revenue project and noted that such dates would not be earlier than January 1, 2015. The lease project is a few months behind the revenue project; however, we would expect the timeline for the lease project to be similar.

This *Heads Up* summarizes the current tentative decisions related to the lease project.

Editor's Note: We expect that the boards will attempt to complete their redeliberations of the lease project at their September 2011 joint meetings, with a goal of issuing the revised ED in November for a 120-day comment period. A final standard is expected to be issued in mid to late 2012. This timeline makes it more likely that the effective date would be 2016, particularly given the current transition requirements, which mandate a form of retrospective adoption.

Note that all the boards' decisions are tentative until the proposed standard is finalized. For example, we expect that on the basis of the comments they will receive during the reexposure period, the boards may further consider their decisions regarding the definition of a lease, contingent rentals, and the lessor model. Although there is concern that certain decisions — particularly those related to the accounting for contingent rentals and the impact of the lessor's right of substitution on whether an arrangement contains a lease — could present structuring opportunities, the boards will need to consider the cost of implementing more complex measurements as well as whether market factors could inherently limit such structuring opportunities. In addition, it is unclear whether investors and analysts will consider the single lessor model to represent an improvement over current lessor accounting, particularly for real estate lessors that are not within the scope of the proposed investment property guidance and other lessors that currently apply operating lease accounting.

In a Nutshell

The table below highlights the most significant provisions of the proposed lease accounting model and compares the recent decisions with the guidance proposed in the August 2010 ED. The table is followed by a more detailed discussion of these provisions along with various other aspects of the models.

Issue	August 2010 ED	Updated Decision
Lessee accounting — right-of-use model	• The lessee recognizes an asset and a liability for all lease contracts. • The 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.	• The ED's right-of-use model is reaffirmed.
Scope	• Overall, similar to scope in current U.S. GAAP.	• The scope in the ED is reaffirmed, with only minor edits.
Definition of a lease	Retained the guidance in Issue 01-8[1] and IFRIC 4:[2] • An arrangement contains a lease if: o Specific property, plant, and equipment (PP&E) is identified. o The fulfillment of the arrangement depends on the identified PP&E. o The arrangement conveys to the lessee the right to use the identified PP&E. • Right to use is conveyed if the right to control the use of the underlying asset is conveyed by: o Ability or right to operate the asset. o Ability or right to control physical access. o Ability to obtain all but an insignificant amount of the output.	• Retains the concept that an asset must be identifiable either explicitly (e.g., by a specific serial number) or implicitly. • The concept of control would be similar to that proposed in the revenue recognition project. • A contract would convey the right to control the use of a specified asset if the customer has the ability to direct, and receive benefits from, the use of that asset. • Obtaining all the outputs, in isolation, is no longer determinative. • If an asset is inseparable from the services requested by the customer, the entire arrangement would be accounted for as a service.
Lease term	• The longest possible term that is more likely than not to occur, including options to renew. • Required probability assessment and reassessment when there is a significant change in the facts and circumstances.	• Noncancelable term plus renewal options if there is a significant economic incentive for an entity to exercise an option to extend the lease. • Entities should consider contract-based, asset-based, market-based, and entity-based factors when assessing whether there is a significant economic incentive. • Requires reassessment of lease term when relevant factors change significantly (i.e., lessee would have or no longer have significant economic incentive to renew). Market-based factors are not considered during reassessment.
Lease payments	• Entities measure lease payments, including contingent payments, by using an expected outcome approach.	• Initial measurement would only include variable payments: o Based on an index or rate (using the index or rate at lease commencement). o That are in-substance fixed lease payments (e.g., lease contains disguised fixed lease payments). • Lease payments that depend on an index or a rate should be reassessed by using the index or rate that exists at the end of each reporting period.
Subsequent measurement — profit and loss (P&L) recognition	• Rent expense is no longer recognized and is replaced with interest expense and amortization. • The liability is amortized by using the interest method and the right-of-use asset will typically be amortized on a straight-line basis. • Total expense in the earlier years is higher than under current operating lease accounting (typically straight-line expense) because higher interest expense is recognized in the earlier years.	• The boards reaffirmed the subsequent measurement method and the P&L recognition pattern.

[1] EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."
[2] IFRIC 4, *Determining Whether an Arrangement Contains a Lease.*

Issue	August 2010 ED	Updated Decision
Lessor accounting	• Hybrid or dual model. • If lessor retains exposure to significant risks or benefits related to the underlying asset, performance obligation is used. • If significant exposure is not retained, derecognition is used.	• A single lessor accounting model should apply to all leases. • A receivable and residual approach is used that is similar to the derecognition approach in the ED. • The lessor would derecognize the underlying asset and recognize: o A lease receivable measured as the present value of the lease payments. o A residual asset measured on an allocated-cost basis (measurement will depend on whether profit is reasonably assured).

Lessee Accounting — Right-of-Use Model

The boards reaffirmed the ED's overall model in which all leases are treated as a financing transaction and recognized on the balance sheet. In addition, the boards reaffirmed that lessees should apply a single model, the right-of-use model, to all leases that are within the scope of the proposed guidance. A lessee would recognize an asset for the right to use the underlying asset and a liability to make lease payments.

Scope

The boards essentially reaffirmed the scope of the ED (which was generally consistent with current accounting), with only a few small changes. The boards decided that entities are not required to account for leases of intangibles in accordance with the proposed leasing guidance. In addition, the following are not within the scope of the leasing standard:

- Leases for the right to explore for or use minerals, oils, natural gas, and similar nonregenerative resources.
- Leases of biological assets, including timber.

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The boards determined that they need to perform further analysis to decide whether inventory and internal-use software (under ASC 350-40-25-16,[3] entities must apply ASC 840 by analogy in determining whether the present value of software license installment payments should be capitalized) are within the scope of the proposed leasing guidance. They are expected to make a decision on this issue before releasing the ED.

Short-Term Leases

The ED had proposed guidance on how lessees and lessors should account for a short-term lease (defined as a lease that has a maximum possible lease term, including options to renew, of 12 months or less). Under the ED, a lessor that has a short-term lease can elect, on a lease-by-lease basis, not to recognize a lease receivable or a liability; however, the lessor would continue to recognize the underlying asset and to recognize lease payments in the income statement over the lease term. A lessee would still record a lease-related asset and liability on the balance sheet but would record them at an undiscounted amount. Several respondents expressed concern that the ED's exception for short-term leases for lessees was not consistent with that for lessors and that the lessee exception did not provide entities with significant relief.

Accordingly, the boards tentatively decided to allow lessors and lessees to account for leases that have a maximum possible lease term of 12 months or less, including any options to renew, by not recognizing lease assets or lease liabilities and by recognizing lease payments in profit or loss as rental income or expense on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset (i.e., a short-term lease could essentially be treated as an operating lease). Furthermore, entities would no longer make this decision on a lease-by-lease basis; rather, they would make an accounting policy election on the basis of asset class.

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

The boards also tentatively decided to require the disclosure of rental expense associated with short-term leases in each reporting period.

Editor's Note: The boards did not significantly change the ED's definition of a short-term lease. Therefore, we believe that even month-to-month leases — in which a lessee has the unilateral right to continue using the leased asset on a month-to-month basis at the end of the contractual lease term — would not meet the definition of a short-term lease.

Definition of a Lease

The ED primarily retained the guidance in Issue 01-8 and IFRIC 4 on distinguishing between a service contract and a lease contract. That guidance requires lease accounting if an arrangement conveys the right to control the use of a specific asset. Although this guidance exists under current GAAP, the decision to record leases on the balance sheet brought this issue to the forefront. Constituents expressed concern that this definition of a lease was too broad and that many service arrangements would be within the scope of the proposed lease guidance.

The boards spent considerable time redeliberating the definition of a lease and have decided to significantly change this definition. However, they are retaining the ED's concept that a specified asset must be either explicitly (e.g., by a specific serial number) or implicitly identifiable. This concept is consistent with current GAAP and would also require an analysis of a lessor's right to substitute assets, which could result in a conclusion that an arrangement does not contain a lease if it is practical and economically feasible for the owner to substitute alternative assets and the owner can do so without the customer's consent. The boards may provide additional guidance on substitution of the asset by the lessor in the final standard.

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In addition, the boards tentatively decided that the underlying asset can be a physically distinct portion of a larger asset (e.g., a floor of a building) if that portion is explicitly or implicitly specified. A capacity portion of a larger asset that is not physically distinct (e.g., 50 percent of a pipeline) is not a specified asset.

The boards decided that the concept of control will be similar to that in the proposed revenue recognition project — that is, a contract would convey the right to control the use of a specified asset if the customer has the ability to direct the use, and receive benefits from use, of that asset. Such benefits would include economic benefits that arise directly from the use of the asset, such as renewable energy credits and secondary physical output, but would exclude income tax benefits.

The ability to direct the use of a specified asset includes determining how, when, and in what manner the specified asset is used. If the customer can specify the output or benefit from the use of the asset but is unable to make decisions about the input or process that results in that output, the ability to specify the output would not, in and of itself, automatically mean that the customer has the ability to direct the use of the asset.

In addition, the boards tentatively decided that in situations in which a supplier directs how an asset is used to perform services for a customer, the customer and supplier must assess whether the use of the asset is separable from the services provided to the customer. If the asset is separable, the arrangement could contain a lease. However, if the use of an asset is an inseparable part of the services requested by the customer, the arrangement would not be accounted for as a lease. The staff provided indicators for use in determining whether the asset is separable (e.g., whether the asset is sold or leased separately by the supplier and whether the customer can use the asset on its own or together with other resources available to the customer).

Editor's Note: We believe that the boards' revised definition of the right to control the use of an asset represents a significant change from the Issue 01-8 model, as illustrated by some of the application examples in the board memos. The change in definition could significantly reduce the number of take-or-pay and supply contracts subject to lease accounting since it appears to remove the notion that an arrangement contains a lease simply because the purchaser obtains all but an insignificant amount of the output of an asset. This is illustrated in the staffs' examples concerning application of the tentative conclusion to a power purchase arrangement that were presented at the April 12 and 13, 2011, board meetings.[4] In addition, the tentative decision would appear to change the conclusion for the gas supply contract in Example 1 of Issue 01-8 (which means that neither of the application examples in Issue 01-8 contains a lease).

Inception Versus Commencement

The ED had proposed that a lease arrangement be measured as of the lease inception date[5] and then recognized at lease commencement.[6] The boards believed that measuring the assets and liabilities at inception would capture the nature of the transaction. However, there was some concern that gains and losses could develop between inception and commencement and that assumptions regarding renewal and purchase options or contingent rent could change between the two dates, which could lead to accounting changes before lease commencement. To simplify this accounting, the boards tentatively decided that initial measurement and recognition will both be as of the date of commencement of the lease rather than at lease inception.

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Editor's Note: The requirement to measure the lease at lease commencement as opposed to lease inception means that the lessee would use its incremental borrowing rate as of lease commencement rather than at lease inception (if the lessee does not know the rate the lessor is charging the lessee). This is a change from current GAAP.

Lease Term — Accounting for Renewal Options

The ED proposed that the lease term be measured as the "longest possible term that is more likely than not to occur," including options to renew. Comment letters expressed almost unanimous opposition to this measurement method. The boards agreed with many of the concerns raised in the comment letters and tentatively decided on the use of a higher threshold to define the lease term.

The proposed language would require the lease term to be the noncancelable period and would only include renewal periods in the lease term if there is a significant economic incentive for an entity to exercise an option to extend the lease. The criteria entities would use to determine whether there is a significant economic incentive are generally similar to those in current guidance on identifying when renewal periods should be included in the lease term.

The boards have identified the following factors for entities to consider at lease commencement when evaluating whether they have a significant economic incentive to renew:

- *Contract-based* — Terms included in 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* — 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* — Market rentals for comparable assets.

[4] Examples 6 and 7 in the appendix of IASB Memo 1D and FASB Memo 158.

[5] The ED defines "date of inception of the lease" as the "earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement."

[6] The ED defines "the date of commencement of the lease" as the "date on which the lessor makes the underlying asset available for use by the lessee."

- *Entity-specific* — The historical practice of the entity, management's intent, and common industry practice.

The boards decided to require reassessment of the lease term when the relevant factors change so significantly that a lessee would have, or no longer have, a significant economic incentive to renew. However, changes in market rates should be considered only during the initial determination of the lease term at lease commencement, not during reassessment. Changes in lease payments that are due to a reassessment would result in a lessee's adjusting its obligation to make lease payments and its right-of-use asset, as illustrated in the example below. The discount rate would also be reassessed when there is a change in lease payments that is due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease.

The boards decided to require reassessment of the lease term when the relevant factors change so significantly that a lessee would have, or no longer have, a significant economic incentive to renew.

Editor's Note: The boards' tentative decision replaces the ED's much-maligned "FIN 48–like" approach to assessing the lease term. The revised guidance more closely aligns with current GAAP. However, we understand that entities may have concerns with the practicality of applying some of the factors, particularly when performing a reassessment.

Consider an example in which an entity enters into a lease agreement that includes fixed-rate renewal options. At lease commencement, the entity determines that the renewal options are not a bargain renewal and therefore does not include these in the initial lease term. At some point during the lease term, the renewal options become a significant bargain as a result of market fluctuations. Although the proposed guidance states that market-based factors should not be considered as part of the reassessment, management's intent would be considered. Certainly, the market rates would factor into management's intent and therefore might be difficult to exclude. At their meetings, the boards also debated when an entity would be expected to conclude that a significant economic incentive exists to exercise a fair value renewal option. We expect the boards to further discuss these topics during their redeliberations.

In addition, while the boards' higher threshold (relative to the ED) for including renewal options might provide some relief, the requirement to reassess the lease term will continue to represent a challenge for many entities. Although a higher threshold reduces some of the burden of reassessment, it still puts the onus on preparers to either perform a continual reassessment or establish a robust list of "renewal indicators." This will be particularly challenging for companies whose lease and real estate decisions are not centralized (e.g., some multinational companies).

Example 1: Lessee Accounting Including Reassessment of Renewal Options

The following examples illustrate the application of the right-of-use model for a lessee on the lease commencement date and subsequently when there is a change in the lessee's expectations about whether there is a significant economic incentive to exercise a renewal option.

Fact Pattern	
Lease term	10 years
Annual payments in years 1–5	$2,000,000
Annual payments in years 6–10	$2,500,000
Renewal option years 11–15	$3,000,000
Concessions	None
Guaranteed residual value	None
Purchase option	None
Lessee's incremental borrowing rate at lease commencement*	7%
Lessee's incremental borrowing rate on reassessment date	8%

* Incremental borrowing rate is used because the rate the lessor charges the lessee is not known in this example.

Example 1: Lessee Accounting Including Reassessment of Renewal Options (continued)

Lessee Accounting for the Initial Lease Term[7]

Year	Payment	End-of-Year Right-of-Use Asset	End-of-Year Lease Liability	Amortization Expense	Interest Expense at 7%	Principal Portion of Lease Payment	Lease Expense
0		$ 15,508,855	$ 15,508,855				
1	$ 2,000,000	13,957,970	14,594,475	$ 1,550,885	$ 1,085,620	$ 914,380	$ 2,636,505
2	2,000,000	12,407,084	13,616,088	1,550,886	1,021,613	978,387	2,572,499
3	2,000,000	10,856,199	12,569,214	1,550,885	953,126	1,046,874	2,504,011
4	2,000,000	9,305,313	11,449,059	1,550,886	879,845	1,120,155	2,430,731
5	2,000,000	7,754,428	10,250,493	1,550,885	801,434	1,198,566	2,352,319
6	2,500,000	6,203,542	8,468,028	1,550,886	717,535	1,782,465	2,268,421
7	2,500,000	4,652,657	6,560,790	1,550,885	592,762	1,907,238	2,143,647
8	2,500,000	3,101,771	4,520,045	1,550,886	459,255	2,040,745	2,010,141
9	2,500,000	1,550,886	2,336,448	1,550,885	316,403	2,183,597	1,867,288
10	2,500,000	–	–	1,550,886	163,552	2,336,448	1,714,438
Total	$ 22,500,000			$ 15,508,855	$ 6,991,145	$ 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.

At the end of year 6:

Carrying amount of lease asset: $6,203,542 (see table above).

Carrying amount of lease liability: $8,468,028 (see table above).

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

(See table below. Note that the new present value of year 7 to year 15 payments is computed at the new incremental borrowing rate of 8 percent.)

The accounting entry on the reassessment date is as follows:

	Debit	Credit
Leased asset	$ 8,616,572*	
Leased liability		$ 8,616,572
To record the impact of the reassessment of the renewal option ($17,084,600 – $8,468,028).		

* In a manner consistent with the ED, changes in lease payments that are due to a reassessment would result in a lessee's adjusting its obligation to make lease payments and the right-of-use asset would be adjusted to reflect any change in the liability to make lease payments. In other words, the lease asset and liability would generally be adjusted by the same amount when a renewal period is added to the measurement.

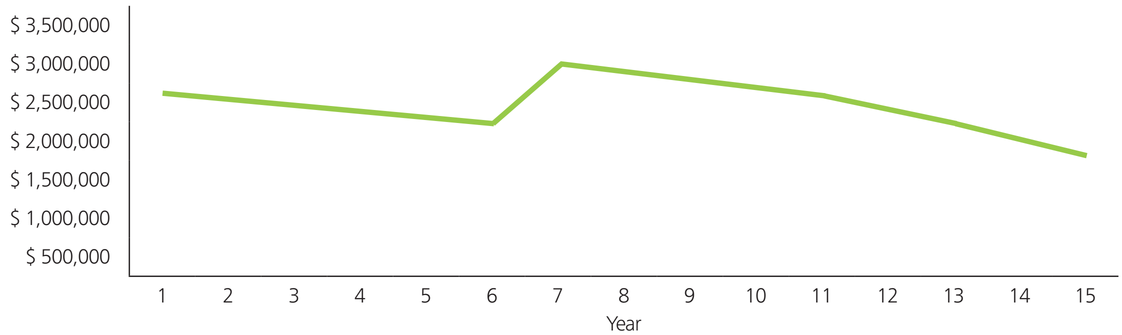
Lessee Accounting After Reassessment and Inclusion of Additional Renewal Option

Year	Payment	Right-of-Use Asset	Lease Liability	Amortization Expense	Interest Expense at 8%	Principal Portion of Lease Payment	Lease Expense
		$ 14,820,114	$ 17,084,600				
7	$ 2,500,000	13,173,435	15,951,368	$ 1,646,679	$ 1,366,768	$ 1,133,232	$ 3,013,447
8	2,500,000	11,526,755	14,727,477	1,646,680	1,276,109	1,223,891	2,922,789
9	2,500,000	9,880,076	13,405,676	1,646,679	1,178,199	1,321,801	2,824,878
10	2,500,000	8,233,397	11,978,130	1,646,679	1,072,454	1,427,546	2,719,133
11	3,000,000	6,586,717	9,936,380	1,646,680	958,250	2,041,750	2,604,930
12	3,000,000	4,940,038	7,731,290	1,646,679	794,910	2,205,090	2,441,589
13	3,000,000	3,293,359	5,349,794	1,646,679	618,504	2,381,496	2,265,183
14	3,000,000	1,646,679	2,777,778	1,646,680	427,984	2,572,016	2,074,664
15	3,000,000	–	–	1,646,679	222,222	2,777,778	1,868,901
Total	$ 25,000,000			$ 14,820,114	$ 7,915,400	$ 17,084,600	$ 22,735,514

[7] The lessee has determined that it does not have a significant economic incentive to exercise the renewal option at lease commencement.

Example 1: Lessee Accounting Including Reassessment of Renewal Options (continued)

The following chart illustrates the expense impact over the life of the lease, including reassessment:



Editor's Note: The example illustrates that the front loading of lease expense restarts when a renewal option is added to the liability measurement after lease commencement. If the renewal option was included in the original measurement, the initial lease liability would have been higher but the lease expense would be spread over the longer term (i.e., including the renewal in the initial measurement provides a smoother expense pattern).

Lease Payments

The ED would have required the use of a probability-weighted expected outcome approach to estimate lease payments that include contingent rentals. Many respondents to the ED objected to this proposal, noting that the approach could add significant earnings volatility and would be costly to implement.

On the basis of both this feedback and that from the staffs' outreach efforts, the boards tentatively concluded that the initial measurement would only include variable payments (1) based on an index or rate or (2) that are in-substance fixed lease payments (e.g., the lease contains disguised fixed lease payments). In addition, the boards agreed that entities should use the spot rate, rather than a forward rate, to measure variable payments related to an index or rate.

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

The boards also decided that the measurement of the variable lease payments that depend on an index or rate should be reassessed by using the index or rate that exists at the end of each reporting period. A lessee will recognize these changes in current income to the extent that they relate to current periods and as an adjustment to the right-of-use asset when they relate to a future period. Some board members expressed concerns about how a lessor would recognize changes and instructed the staffs to consider the issue and present their findings to the boards at a future meeting.

Editor's Note: The boards directed the staffs to perform further work on the concept of disguised fixed lease payments. On the basis of our observations at the board meetings, we believe that the concept the boards are working toward consists of the identification of situations in which a lease provision is structured solely to enable the exclusion of rental payments from the right-of-use asset and lease liability (i.e., abusive situations in which there is no economic reason for the contingent rental provision other than the avoidance of booking the payments or the escalation of payments as a liability).

An example of how this type of concept is applied under current GAAP is a situation in which a lease establishes a lessee's base rent in the first year and increases the rent in each subsequent year to an amount calculated as the lesser of (1) a stated fixed rental amount or (2) the original rental amount increased by a percentage equal to the consumer price index multiplied by five. In this situation, there does not seem to be any economic reason for the leverage factor, and it appears virtually certain that the future lease payments will be capped at the fixed amounts. Therefore, the stated fixed rental amounts would be included in minimum lease payments.

Editor's Note (continued): This is different from a scenario in which rentals vary entirely on the basis of usage or sales (i.e., specified dollar amount of rent per copy in a copier lease or per mile in an automobile lease with no minimum usage requirements). However, it remains to be seen how the boards will decide to articulate this principle in the final standard since board members appear to have different views on its application.

Example 2: Variable Lease Payments Indexed to Consumer Price Index

This example illustrates the requirement to reassess variable lease payments that are based on an index. The boards tentatively decided that entities should use the index that exists at the end of each reporting period, rather than a forward rate, to reassess variable payments related to an index. Therefore, at the end of each reporting period, entities would remeasure the lease liability by using the index at the end of the reporting period. This example illustrates the impact that this reassessment would have had throughout the entire lease term on the basis of the actual indices.

A lessee enters into a lease of a retail space for a seven-year term. The base rent is $100,000 per year and will be adjusted each year for the change in the consumer price index (CPI) since lease commencement. At lease commencement, the CPI is 172. The incremental borrowing rate at lease commencement is 8 percent.

The following tables summarize the lessee's right-of-use asset, lease liability, and lease-related expenses throughout the lease term, which include the effects of reassessment as a result of the change in CPI.

Year	Base Rent Payments	CPI	Actual Payments	Ending Right-of-Use Asset	Ending Lease Liability	Amortization Expense (A)	Interest Expense at 8% (B)	Additional Variable Lease Expense (C)	PV of Additional Variable Lease Expense*	Total Lease Expense (A + B + C)
0		172		$ 520,637	$ 520,637					
1	$ 100,000	177	$ 102,907	459,699	475,727	$ 74,377	$ 41,651	$ 2,907	$ 13,439	$ 118,935
2	100,000	180	104,651	390,046	417,841	76,617	38,058	1,744	6,963	116,419
3	100,000	184	106,977	319,741	354,321	78,009	33,427	2,326	7,704	113,762
4	100,000	189	109,884	247,297	283,182	79,935	28,346	2,907	7,491	111,188
5	100,000	195	113,372	171,085	202,173	82,432	22,655	3,488	6,220	108,575
6	100,000	202	117,442	89,311	108,743	85,542	16,174	4,070	3,769	105,786
7	100,000	207	120,349	–	–	89,311	8,699	2,907	–	100,917
	$ 700,000		$ 775,582			$ 566,223	$ 189,010	$ 20,349		$ 775,582

* The amounts represent the present value of the additional variable lease expense over the remaining lease term added to the right-of-use asset and the lease liability upon reassessment.

End of Year 1 Journal Entries	Debit	Credit
Lease obligation	$ 58,349	
Amortization expense	74,377	
Right-of-use asset		$ 74,377
Interest expense	41,651	
Variable lease expense	2,907	
Cash		102,907
To record lease-related expenses and payments before reassessment.		
Right-of-use asset	$ 13,439	
Lease obligation		$ 13,439
To record impact of reassessment of change in index to variable payments to future periods.		

Editor's Note: Although the income statement effect of reassessing the CPI may be insignificant, particularly for shorter-term leases, the effect on the lease liability and right-of-use asset could be significant and could result in a higher liability balance throughout the lease term, especially for longer-term leases.

Purchase Options

In a departure from the ED, the boards tentatively agreed that purchase options should be accounted for similarly to options to renew. Therefore, purchase options with a "significant economic incentive to exercise" will be included in lease payments. In addition, the boards decided that the reassessment guidance for purchase options should be the same as that for lease terms.

Discount Rate

The ED had noted that the rate the lessor charges the lessee could be the lessee's incremental borrowing rate; the rate implicit in the lease; or, for property leases, the yield on the property.

The boards tentatively decided that the guidance on determining the appropriate discount rate for initially measuring the lease payments would be generally consistent with that in the ED. One exception is that the new guidance would clarify that if the rate the lessor charges the lessee is available, that rate should be used rather than the lessee's incremental borrowing rate.

In addition, the boards tentatively decided that if the lessee is using its incremental borrowing rate as the discount rate, this rate should be determined at lease commencement rather than at lease inception.

The boards also tentatively decided to provide guidance on how entities should calculate the discount rate when considering the use of a group discount rate and determining the yield on property. In addition, they tentatively decided that the discount rate will only be reassessed when there is a change in lease payments that is due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease.

Rent expense would mostly be eliminated and would be replaced with amortization and interest expense.

Subsequent Measurement — Profit and Loss Recognition

The P&L recognition pattern under the proposed lease guidance differs significantly from that under current operating lease accounting. Rent expense would mostly be eliminated and would be replaced with amortization and interest expense. In addition, the expense in earlier years of a lease arrangement would typically be higher than the straight-line expense under current accounting.

Editor's Note: The staffs' examples seem to indicate that rent expense, as opposed to interest or amortization expense, would still be recorded for short-term leases that are exempted from the proposed guidance and contingent rents that are not included in the initial or subsequent measurement of the lease liability.

This recognition pattern is a function of treating the lease arrangement as a financing. The right-of-use asset is amortized on a systematic basis (typically, straight-line) that reflects the pattern of consumption of the expected future economic benefits. The liability is amortized by using the effective interest method, which results in higher interest expense in earlier periods.

The boards recognized this concern and at one point during the redeliberations decided that there should be two types of leases for income statement recognition purposes: finance and other-than-finance leases. They also discussed possible methods that would result in straight-line P&L recognition for leases classified as other than finance, including an annuity method of amortizing the asset or using other comprehensive income.

However, after further deliberation, the boards had too many concerns about this approach, including (1) making the right cut between the two types of leases and (2) inadequate conceptual justification for different methods of P&L recognition. They therefore reversed their decision and reverted back to the proposed guidance in the ED (i.e., amortize the liability by using the interest method and amortize the right-of-use asset typically on a straight-line basis).

Contracts That Contain Lease and Nonlease Components

Under the ED, for a contract that contains both lease and service elements, the services that are distinct would have been separated and accounted for separately from the lease elements (nondistinct elements would have been accounted for as part of the lease contract). However, the boards tentatively decided that for a multiple-element contract that contains a lease, an entity would be required to separate all nonlease elements from the lease elements and to account for them in accordance with other GAAP — that is, all nonlease elements would typically be separated from the lease accounting, regardless of whether the nonlease elements are distinct. Lessors would allocate payments to lease components and nonlease components in a manner consistent with the allocation methods in the revenue recognition project. Lessees would allocate payments to the lease and nonlease components on the basis of the relative observable purchase price of the individual components. If there are no observable purchase prices, lessees would account for all payments as a lease.

Editor's Note: The original proposal led to many questions about whether certain elements common in many leases (e.g., property taxes, insurance, and maintenance) meet the definition of a distinct service. We believe that the boards' tentative decision to separate lease elements from nonlease elements is meant to clarify that such elements would typically not be part of the lease liability that is recorded on the balance sheet.

The boards tentatively decided that for a multiple-element contract that contains a lease, an entity would be required to separate all nonlease elements from the lease elements and to account for them in accordance with other GAAP.

In-Substance Purchase/Sale

The ED had proposed excluding, from the lease standard, contracts that (1) automatically transferred title to the underlying asset at the end of the contract or included a bargain purchase option and (2) transferred all but a trivial amount of the risks and benefits associated with the underlying asset. However, the boards tentatively decided that this guidance is not necessary and will not incorporate it into a final standard. Therefore, such contracts would continue to be accounted for under the revised leasing guidance rather than under other GAAP.

Lease Payments Before Commencement Date and Lease Incentives

The boards tentatively decided that any lease payments made by the lessee before the asset is available for use (commencement date) should be accounted for as prepayments for the right-of-use asset. These prepayments would then be added to the right-of-use asset on the commencement date.

In addition, because the ED did not discuss lease incentive payments, a common question in comment letters was how these payments should be accounted for. The boards have tentatively decided that a lessee should include lease incentives in the initial measurement of the right-of-use asset (i.e., receipts from the lessor would reduce the right-of-use asset).

Editor's Note: Entities would account for "rent holidays," or free rent periods that simply affect the timing of cash flows under the lease, by accruing interest during the rent holiday period and amortizing the right-of-use asset. We understand that the boards may further discuss the accounting for leasehold improvements as part of their discussion of transition methods.

Modification

The ED did not address how to account for modifications to lease agreements. However, the boards tentatively decided to include such guidance in the final standard — specifically, that a modification that is a substantive change would result in the termination of the existing contract and that the modified contract should be treated as a new lease. In addition, any changes that would affect the determination of whether an arrangement contains a lease should result in the reassessment of whether the arrangement contains a lease.

Lessor Accounting

The boards have struggled to develop a single lessor model that is conceptually consistent with the lessee model and that is acceptable to both the boards and their constituents.

The ED had proposed a hybrid or dual accounting model for lessors. The choice of model depended on whether the lessor retained exposure to significant risks or benefits associated with the underlying asset. A lessor that retained exposure to significant risks or benefits associated with the underlying asset would have kept the underlying asset on its balance sheet and recognized a receivable and a performance obligation. If the lessor did not retain exposure to significant risks or benefits, the underlying asset would have been derecognized and replaced with a receivable and a residual asset and profit might be recognized at lease commencement. Many respondents to the ED stated that the lessor accounting proposals need significant further development and refinement and that lessors would need additional guidance to determine which approach to apply. In addition, many respondents believed that the current lessor accounting model is "not broken" and questioned whether the costs of implementing the new model were accompanied by an improvement in financial reporting.

The boards tentatively decided that a single lessor accounting model, the receivable and residual method, should apply to all leases.

After further redeliberations, the boards tentatively decided that a single lessor accounting model, the receivable and residual method, should apply to all leases. The only exceptions would be short-term leases and leases of investment property measured at fair value (which the FASB is proposing for investment property entities as part of its investment property project and the IASB permits in IAS 40[8]). The proposed model employs a receivable and residual approach that is similar to the derecognition approach proposed in the ED. This model allows for profit recognition at lease commencement depending on whether the profit is reasonably assured. The staff indicated that it would have further discussions with the Board regarding the need for additional clarification of, or application guidance on, the term "reasonably assured." Many Board members indicated that they would prefer this application guidance to be consistent with the definition of "reasonably assured" in the revenue recognition project but asked the staff to add criteria that would be appropriate to a leasing environment.

Under the model, the lessor will derecognize the underlying asset and recognize (1) a lease receivable measured as the present value of the lease payments discounted at the rate the lessor charges the lessee and (2) a residual asset measured on an allocated cost basis, with the measurement depending on whether profit is reasonably assured. The lease receivable is subsequently amortized by using the effective interest method.

If profit is reasonably assured, the profit and residual asset will be measured as follows at lease commencement:

- Profit = (lease receivable + residual asset) – carrying amount of underlying asset.
- Residual asset = carrying amount of the underlying asset – [(present value of lease receivable ÷ fair value of the underlying asset) × carrying amount of the underlying asset].

The residual asset is subsequently accreted by using the rate the lessor charges the lessee.

If profit is not reasonably assured, the profit will be recognized subsequently over the lease term and the residual asset on the commencement date of the lease will be measured as the difference between the carrying amount of the underlying asset and the

[8] IAS 40, *Investment Property.*

lease receivable. The lessor would subsequently use a constant rate of return to accrete the residual asset to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation.

If the right to receive lease payments is greater than the carrying amount of the underlying asset as of the lease commencement date, the lessor would recognize, at a minimum, the difference between those two amounts as profit on that date. No profit would be recognized at lease commencement if the carrying amount of the underlying asset is equal to its fair value and the right to receive lease payments is not greater than the carrying amount of the underlying asset.

We believe that the lessor model will require significant consideration during the comment period and redeliberations.

Editor's Note: We believe that the lessor model will require significant consideration during the comment period and redeliberations because:

- The boards are describing the proposed lessor model as a single model. However, a distinction will be made on the basis of whether profit is reasonably assured. This distinction will result in a different profit recognition up front, a different measurement of the residual asset, and ultimately different profit recognition over the lease arrangement. In many cases, the profit recognized over the lease term when the profit is not reasonably assured is higher than when it is reasonably assured, as illustrated in the examples below.
- It is uncertain how users will view the income statement recognition and presentation in comparison with current operating lease accounting.

For entities that preferred current operating lease accounting, this is not a favorable decision. As a result, the scope of the investment property project that the FASB is developing will receive greater scrutiny since some lessors that currently treat their leases as operating leases may want to avoid this accounting and be able to measure the underlying asset at fair value instead. The boards discussed an exception for lessors that enter into numerous lease contracts for physically distinct portions of a single asset (e.g., real estate leases that do not qualify for fair value accounting). However, they ultimately rejected providing this exception.

Example 3: Lessor Accounting

The lessor examples below are based on the following fact pattern:[9]

A manufacturer lessor leases an asset that it has manufactured to a lessee.

The underlying asset has a carrying amount of $100 and a fair value of $120 at lease commencement. Note that if the lessor was a financial institution, the carrying amount would typically equal the fair value of the underlying asset.

Lease term	3 years
Lease payments	$28/year
Estimated useful life of underlying asset	6 years
Rate the lessor charges the lessee (implicit rate in the lease)	6.4%
Present value of lease payments at lease commencement	$74
Estimated residual value at the end of the lease term	$55

Lessor Example 1: Profit Is Reasonably Assured

On lease commencement date, the lessor will book the following entry:

	Debit	Credit
Lease receivable	$ 74	
Residual asset	38	
Underlying asset		$ 100
Lease income		12

[9] The examples are derived from IASB Agenda Paper 5G/FASB Memorandum 193 for the boards' July 20–21 meetings, which are available at www.ifrs.org.

Example 3: Lessor Accounting (continued)

If profit **is reasonably assured,** the manufacturer lessor would calculate the residual asset as illustrated below and would accrete it to the end of the lease term by using the rate the lessor charges the lessee.

Receivable and Residual Model				
Year	Lease Receivable	Residual Asset	Profit	Return on Assets[d]
0	$ 74	$ 38[a]	$ 12[b]	
1	51	40	7	6.4%
2	26	43	6	6.4%
3	–	46	5	6.4%
			$ 30[c]	

Current Operating Lease Accounting		
Underlying Asset	Profit[e]	Return on Assets
$ 100	$ –	
85	13	15.0%
70	13	17.7%
55	13	21.4%
	$ 39	

[a] The residual asset is initially measured on an allocated cost basis [100 – ((74 ÷ 120) × 100)] and subsequently accreted using the rate the lessor charges the lessee (6.4%).

[b] The year 0 profit of $12 represents profit on the right-of-use asset transferred to the lessee recognized at lease commencement, subject to that profit being reasonably assured. The manufacturer lessor is likely to present revenue of $74 and cost of sales of $62 (resulting in profit of $12) at lease commencement. The profit recognised in years 1, 2, and 3 represents interest income on the lease receivable and accretion of the residual asset.

[c] Profit recognized under the "receivable and residual" approach over the lease term of $30 is lower than under current operating lease accounting of $39. This is because any profit on the residual asset is not recognized until the leased asset is sold or released at the end of the lease term. Under current operating lease accounting, profit on the residual asset is often recognized over the lease term by depreciating to the leased asset's estimated residual value at the end of the lease term (in this example, the estimated residual value at the end of the lease term is $55).

[d] Return on assets is calculated as profit divided by the lease receivable plus residual asset.

[e] Lease income of $28 less depreciation of $15 in each year.

Lessor Example 2: Profit Is Not Reasonably Assured

On the lease commencement date, the lessor will book the following entry:

	Debit	Credit
Lease receivable	$ 74	
Residual asset	26	
Underlying asset		$ 100

If profit **is not reasonably assured,** the manufacturer lessor would calculate the residual asset as illustrated below and would accrete it to its estimated future value at the end of the lease term to produce a constant rate of return on the carrying amount of the residual.

Receivable and Residual Model				
Year	Lease Receivable	Residual Asset[b]	Profit	Return on Assets
0	$ 74	$ 26	$ –[a]	
1	51	33	12	12.2%
2	26	43	13	15.2%
3	–	55	14	20.3%
			$ 39	

Current Operating Lease Accounting		
Underlying Asset	Profit	Return on Assets
$ 100	$ –	
85	13	15.0%
70	13	17.7%
55	13	21.4%
	$ 39	

[a] The profit of $12 not recognized at lease commencement is netted against the residual asset. Therefore, the residual asset is initially measured at $26 ($38 – $12) and is subsequently accreted to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation. The profit of $12 is then recognized over the lease term.

Leveraged Leases

The ED did not provide a separate approach for lessors with leveraged leases, nor did it contain transition guidance on outstanding leveraged leases. The FASB has reaffirmed that there will be no specialized accounting for leveraged leases. That is, the accounting for leveraged leases will be the same as that for all other leases. In addition, the after-tax yield recognition required for leveraged leases under current U.S. GAAP would be precluded. The boards also voted that leveraged lease transactions that exist upon the adoption of the proposed lease guidance will not be grandfathered. Therefore, lessors will be required to account for new and existing leveraged lease arrangements under the new standard once it becomes effective.

Disclosure and Presentation Requirements

Presentation — Lessee

The FASB and IASB tentatively decided that lease assets and liabilities should be presented separately in the statement of financial position or disclosed in the notes. In addition, the right-of-use asset should be classified with owned assets that are similar to the underlying asset associated with the lease or the right-of-use asset.

In contemplating a question posed by some ED respondents, specifically financial institutions and regulators, the boards discussed the need to clarify whether the right-of-use asset is an intangible or tangible asset. After some debate, the boards ultimately agreed that it was not necessary to clarify the nature of the asset for financial reporting purposes.

The FASB and IASB voted to retain the ED's disclosure requirements but made certain editorial changes and added some new disclosures.

The boards also tentatively decided how cash paid that is related to various lease components should be classified in the statement of cash flows:

- Cash paid related to principal should be classified as a financing activity.
- Cash paid related to interest should be classified in accordance with applicable IFRS or U.S. GAAP requirements.
- Cash paid for variable lease payments that are not included in the measurement of the lease liability should be included in operating activities.
- Cash paid for short-term leases that are excluded from the lease liability should be included in operating activities.

Editor's Note: The determination of whether a right-of-use asset is a tangible or intangible asset could significantly affect some industries. For example, a financial institution's regulatory capital may be affected depending on how the regulator views these assets.

The requirements for classifying interest in the statement of cash flows under U.S. GAAP are different from those under IFRSs. IAS 7[10] permits an option to classify interest as either operating or financing. ASC 230 requires cash paid for interest to be classified in operating activities.

Disclosure — Lessee

The FASB and IASB voted to retain the ED's disclosure requirements but made certain editorial changes and added some new disclosures. The more significant required disclosures include:

- Reconciliation of the beginning and ending balances of the right-of-use asset and the liability to make lease payments.
- Maturity analysis of the liabilities to make lease payments.

[10] IAS 7, *Statement of Cash Flows.*

The boards expressed some concern about the potential confusion they are creating by splitting the current concept of rent expense into several components. Therefore, they tentatively agreed to require a single disclosure detailing all various expense components (e.g., amortization expense, interest expense, short-term lease expense, and variable lease expense). However, they also agreed that this disclosure would not be combined and presented as lease expense.

Editor's Note: The boards' decision not to combine amortization and interest expense and label it as lease expense could affect entities that have "cost-plus" contracts with government organizations or regulatory rate agreements. These contracts will often allow for reimbursement of rent expense but not interest expense. As a result of the boards' decision, government organizations will need to provide guidance on how to treat these expenses under the new standard.

Other Lease Considerations

Subleases

The ED did not include detailed guidance on subleasing, other than noting that an intermediate lessor in a sublease "would account for the assets and liabilities arising from the head lease in accordance with the lessee model" and "would account for the assets and liabilities arising from the sublease in accordance with the lessor model." During redeliberations, the boards reaffirmed this guidance on accounting for subleases.

The boards tentatively decided that the accounting for term option penalties should be consistent with the accounting for options to extend or terminate a lease.

Residual Value Guarantees

The ED stated that residual value guarantees are included in the initial measurement of the lease payments except for amounts payable under guarantees provided by an unrelated third party.

During redeliberations, the boards reaffirmed that residual value guarantees should be included in the initial measurement of the lease liability at the amount expected to be payable under the residual value guarantee. The boards also redeliberated the subsequent measurement of residual value guarantees by lessees and tentatively decided that the residual value guarantees that are included in the measurement of the lessee's right-of-use asset should be amortized consistently with the way the right-of-use asset is amortized. The amounts expected to be payable under residual value guarantees that are included in the lessee's lease liability should be reassessed when events or circumstances indicate that there has been a significant 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 (1) in net income to the extent that those changes relate to current or prior periods and (2) as an adjustment to the right-of-use asset to the extent those changes relate to future periods.

Embedded Derivatives

The ED was silent on how to account for embedded derivatives included in lease contracts. The boards decided to retain current accounting guidance and to require entities to assess whether lease contracts include embedded derivatives that should be bifurcated and accounted for in accordance with the financial instrument guidance.

Term Option Penalties

The boards tentatively decided 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 if it does not 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.

Foreign Exchange Differences

The ED did not address the accounting for foreign exchange differences. During redeliberations, the boards discussed the accounting by lessees for leases denominated in a foreign currency and tentatively decided that foreign exchange differences related to the liability to make lease payments should be recognized in profit or loss. This is consistent with the foreign exchange guidance in existing IFRSs and U.S. GAAP.

Build-to-Suit Leases

In build-to-suit lease arrangements, the lessee typically is involved with the construction of the asset. Although IFRSs do not contain any specific guidance on these arrangements, ASC 840 includes requirements for how to account for them. Under these requirements, the lessee is sometimes deemed the accounting owner of the leased property.

The boards have tentatively decided that, like the ED, the new lease standard will not include any specific accounting requirements related to the lessee's involvement in the construction of an asset. The boards will provide additional guidance on (1) construction costs incurred by the lessee before the commencement date and (2) prepaid rents.

Editor's Note: We suspect that the official demise of the guidance formerly contained in Issue 97-10[11] will be greeted with thunderous applause by lease accountants everywhere. Because the guidance on these arrangements will not be included in the final lease standard, lessees involved in the construction of the asset will need to consider other accounting literature for these arrangements during the construction period (e.g., consolidation guidance if the asset is included within an entity).

The ED had stated that all outstanding leases as of the date of initial application will be subject to the proposed lease accounting.

Sale-and-Leaseback Transactions

Under the ED, in a sale-and-leaseback transaction, the threshold for achieving a sale would have been higher than that in the revenue recognition project. Many respondents to the ED noted this inconsistency. The proposed conditions precluding sale recognition were mostly carried forward from ASC 840 (formerly Statement 98[12]). Because the boards are eliminating the off-balance-sheet accounting for leases, they believe the structuring opportunities afforded by a sale-and-leaseback transaction are minimized. Therefore, the boards have tentatively decided that this guidance is no longer necessary. Under the final guidance, entities would look to the revenue recognition project to determine whether the conditions of a sale are met. In addition, the boards tentatively decided that if the consideration is at fair value, gains or losses would not be deferred; this decision is consistent with the ED.

Editor's Note: The boards plan to discuss transition issues related to existing sale-and-leaseback transactions at a future meeting.

Transition Method

The ED had stated that all outstanding leases as of the date of initial application will be subject to the proposed lease accounting. The ED defines the date of initial application as "the beginning of the first comparative period presented in the first financial statements in which the entity applies this guidance" and requires lessees and lessors to apply the provisions of the new model by using a simplified retrospective approach as of that date.

The boards have not redeliberated these decisions.

[11] EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction."

[12] FASB Statement No. 98, *Accounting for Leases.*

Items Still to Come

The boards plan to discuss the following items at future meetings or to clarify them in the revised ED:

For Lessors Only
Variable lease payment measurements.
Application of the "reasonably assured" notion for profit recognition.
Presentation and disclosure.
Transition issues related to existing leveraged leases.
For Lessees Only
Additional guidance on construction costs incurred by the lessee before the lease commencement date and prepaid rents.
Transition issues related to existing sale-and-leaseback transactions.
For Lessors and Lessees
Transition method.
Effective date.
Scope clarification for leases of inventory and internal-use software.
Guidance on how entities should calculate the discount rate when considering the use of a group discount rate and determining the yield on property.
Additional guidance on the concept of disguised fixed lease payments.

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