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Technical Line

FASB — proposed guidance

Leases project on the brink of re-exposure

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What you need to know

- The Boards have made significant revisions to their original proposal, primarily to address constituents' concerns.
- The revised lessee proposal would nearly eliminate off-balance sheet financing through operating leases and could significantly change the timing of lease expense recognition for certain leases.
- Entities would still have to classify leases, but the criteria would be different from today's criteria, and classification would be used to determine the method of recognizing lease revenue and expense.
- Under the revised proposal, certain judgments, including identifying a lease and determining the lease term, would be of increased importance.
- The Boards plan to issue the revised proposal for comment in the fourth quarter of 2012.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) have made significant changes to their proposed leases model to address conceptual and operational concerns constituents raised about their 2010 exposure draft (2010 ED).[1]

The revised proposal, which the Boards adjusted during redeliberations, would require most leases to be recognized on the balance sheets of lessees. Consistent with current accounting, lessees and lessors would still have more than one type of lease accounting. However, lease classification would no longer be based on whether the lease transfers substantially all of the risks and benefits of ownership

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of the underlying asset. Under the revised proposal, lease classification would be based primarily on the nature of the underlying asset being leased, and it would be used to determine the method of recognizing lease revenue and expense.

The revised proposal would also require lessors and lessees to make a number of judgments and to periodically reassess them. The business implications for lessees could be significant, including:

- Key balance sheet metrics such as leverage and capital ratios would change.
- The lease expense recognition pattern would be accelerated for some of today's operating leases. Income statement metrics such as EBITDA would also change for these leases.
- Debt covenants and borrowing capacity may be affected.
- These changes may affect decisions to lease versus buy significant assets.

Lessors would also be affected. Lessor financial statements and related metrics could be significantly altered. For example, profit would be recognized upon lease commencement instead of over time for certain equipment leases. Lessors could change their business practices. For instance, lessors may reduce the use of third-party residual value guarantees because such guarantees would no longer affect lease classification.

The Boards have almost finished their redeliberations. They expect to issue a new exposure draft in the fourth quarter of 2012. A proposed effective date has not yet been set.

This publication discusses tentative decisions made by the Boards during redeliberations. These decisions will not be final until the Boards approve a final standard. The Appendix recaps the significant revisions the Boards have made to the 2010 ED.

Background

The Boards are jointly developing a new approach to lease accounting to address criticisms of the current model, including:

- Material assets and obligations arising from operating leases are not recognized.
- Economically similar lease transactions result in different accounting.
- Estimates at inception of a lease are not reassessed.

Most criticism of today's model focuses on lessee accounting. The Boards decided to also address lessor accounting to make it consistent with the proposed accounting for leases by lessees.

In 2010, the Boards issued an exposure draft that addressed many criticisms, but raised new concerns. Based on feedback they received, the Boards identified the following key issues for redeliberation:

- The definition of a lease
- Lease term

- Variable lease payments (including contingent rent)
- Income and expense recognition pattern
- Lessor accounting model

The Boards have made significant changes to their 2010 ED to address these issues.

Scope

The 2010 ED proposed using existing guidance to determine the scope of a new leases standard. The definition of a lease and application guidance in the 2010 ED were largely carried forward from existing standards and would apply to both lessees and lessors. Many respondents raised concerns about applying that guidance in the new model, particularly given the elimination of operating lease accounting for many leases.

Definition of a lease

A lease would be defined as a contract in which the right to use an asset is conveyed, for a period of time, in exchange for consideration. To be a lease, an arrangement would have to meet two criteria: (1) fulfillment of the contract would have to depend on a "specified asset" and (2) the contract would have to convey the "right to control the use" of the specified asset.

Given the significant accounting implications, companies will have to pay more attention to their contracts to identify any that are or contain leases.

Consistent with current standards, a "specified asset" would be an asset that is implicitly or explicitly identifiable. Although a physically distinct portion of a larger asset (e.g., a floor in a multistory building) could be a specified asset, a non-physically distinguishable portion of an asset (e.g., 50% of the capacity of a pipeline) would not qualify as a specified asset and would not be the subject of a lease.

Contracts that provide the vendor with substantive substitution rights (i.e., allow the vendor to use any one of a number of different assets to fulfill the contract) would not be considered leases because fulfillment of the contract would not depend on the use of a specified asset. A substitution right would be considered substantive if substitution of the asset is both practical and economically feasible and the asset could be substituted without the customer's consent.

Illustration 1 — Substitution rights

Assume that a contract specifies that a service is rendered to a customer and it involves the use of processor No. 9, but the vendor can substitute another processor for No. 9 without the consent of the customer. The vendor has many identical processors, the processors are maintained in a single, accessible location and the vendor could easily substitute another one for No. 9 at a nominal cost. Fulfillment of this contract would not depend on the use of a specified asset because the substitution right is substantive.

Now assume the same facts except that processor No. 9 is customized and located in an isolated area, making vendor substitution impractical and uneconomical. Therefore, the substitution right would not be substantive (i.e., fulfillment of the contract depends on the use of processor No. 9).

Contracts that provide vendors with substantive substitution rights would not be within the scope of the proposed leases standard and likely would be accounted for as executory arrangements by customers and as contracts most likely subject to the proposed revenue recognition standard by vendors. The specified asset criterion is generally consistent with current guidance.

The "right to control the use" of a specified asset would be conveyed if the customer has the ability to both direct the use of the asset and receive the benefit from its use. An arrangement under which a customer obtains all of the benefit from the use of an asset, but does not direct its use, would not be considered a lease.

The ability to direct the use of the asset would be demonstrated by the ability to make decisions about the use of the specified asset (e.g., determining how, when and in what manner the specified asset is used) that significantly affect the benefits received by the customer from the asset. For example, specifying the quantity and timing of the delivery of goods would not, by itself, indicate that the customer has the ability to direct the use of the asset used to produce or deliver those goods. In contrast, if the vendor operates the asset according to the specific instructions of the customer, the customer has the ability to direct the use of the asset.

The revised right to control the use criterion is intended to align with control concepts the Boards have developed in their joint revenue recognition project by requiring that the customer meet both factors (direct the use and receive the benefits). Pricing terms would not be considered in evaluating this criterion.

This would be a change from current standards, under which contracts meet the right to control the use criterion if the customer obtains substantially all of the benefits and the contractual price is neither fixed per unit of output nor equal to the market price per unit of output. Under current standards, the control criterion may be met even if the customer does not have any rights to direct the use of the asset.

Under the revised proposal, certain arrangements (e.g., some take-or-pay arrangements) that are currently accounted for as leases would no longer be considered leases. The Boards plan to provide additional guidance to help entities determine whether arrangements meet the definition of a lease.

How we see it

- Companies should carefully scrutinize their contracts to assess whether arrangements would be considered to be or contain leases. The current accounting for operating leases and service contracts is often similar. Under the revised proposal, the determination of whether an arrangement is or contains a lease could have significant accounting implications, particularly for lessees.

- Many arrangements involve providing or using fixed assets, including those that are used exclusively to provide services, and both parties often have some rights over the control of the asset. The determination of which party has the right to control the use of the underlying asset would be very subjective in certain arrangements (e.g., time charter arrangements). Given the significant accounting implications, companies would have to pay more attention to their contracts to identify any that are or contain a lease.

Scope exclusions

The following arrangements would not be in scope:

- Leases for the right to explore for or use natural resources (such as minerals, oil, natural gas and similar non-regenerative resources)
- Leases of biological assets, including timber

Current US GAAP specifies that only property, plant or equipment can be subject to a lease. The proposed definition of a lease would include any asset except for the scope exclusions described above. The Boards also stated that leases of intangible assets would not be required to be accounted for in accordance with the leases standard. This leaves open the possibility that an entity could choose, presumably as an accounting policy election, to account for leases of intangible assets under the leases standard.

Short-term leases

The revised proposal would allow (but not require) lessees and lessors to apply current operating lease accounting to short-term leases. A short-term lease would have a maximum possible lease term, including any options to renew, of 12 months. For example, a nine-month lease with a one-month renewal option (i.e., the maximum possible lease term is 10 months) would qualify as a short-term lease. In contrast, a nine-month lease with four one-month renewal options (i.e., the maximum possible lease term is 13 months) would not.

The determination of whether a lease is a short-term lease would be based solely on the maximum possible lease term in the contract (i.e., the periods for which enforceable rights and obligations arise). The entity's intentions, expectations and lease term for accounting purposes would not be considered.

How we see it

Companies should carefully evaluate whether short-term lease accounting applies to their arrangements, with particular attention to renewal rights contained in them.

Lessees and lessors electing to use operating lease accounting for short-term leases would recognize lease expense and income on a straight-line basis over the lease term (unless another systematic and rational basis better represents the pattern of use) and would not recognize lease-related assets and lease liabilities.

Separation of lease and non-lease components

For contracts that contain lease and non-lease components, non-lease components, including services and executory costs, would be separated from the lease components, except in limited circumstances. Executory costs have not been defined, but would likely include insurance, maintenance and taxes.

Lessors would be required to allocate payments in accordance with the proposed revenue recognition guidance (i.e., on a relative standalone selling price basis). Lessors are expected to be knowledgeable about their services and products and therefore would be required to develop an estimated selling price if a standalone price was not directly observable. To determine the estimated selling price, lessors could use various techniques including the expected cost plus a margin approach, an adjusted market assessment approach or the residual technique in limited circumstances.

Lessees would allocate payments on a relative purchase price basis (if the purchase price of each component can be observed) or using a residual method (if the purchase price of one or more but not all of the components can be observed). If there are no observable purchase prices, lessees would account for all of the payments required by the contract as a lease (i.e., not separate payments between lease and non-lease components). The Boards agreed to include in the standard application guidance on how a lessee should determine what would be an observable price.

How we see it

- Application guidance for determining an observable price for a lessee will be critical to understanding when non-lease components would be accounted for as part of a lease. It is not yet clear what would constitute an observable price and whether a lessee could use estimation techniques to develop an estimated purchase price.
- Separating service payments and executory costs from leases may require a change in practice for some lessors and lessees. Under current lease accounting, these payments are excluded from minimum lease payments, but many entities may not have focused on separating them because the accounting treatment for these payments is often the same as the treatment for operating lease payments. Entities would need to develop processes to identify observable prices for the lease and non-lease components in arrangements that contain a lease. This may involve the use of significant judgment.

Application guidance for determining observable prices is being developed in light of new guidance in other projects, such as revenue recognition.

Illustration 2 — Separating lease and non-lease components

A company (lessee) enters into a three-year equipment lease. The contract requires the company to make fixed monthly payments of $180 to cover the lease, routine maintenance of the equipment and the cost of training the company's employees to use the equipment.

<u>Lessee/customer</u>

Scenario A

The company determines an observable purchase price for each of the components of the contract and calculates the amount allocated to each component as follows:

	Standalone price	% allocation	Monthly payment	Monthly allocation
Equipment lease	$ 160	80%	$ 180	$ 144
Maintenance services	30	15%	$ 180	27
Training	10	5%	$ 180	9
	$ 200	100%		$ 180

Illustration 2 — Separating lease and non-lease components (continued)

For this contract, the company would allocate $144 of the monthly payment to the equipment lease, $27 to the maintenance services and $9 to the training. The company would recognize and measure the assets and liabilities related to the equipment lease using the proposed lease accounting standard. The portion of the payment allocated to the maintenance and training would be accounted for like other executory arrangements.

Scenario B

Assume that observable prices exist for the equipment lease ($160) and training ($10), but not the maintenance services. For instance, the vendor may offer the equipment either with or without a maintenance plan; however, neither the vendor nor others offer a maintenance plan separately. The company would use the residual method as follows:

Monthly payment	$ 180
Equipment lease	(160)
Training	(10)
Maintenance	$ 10

The company would allocate $160 of the monthly payment to the equipment lease and recognize and measure the assets and liabilities related to the equipment lease using the proposed lease accounting standard. The portion of the payment allocated to maintenance ($10) and training ($10) would be accounted for like other executory arrangements.

Scenario C

If the company has an observable price for the maintenance services ($30) but cannot obtain observable prices for the equipment lease and training, the training component would be accounted for together with the equipment lease. The company would separately account for the maintenance as an executory arrangement, and $150 of the monthly payment (the amount that cannot be allocated) would be recognized and measured using the proposed lease accounting standard.

Scenario D

Assume that the company cannot obtain an observable price for any component. All payments (i.e., the monthly payments of $180) would be recognized and measured using the proposed lease accounting standard.

Lessor/vendor

The lessor's allocation approach to separating the lease and non-lease components would be similar to Scenario A, but the amounts allocated could be different from those determined by the lessee because of different information available to each party.

The lessor would account for the lease payments using the proposed lease accounting standard. The payments allocated to the maintenance and training would be accounted for in accordance with the proposed revenue recognition standard. Note that the requirement for lessors to always separate the lease and non-lease components could result in income recognition in differing periods than the lessee's expense recognition (e.g., in situations where there are not observable prices).

Contract changes or changes in circumstances

A modification to the terms of a contract that causes a change to the determination of whether a contract is or contains a lease would be accounted for as a new contract. In addition, other changes in circumstances would require a reassessment of whether a contract is or contains a lease. For example, if a change in circumstances results in a supplier's substitution right no longer being substantive, the parties would need to assess whether the arrangement has become a lease.

Overall right-of-use model

For leases within the scope of the revised proposal, the Boards propose using a "right-of-use" model. The right-of-use model would be based on the principle that upon lease commencement, lessees have obtained and lessors have provided the right to use an asset for a period of time and the lessees are obligated to pay for that right. The extent to which the lessee "consumes" the underlying asset would determine the income statement recognition pattern.

This would be a change from the current model (i.e., ASC 840, *Leases*), which is based on the principle that a lease that transfers substantially all of the benefits and risks of ownership of the underlying asset is accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases are accounted for as operating leases under the current model.

Under the revised proposal, the amounts recognized for leases would initially be measured and recognized as of the commencement date of the lease (i.e., the date the lessor makes the underlying asset available for use by the lessee).

Lessees would initially recognize a right-of-use asset and a liability to make lease payments. For some leases, lessors would initially recognize a receivable, a residual asset (representing the lessor's current interest in the underlying asset at the end of the lease term) and profit, if any. Lessors would account for all other leases in a manner similar to current operating lease accounting.

The lessee's liability and lessor's receivable (for leases for which the lessor recognizes a receivable on its balance sheet at lease commencement) would be initially measured at the present value of lease payments over the lease term.

Key concepts

Certain key concepts would be used by both lessees and lessors in classifying (for expense and revenue recognition purposes) and measuring leases. Lessees and lessors would apply these concepts consistently unless specifically noted.

Lease term

Lease term would be defined as the non-cancelable period, plus any optional periods where there is a significant economic incentive to extend or not terminate the lease. Factors that might create an economic incentive for the lessee include:

- Renewal rates priced at a bargain
- Penalty payments for cancellation or nonrenewal

- Economic penalties such as significant customization or installation costs (e.g., leasehold improvements)
- A sublease term that extends beyond the noncancelable period of the head lease (e.g., the head lease has a noncancelable term of five years and a five-year renewal option and the sublease term is 10 years)

Illustration 3 — Determining lease term

Assume a company enters into a lease for office space that includes a noncancelable term of two years and two four-year renewal options. If there is no significant economic incentive for the lessee to exercise the renewal options, the lease term for accounting purposes would be two years.

Now assume that the lessee installed a significant amount of leasehold improvements at the beginning of the lease and that the leasehold improvements have a useful life of 10 years. The company may determine that a significant economic incentive exists through 10 years (i.e., the lessee would walk away from significant leasehold improvements at the end of two or six years if the lease is not renewed) and, therefore, conclude that the lease term for accounting purposes is 10 years.

The determination of the lease term when lessee renewal options are present would be subjective because companies would have to determine whether a significant economic incentive exists.

Purchase options

Accounting for purchase options included in lease arrangements would be consistent with the accounting for options to extend a lease. That is, if the lessee has a significant economic incentive to exercise a purchase option, the exercise price would be included in the lease payments and the lessee's right-of-use asset would be amortized over the life of the underlying asset rather than the shorter of the term of the lease or life of the underlying asset.

Illustration 4 — Purchase options

Scenario A

A lessee enters into a five-year lease for equipment that includes a purchase option under which the lessee can purchase the equipment for $1,000 at the end of the lease. The equipment has a seven-year life, and the expected fair value of the equipment at the end of five years is $100,000. The lessee has a significant economic incentive to exercise the purchase option because the lessee can obtain the equipment at a price that is significantly less than the expected fair value at the time of exercise. The present value of the $1,000 purchase option payment would be included as a lease payment.

<u>Lessee</u>

The present value of the $1,000 purchase option payment would be included in the initial right-of-use asset and liability to make lease payments. The amortization period used to determine periodic amortization expense of the lessee's right-of-use asset would be seven years (i.e., the life of the equipment).

<u>Lessor</u>

The present value of the $1,000 purchase option would be included in the initial lease receivable.

Illustration 4 — Purchase options (continued)

Scenario B

Now assume that a lessee enters into a five-year lease of the same equipment and that the contract specifies that the lessee can purchase the equipment at the end of the contract for $100,000. In this scenario, assuming no other factors (e.g., economic incentives beyond the pricing of the purchase option) would indicate otherwise, the lessee would not have a significant economic incentive to exercise the purchase option.

Therefore, the purchase option exercise price would be excluded from lease payments (i.e., it would not be included in any lease-related assets and liabilities). The lessee would amortize the right-of-use asset over five years (five years is the shorter of the lease term or the life of the equipment).

How we see it

- We believe that the determination of the lease term for accounting purposes and the treatment of purchase options under the Boards' revised proposal would be very similar to current practice. This change from the 2010 ED should reduce the burden on preparers, many of whom said the Boards' original proposal was overly complex.
- Assessing whether an economic incentive is significant would be a subjective determination. Including renewal periods in the lease term for accounting purposes could have significant effects as more leases would be recognized on the balance sheet.
- Based on the proposed approach to lessor accounting (discussed later in this publication) it appears that a lessor could recognize a residual asset in situations in which a lessee has a purchase option to acquire the underlying asset and a significant economic incentive to exercise the option exists. That is, the proposed method to measure the residual asset could result in an asset being recognized even though the lessee has a significant incentive to exercise a purchase option, although such an asset would be subject to impairment. The Boards have not directly addressed this issue and may provide clarifying guidance in the revised exposure draft.

Lease payments

Lease payments used to determine the amounts recognized on the balance sheet would include:

- Fixed lease payments
- Exercise price of purchase options for which a significant economic incentive to exercise exists
- Residual value guarantees (lessees only)
- Termination option penalties
- Lease payments that depend on an index or rate

Lessors would apply operating lease accounting (i.e., they would retain the underlying asset and wouldn't recognize a lease receivable on their balance sheets) for some leases. It is currently unclear whether lessors applying operating lease accounting under the revised proposal would use the proposed lease payment guidance developed for on-balance sheet leases to determine the amount of periodic lease revenue to recognize or use current accounting guidance for operating leases.

Residual value guarantees

Lessees would include the amounts expected to be payable (e.g., gross guaranteed amount minus the expected value of the underlying asset) under residual value guarantees as lease payments.

For example, consider a lease agreement that includes a guarantee by the lessee that the lessor will realize $10,000 from selling the asset when the lease expires. At lease commencement, the lessee estimates that the asset will have a value of $4,000 at the end of the lease. Therefore, the lessee expects to pay the lessor $6,000 under the residual value guarantee and would include this amount as a lease payment. Amounts payable under guarantees provided by a third party would not be lease payments.

Lessors would not include the amount they expect to receive from a residual value guarantee, either from the lessee or a third party, as a lease payment. Instead, they would recognize amounts received under a residual value guarantee at the end of the lease.

Termination option penalties

The determination of whether to include termination option penalties would be consistent with the determination of the lease term for accounting purposes. That is, if a lessee would be required to pay a penalty if it does not extend the lease beyond the noncancelable period and the lease term for accounting purposes excludes the extension period, the penalty would be included in the recognized lease payments.

For example, assume that a lessee has a lease with a five-year term and an option to terminate after two years if the lessee pays the lessor a termination option payment of $50,000. If the lease term for accounting purposes is two years (because the noncancelable period is two years and the lessee does not have a significant economic incentive to extend the lease), the $50,000 termination payment would be included as a lease payment. In contrast, if the lease term for accounting purposes is five years, the $50,000 termination payment would not be considered a lease payment.

Lease payments that depend on an index or a rate

Lease payments that depend on an index or a rate would be measured using the prevailing or spot rate. The forward curve would not be considered in determining the lease payments over the lease term. For example, assume a five-year lease requires annual payments including a base amount of $10,000 and a variable component based on the then-current 12-month LIBOR rate applied to the base amount. If the 12-month LIBOR rate is 3% at commencement, annual payments of $10,300 would be included in the lessee's liability to make lease payments and the lessor's receivable.

Contractual lease payments are sometimes adjusted based on the changes in an index, such as the consumer price index (CPI). Because variable lease payments would be measured using the rate at the commencement date, the lease payments included in the initial measurement would not include any projected lease payment increase. For example, assume the lease payment was $1,000 for the first year and the annual rent would be adjusted each year by the change in CPI. The annual lease payments included in the initial measurement of the lessor's receivable and the lessee's liability would be $1,000.

Lease payments based on performance or usage

Contingent rents based on performance (e.g., a percentage of sales) or usage (e.g., the number of miles flown) of the underlying asset would be recognized in the income statement when they are incurred or accrued but wouldn't be included in the liability to make lease payments or the lease receivable initially recognized on the balance sheet. For example, a contingent rent based on annual sales of a leased store would not be included in the right-of-use asset and liability to make lease payments recognized by the lessee. Instead, these payments would be recognized as expenses (by lessees) and income (by lessors) as the sales at the store occur.

Payments that are contractually described as variable, but in substance are fixed, should be treated as fixed lease payments.

Usage-based and performance-based contingent rents would not be recognized on the balance sheet.

Illustration 5 — In substance fixed payments

Consider a lease that calls for lease payments to increase each year by 10 times the annual increase in the CPI with a cap of 2%.

Truly variable lease payments that depend on an index, such as the CPI, would be included as a lease payment based on the prevailing rate for the index. However, because the combination of the multiplier and cap is specifically designed to ensure that the cap is reached, the lease payments are in substance fixed payments. Therefore, the 2% escalation would be included as a lease payment.

How we see it

- The Boards' decision to exclude performance and usage-based contingent rents from the amounts recognized on the balance sheet reduces the complexity of the proposed accounting for leases. The Boards received feedback from many constituents that the approach in the 2010 ED was complicated and would have been costly to implement.
- Under the revised proposal, lessees and lessors would likely account for many variable payment features such as rent based on a percentage of sales and mileage-based fees in much the same way as they do today.

Discount rate

The discount rate would be determined on a lease-by-lease basis. The discount rate used by the lessee to determine the present value of lease payments would be the rate that the lessor charges the lessee, if available; otherwise, the lessee would use its incremental borrowing rate. Practically speaking, lessees will rarely know the rate they are charged by the lessor.

The lessee's incremental borrowing rate would be the rate of interest that the lessee would have to pay to borrow over a similar term (i.e., the lease term), and with a similar security (e.g., rights to the underlying asset as collateral for the borrowing), the funds necessary to purchase a similar underlying asset.

The lessor would use the rate it charges the lessee, which could be the lessee's incremental borrowing rate, the rate implicit in the lease or, for property leases, the yield on the property. When more than one indicator of the rate is available, the lessor would use the rate implicit in the lease. For most leases subject to the receivable and residual approach, lessors would likely be able to determine the implicit rate.

As described in the 2010 ED, the rate implicit in the lease is the discount rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to be equal to the fair value of the underlying asset. If the Boards keep a consistent description of the implicit rate, this calculation would include cash flows that may not be included on the balance sheet (e.g., contingent rents based on performance or usage).

The Boards agreed to provide application guidance for determining the yield on property and whether to use a lessee's incremental borrowing rate that reflects the incremental borrowing rate of a parent or a subsidiary.

The revised proposal once again features lease classification, but it would principally determine expense and revenue recognition.

Lease classification

The Boards decided that two types of leases for accounting purposes best reflect the underlying economics of the wide array of lease contracts. One type, which we refer to as straight-line leases, would have an even income and expense recognition pattern. The other, which we call accelerated leases, would have an uneven income and expense recognition pattern (e.g., for lessees, the expense recognition pattern would be front-loaded). Both lessees and lessors would use the same criteria to classify leases.

How we see it

Current accounting requires lessees and lessors to reassess the classification of a lease if certain conditions occur (e.g., lease renewal beyond original lease term). It is unclear whether and how lessees and lessors would reassess lease classification in similar situations. It is also unclear whether lease classification would be reassessed upon a business combination or how lease classification would be considered at transition to the new lease guidance.

Leases would be classified based on whether the lessee acquires and consumes more than an insignificant portion of the underlying asset over the lease term. To simplify the assessment, the Boards added a practical expedient that leases would be classified based primarily on the nature of the underlying asset being leased. Leases would be classified as follows:

- Leases of property (i.e., land, building or part of a building) would be classified as straight-line leases, unless either of the following conditions is met:
  - The lease term is for the major part of the economic life of the underlying asset.

    - The present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.

- Leases of assets other than property (e.g., equipment) would be classified as accelerated leases, unless either of the following conditions is met:
    - The lease term is an insignificant portion of the economic life of the underlying asset.
    - The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

The classification assessment focuses on whether the lessee is paying to finance the acquisition of the portion of the underlying asset that it consumes or simply paying to use the asset. The presumption is that in most property leases, lessees do not consume more than an insignificant portion of the underlying asset during the lease term, while in most other leases, they do. This presumption would be overcome if the conditions above are met.

The terminology used in these conditions (e.g., lease term) is consistent with the key concepts described in the previous section.

The two conditions under which a property lease would be an accelerated lease are the same as two of the indicators included in IFRS today to distinguish between finance (i.e., capital) and operating leases. These conditions are similar to the 75% of useful life and the 90% of fair value tests in current US GAAP, except without the "bright lines." In practice, IFRS indicators are interpreted using similar thresholds to the bright-line tests in US GAAP.

The Boards did not provide any further insight into the meaning of "insignificant" when assessing the conditions specified for leases other than property. The Boards' staff have said that the exposure draft would likely not provide numerical guidelines. However, the staff noted they believe the conditions would be met for a relatively small population of leases. The Boards provided the practical expedient based on the nature of the underlying asset to make the revised proposal more operational and reduce the overall costs of applying it. However, that does not mean the evaluation of the criteria is elective.

Illustration 6 — Determining lease type

A lessee leases a ship for 15 years with no option to renew. The economic life of the ship is 50 years. The lease term represents 30% of the economic life of the ship. The present value of the fixed lease payments represents 37% of the fair value of the ship. The lessee concludes that the lease term and present value of the fixed lease payments represent a more than insignificant portion of the ship's economic life and fair value. Because the underlying asset is equipment and neither of the exception conditions are met, the arrangement would be an accelerated lease.

Alternatively, a lessee leases the same ship for 1.25 years with no options to renew. The lease represents 2.5% of the economic life. The lessee determines that the lease term is an insignificant portion of the economic life of the underlying asset (1.25 years as compared with 50 years). The arrangement is for a piece of equipment and meets one of the exception conditions; therefore, the arrangement would be accounted for as a straight-line lease.

How we see it

- It appears that certain leases of integral equipment such as cellular towers, pipelines and underground fiber optic cables, which are considered a form of real estate under current accounting, would be considered leases of assets other than property (i.e., equipment rather than real estate) under the revised proposal resulting in significantly different accounting than if they were considered property like many other forms of real estate would be.
- Current US GAAP provides additional guidance for assessing lease classification for certain leases (e.g., leases of land, leases of land and buildings (and integral equipment), leases involving only part of a building, leases that begin in the last 25% of the total estimated economic life of leased property, leases of property from a governmental unit). For example, under current accounting, the 75% of useful life and 90% of fair value tests are not applicable when classifying a lease that begins in the last 25% of the total estimated economic life of the leased property. It is unclear whether any similar situation-specific guidance will be included in the proposed classification guidance.

Lessee accounting

While the Boards have significantly revised their proposed lessee accounting model, all leases (except short-term leases) would still be recognized on the balance sheet. The initial accounting treatment and subsequent measurement of the lease liability would be the same for both types of leases. In contrast, the subsequent measurement of the right-of-use asset and corresponding lease expense recognition pattern as well as presentation would differ for the two types of leases.

Initial recognition and measurement

For both types of leases, a lessee would recognize a liability for the obligation to make lease payments (the liability to make lease payments) and an asset representing the right to use the leased item for the lease term (the right-of-use asset) at the lease commencement date.

The liability to make lease payments would be measured based on the present value of the lease payments to be made over the lease term. Lessees would use the key concepts described previously to determine the lease term, lease payments and discount rate measured as of the lease commencement date.

The right-of-use asset would be measured initially at cost and would include the amount of the liability to make lease payments plus any initial direct costs incurred by the lessee. Initial direct costs are direct and incremental to the lease transaction (e.g., commissions, legal fees).

Subsequent measurement

For both types of leases, accretion of the liability to make lease payments would be calculated using the interest method (i.e., the method used to arrive at a periodic interest cost that would represent a level effective rate on the liability and expense at the beginning of each period) and lease payments would reduce the liability.

Therefore, the liability to make lease payments would always be the same for both lease types.

The different expense recognition patterns between the two types of leases would be achieved through different subsequent measurement of the right-of-use asset.

Accelerated lease

In addition to recognizing interest expense for the accretion of the liability, a lessee would amortize the right-of-use asset on a systematic basis (generally straight-line). The amortization period for most leases would be the shorter of the lease term or the life of the underlying asset. However, if title transfers at the end of the lease term or the lessee has a significant economic incentive to exercise a purchase option, the amortization period would be the remaining life of the underlying asset.

Illustration 7 — Accelerated lease

A company enters into a three-year lease of equipment and concludes that the agreement is an accelerated lease. The lessee agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. The initial measurement of the right-of-use asset and liability to make lease payments is $33,000 using a discount rate of approximately 4.24%.

At lease commencement the lessee would recognize the lease-related asset and liability:

Right-of-use asset	$ 33,000	
Liability to make lease payments		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Interest expense	$ 1,398	
Liability to make lease payments		$ 1,398

*To record interest on the liability to make lease payments using the interest method ($33,000 * 4.24%)*

Amortization expense	$ 11,000	
Right-of-use asset		$ 11,000

To record amortization of the right-of-use asset ($33,000/3 years)

Liability to make lease payments	$ 10,000	
Cash		$ 10,000

To record cash paid

Illustration 7 — Accelerated lease (continued)

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,000	$ 11,000	$ —
Liability to make lease payments	$ (33,000)	$ (24,398)	$ (13,431)	$ —

Because of the consistent interest rate and decreasing liability over the lease term, lessees would generally recognize higher total periodic expense (i.e., total interest and amortization expense) in the earlier periods of a lease and lower total periodic expense in later periods. This pattern is consistent with the treatment of capital leases under current accounting and similar to financed purchases of nonfinancial assets, but when compared to current operating lease accounting it accelerates expense recognition. The accelerated lease model is consistent with the expense recognition approach in the Boards' 2010 proposal.

Amortization expense and interest expense would be presented either separately or with other amortization and interest expense, respectively, on the income statement.

Straight-line lease

Lessees would calculate the periodic straight-line expense — similar to determining straight-line expense for operating leases under current accounting. Lessees would then determine the change in the right-of-use asset by subtracting the period's accretion of the liability from the periodic straight-line expense amount. Total expense for straight-line leases would be presented as a single line item (e.g., lease or rent expense) on the income statement.

Although these leases would be on the balance sheet, the expense related to them would be recognized in much the same way as expense for operating leases is recognized today.

The different expense recognition patterns would be achieved through different subsequent measurement of the right-of-use asset.

Illustration 8 — Straight-line lease

A company enters into a three-year lease of office space and concludes that the agreement is a straight-line lease. The lessee agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. The initial measurement of the right-of-use asset and liability to make lease payments is $33,000 using a discount rate of approximately 4.24%. The company calculates that the annual straight-line lease expense is $12,000/year [($10,000+$12,000+$14,000)/3].

At lease commencement, the lessee would recognize the lease-related asset and liability:

Right-of-use asset	$ 33,000	
Liability to make lease payments		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Lease expense	$ 12,000	
Liability to make lease payments		$ 1,398
Right-of-use asset		$ 10,602

To record lease expense (change in right-of-use asset = $12,000 annual straight-line lease expense less $1,398 accretion of liability using interest method)

Liability to make lease payments	$ 10,000	
Cash		$ 10,000

To record cash paid

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized		$ 12,000	$ 12,000	$ 12,000
Less: Accretion of lease liability [(A)]		(1,398)	(1,033)	(569)
Change in right-of-use asset [(B)]		$ 10,602	$ 10,967	$ 11,431
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,398	$ 11,431	$ —
Liability to make lease payments	$ (33,000)	$ (24,398)	$ (13,431)	$ —

[A] Calculated using the interest method on the liability to make lease payments (same calculation as for accelerated lease).

[B] Calculated as the difference between the straight-line expense to be recognized (i.e., $12,000) and the accretion of the lease liability.

How we see it

While straight-line expense recognition would be achieved for some leases, the approach would not relieve the record-keeping burden the 2010 ED would have imposed on lessees and may even add to it. Lessees would have to assess classification. In addition, lessees would have to perform additional calculations (i.e., calculate the straight-line amount, the periodic accretion of the liability and the difference each period) for straight-line leases.

Illustration 9 — Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the two types of leases discussed in Illustrations 7 and 8:

	Both lease types	Accelerated lease				Straight-line lease		
Time	Lease liability	Interest expense	Amortization expense	Total expense	ROU asset	Lease expense	Change in ROU asset	ROU asset
Initial	$ 33,000				$ 33,000			$ 33,000
Year 1	$ 24,398	$ 1,398	$ 11,000	$ 12,398	$ 22,000	$ 12,000	$ 10,602	$ 22,398
Year 2	$ 13,431	1,033	11,000	12,033	$ 11,000	12,000	10,967	$ 11,431
Year 3	$ –	569	11,000	11,569	$ –	12,000	11,431	$ –
		$ 3,000	$ 33,000	$ 36,000		$ 36,000	$ 33,000	

The initial recognition of the right-of-use asset and the subsequent measurement of the lease liability are the same for both types of leases. While the same total lease expense would be recognized for each type of lease, a lessee would recognize higher total lease expense and a lower right-of-use asset in the earlier part of an accelerated lease compared to a straight-line lease.

Comparison of proposed lessee model to current accounting

The following table compares the classification of leases under current accounting with the classification that would most likely apply under the revised proposal given the nature (i.e., property or other than property) of the underlying asset. However, not all leases would be classified as shown. In addition, other proposed changes would affect the income statement.

Current	Proposed	Effect on income statement
Property (land, buildings, part of a building)		
Operating	Straight-line lease	Generally similar
Capital	Accelerated lease	Generally similar
All other leases (e.g., vehicles and equipment, including integral equipment)		
Operating	Accelerated lease	Acceleration of expense; separate presentation of amortization and interest
Capital	Accelerated lease	Generally similar

The income statement recognition pattern for many leases of land, buildings or part of a building would remain relatively consistent. Differences may occur based on the difference in conditions provided in the revised proposal compared to the current classification test.

For example, under current accounting a lease of land is a capital lease only when the lease has a bargain purchase option or transfers ownership at the end of the lease. The revised proposal does not provide similar conditions for land. Therefore, the present value of fixed lease payments for a longer-term lease of land (e.g., a 99-year lease) could be substantially all of the fair value of the underlying asset and the lease would be an accelerated lease.

Also, residual value guarantees, which are included in minimum lease payments for purposes of applying the 90% of fair value test under current accounting, are not fixed lease payments. Therefore, it appears that such amounts would not be included in the classification assessment under the revised proposal. As such, a lease of property classified as a capital lease under current accounting that includes a significant residual value guarantee could be a straight-line lease under the revised proposal.

Many equipment (including integral equipment) and vehicle leases that are classified as operating leases under current accounting (e.g., an equipment lease for which the lease term is only 30% of the economic life) would be accelerated leases. These leases would have an acceleration of expense recognition when compared to current accounting.

Reassessment

Lessees would be required to reassess certain considerations throughout the life of the lease. The requirements would be the same for both types of leases.

Once a fact pattern requires a reassessment, the lessee would determine the revised inputs and remeasure the liability to make lease payments as of the reassessment date. The lessee would adjust the liability to make lease payments to reflect the change in the calculation, with the offset to either the right-of-use asset or net income.

The reassessment requirements are summarized in the following table.

<table>
<tr><th>Consideration</th><th>Indicator to reassess</th><th>Accounting treatment</th></tr>
<tr><td>Lease term and purchase options</td><td>A significant change in factors (except market factors) relevant to determining whether a significant economic incentive exists</td><td rowspan="2">Adjust the liability
Offset to the right-of-use asset</td></tr>
<tr><td>Discount rate</td><td>Change in lease payments due to a change in lease term</td></tr>
<tr><td>Residual value guarantees</td><td>Events or circumstances indicate that there has been a significant change in the amounts expected to be payable</td><td rowspan="2">Adjust the liability
Offsets:
Relating to current or prior periods to net income
Relating to future periods to the right-of-use asset</td></tr>
<tr><td>Lease payments that depend on an index or rate</td><td>When the index or rate changes</td></tr>
</table>

Requiring reassessments of key considerations would be a significant change. Under today's accounting, lessees do not have to actively monitor many of these considerations, and they adjust the accounting for many of these items (e.g., lease term) only when leases are modified. Some respondents to the 2010 ED said the cost of reassessing could exceed the benefit. As part of their redeliberations, the Boards indicated that the changes they made to the lease term used for accounting purposes and the accounting for contingent rents should reduce the cost of reassessment.

Reassessment would be a significant change from current accounting.

Illustration 10 — Lessee reassessment

A lessee enters into a lease that has a five-year noncancelable initial lease term. The lease includes a five-year renewal option and requires the lessee to make a $10,000 penalty payment if the renewal option is not exercised.

Upon initial measurement (i.e., the lease commencement date), the lessee determines that a significant economic incentive does not exist because the $10,000 is not significant compared with the overall economics of the transaction and no other factors create an economic incentive to renew. Therefore, the lessee determines that the lease term for accounting purposes is five years. The discount rate is based on the lessee's incremental borrowing rate using a five-year term and the $10,000 penalty is included as a lease payment.

At the beginning of year four (i.e., two years remain), the lessee installs significant leasehold improvements that have a useful life of seven years. As part of the reassessment process, the lessee determines it now has a significant economic incentive to exercise the five-year renewal option. To update the liability to make lease payments, the lessee does the following:

- Updates the lease term to include the expected exercise of the renewal option (the remaining lease term will now be seven years)
- Includes as lease payments the fixed lease payments from the remainder of the initial term (i.e., years four and five) and the renewal period (i.e., years six through 10)
- Removes the $10,000 penalty payment as a lease payment
- Reassesses the discount rate (i.e., determines its incremental borrowing rate at the reassessment date assuming a seven-year term)
- Remeasures the liability to make lease payments using the revised lease payments and discount rate
- Adjusts the liability to make lease payments to the remeasured amount and recognizes the change as an adjustment to the right-of-use asset

Although market factors such as market rentals or the fair value of the underlying asset would be considered when initially determining whether a significant economic incentive exists, changes in market factors would not be considered when reassessing the lease term. The Boards made this decision to address concerns that including market factors could make reassessment impractical or onerous (e.g., may require entities to obtain pricing information that may not be readily available). However, it remains to be seen how entities would be able to determine whether a significant economic incentive exists upon reassessment without considering market factors such as current market pricing for similar assets.

Leases with variable lease payments based on a change in CPI would need to be reassessed when the rate changes, which could be every reporting period. Each period, the liability would include remaining lease payments using CPI at the reporting date. That is, the liability would be adjusted for the revised index. Changes affecting the lease payment for the current period would be reflected in net income, and changes related to future periods would be reflected as an adjustment to the right-of-use asset.

Current accounting guidance does not include variable lease payments based on changes in CPI in the straight-line lease calculation for operating leases. Therefore, only changes in lease payments in the current period related to changes in CPI are recognized (as expense). The revised proposal would increase the complexity of the accounting for variable lease payments based on an index or rate and it would change the lease expense recognition pattern.

How we see it

Companies would need to develop processes and related controls to reassess key considerations, including how changes in facts and circumstances affect their assessment of economic incentives and amounts payable under residual value guarantees. We believe this would be a subjective process.

Other lessee matters

Impairment

Right-of-use assets for both types of leases would be subject to the impairment guidance for amortizing intangible assets (ASC 350, *Intangibles — Goodwill and Other*). ASC 350 requires an impairment indicator analysis at each reporting period and, if any indicators are present, a test for recoverability using undiscounted cash flows. If the recoverability test fails, the standard requires a fair value test. After an impairment loss is recognized, the adjusted carrying amount of the right-of-use asset would be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited. Consistent with ASC 350, the impairment analysis will often be performed at an asset group level.

Lessees currently apply the same impairment analysis to assets held under capital leases. This analysis would be new for leases currently accounted for as operating leases and could significantly affect the timing of expense recognition.

How we see it

- The carrying amount of right-of-use assets recognized for straight-line leases would typically decrease more slowly than similar assets recognized for accelerated leases. That is, the decrease in the right-of-use asset wouldn't be on a straight-line basis. As a result, the right-of-use asset recognized for a straight-line lease would be more likely to become impaired than the right-of-use asset recognized for an accelerated lease.
- In order to measure an impairment under the guidance in ASC 350, an entity must determine the fair value of the long-lived asset (or asset group). Although the Boards have not discussed measuring the fair value of right-of-use assets, we presume that the fair value of a right-of-use asset measured in accordance with ASC 820, *Fair Value Measurement*, would be either the amount for which the lessee could sublease the asset or what a market participant would pay to enter into an equivalent lease at the measurement date.

Lease incentives

A new lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee's existing lease with a third party. A lessee would deduct all lease incentives from the initial measurement of the right-of-use asset; however, a lessee would not adjust the lease obligation. This accounting would result in lease incentives being recognized as a reduction in periodic expense over the term of the lease.

Illustration 11 — Lease incentives

A company enters into a three-year lease of equipment and concludes that the agreement is an accelerated lease. The lessee agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three (the same facts as in Illustration 7). The initial measurement of the liability to make lease payments is $33,000 using a discount rate of approximately 4.24%. The lessor also agrees to reimburse the lessee for up to $3,000 of costs incurred to remove the lessee's existing equipment that will be replaced by the leased equipment. The lessee actually incurs $3,500 of removal costs.

The lessee records the following entries:

Right-of-use asset	$ 33,000	
Liability to make lease payments		$ 33,000

To initially recognize the lease-related asset and liability

Illustration 11 — Lease incentives (continued)

Removal expense	$	3,500		
Cash			$	3,500
To record removal costs incurred				
Cash	$	3,000		
Right-of-use asset			$	3,000
To record reimbursement from lessor (lease incentive)				

Accretion of the liability through the lease term would be the same as in Illustration 7 because the liability to make lease payments did not change. Compared to Illustration 7, periodic expense is decreased by $1,000 per year.

The summary of the lease contract's accounting including the lease incentive (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		10,000	10,000	10,000
Total expense		$ 11,398	$ 11,033	$ 10,569
Balance sheet				
Right-of-use asset	$ 30,000	$ 20,000	$ 10,000	$ —
Liability to make lease payments	$ (33,000)	$ (24,398)	$ (13,431)	$ —

The recognition of lease incentives as a reduction of expense over the term of the lease is consistent with current operating lease accounting. But the balance sheet presentation is different because under the revised proposal the incentive would reduce the right-of-use asset instead of being recognized as a liability.

Foreign exchange

For leases denominated in a foreign currency, lessees would apply ASC 830, *Foreign Currency Matters*, and remeasure monetary items using the exchange rate at each reporting date. Therefore, any change in the liability to make lease payments due to exchange rate changes would be reflected in net income. The right-of-use asset would be a nonmonetary asset measured at historical cost and therefore would not be remeasured to reflect changes in foreign exchange rates.

Presentation

The following table summarizes how lease-related activity would be presented on the financial statements of lessees:

Financial statement	Lessee presentation
Balance sheet	▸ Right-of-use assets and liabilities to make lease payments for each type of lease presented separately or disclosed in notes along with the line item in the balance sheet ▸ Whether presented separately or together with other assets, right-of-use assets presented as if the underlying asset were owned
Income statement	▸ Accelerated leases: Lease-related amortization and interest expense presented separately from other amortization and interest expense or disclosed. Lease-related amortization and interest expense cannot be combined. ▸ Straight-line leases: Lease-related expense presented as a single line item (e.g., lease or rent expense)
Statement of cash flows	▸ Accelerated leases: Cash payments for principal presented as financing activities and cash payments for interest presented as operating activities ▸ Straight-line leases: Cash payments for lease payments presented as operating activities ▸ Both types of leases: Cash payments for variable lease payments not included in the liability presented as operating activities ▸ Cash payments for short-term leases presented as operating activities

Any noncash activity, including the initial recognition of the lease at the lease commencement date, would be disclosed as a supplemental noncash item. In addition, interest paid for accelerated leases would need to be separately disclosed if using the indirect cash flow method.

How we see it

The presentation requirements for the income statement and statement of cash flows for accelerated and straight-line leases are similar to current requirements for capital and operating leases, respectively. However, the revised proposal would increase the population of leases accounted for using an accelerated lease expense recognition pattern, which would cause certain financial metrics to change.

For companies that have a significant amount of other-than-property leases currently accounted for as operating leases, EBITDA would increase because today's rent expense would be presented as amortization expense and interest expense. Operating cash flow would increase because cash payments related to principal would be classified as financing activities.

Companies should consider the effect of these presentation changes and other effects when developing and communicating key performance metrics to stakeholders.

Lessor accounting

Under the 2010 ED, a lessor would have applied one of two approaches based on whether it retained exposure to significant risks or benefits associated with the underlying asset. Feedback on this was mixed. Some favored having only one approach. Others questioned whether the proposal represented an improvement over existing guidance for lessors and encouraged the Boards to retain the current model.

After redeliberations, the Boards decided the lessor accounting proposal would continue to have two approaches. But the Boards significantly changed how the approaches would be applied.

Under the revised proposal, lessors would account for straight-line leases in a manner similar to current operating lease accounting. That is, a lessor would continue to recognize the underlying asset and would recognize lease income on a straight-line basis or another systematic basis that better represents the pattern in which it earns rent.

The Boards have not extensively discussed the lessor approach to straight-line leases. We believe that many of the key concepts described earlier would apply to straight-line leases; however, it is not clear whether certain aspects of the proposed accounting model developed for leases recognized on the balance sheet (e.g., the requirement to reassess certain items on a periodic basis) would apply to operating leases.

The Boards' proposed approach would have lessees recognize a payable for straight-line leases, but the lessors would not recognize a receivable.

For accelerated leases, lessors would apply the receivable and residual approach described below. Specialized accounting for leveraged leases would not be retained.

Initial recognition and measurement under the receivable and residual approach

Upon commencement of the lease, the lessor would:

- Recognize a lease receivable for the lessor's right to receive lease payments
- Allocate the carrying amount of the underlying asset being leased between the portion related to the right of use granted to the lessee (cost derecognized) and the portion retained by the lessor (i.e., the residual asset)
- Measure the total profit, if any, inherent in the underlying asset (i.e., the difference between the fair value and the carrying amount of the underlying asset) and recognize the portion of the profit related to the right of use granted to the lessee (portion leased)

Lease receivable

The lease receivable would be initially measured at:

- The present value of the lease payments over the lease term using the key concepts described previously for lease term, lease payments and discount rate
- Any initial direct costs (i.e., direct and incremental costs to the lease transaction such as commissions and legal fees)

The accounting treatment for initial direct costs would be similar to current direct financing leases but different from current sales-type leases, which require expensing of the initial direct costs at lease commencement.

The Boards decided that the fair value option would not be allowed for the measurement of the lease receivable, even if the receivable is held for sale.

How we see it

The lessor's receivable would be calculated similarly to the lessee's liability to make lease payments, with a few differences. Differences would include the lessor's inclusion of initial direct costs in the receivable and the lessor's exclusion of any residual value guarantees. Also, the lessee and lessor could make different determinations for key inputs such as the discount rate, based on the different information available to each party.

Allocation of the carrying amount of the underlying asset

Under the receivable and residual approach, lessors would recognize profit (if any) on the right of use granted to the lessee for all leases at lease commencement.

The carrying amount of the underlying asset would be allocated between the portion leased and the residual asset. It appears that the allocation method would be based on the ratio of the present value of the lease payments to the fair value of the underlying asset being leased. However, the Boards may refine the method used to determine this allocation.

The amount remaining on the lessor's balance sheet (i.e., the residual asset) would be initially measured as the carrying amount of the underlying asset less the cost derecognized. That is, the residual asset would be initially measured as:

$$\text{Carrying amount of underlying} - \left\{ \text{Carrying amount of underlying} \times \frac{\text{Present value of lease payments}}{\text{Fair value of underlying asset}} \right\}$$

Illustration 12 — Allocation of the carrying amount
Using the allocation method described, if the present value of lease payments is 70% of the fair value of the underlying asset, 70% of the underlying asset's carrying amount would be derecognized and the remaining 30% of the carrying amount would be the residual asset.

Profit

At the commencement of the lease, profit would be recognized for the difference between the present value of lease payments recognized as part of the receivable and the cost derecognized. This profit would represent the profit related to the leased portion of the asset.

Illustration 13 — Profit upon commencement

Assume the lessor leases a piece of equipment with a fair value of $1,000 and a carrying amount of $900. The lessor calculates the present value of lease payments to be $700. Therefore, the portion of the underlying asset granted to the lessee is 70% ($700/$1,000).

Total profit would be $100 ($1,000 — $900). The lessor would recognize $70 of profit (70% of $100) upon commencement of the lease.

Alternatively, the $70 profit could be calculated by taking the difference between the present value of the lease payments ($700) and cost derecognized (70% * $900 = $630).

The initial measurement of the residual asset would be calculated as the difference between the carrying amount of the asset and the cost derecognized ($900 — $630 = $270) or alternatively calculated using the formula above [$900 — $900 * ($700/$1,000)].

Under current sales-type lease accounting, because of the way the residual is calculated, initial profit recognized reflects the profit on the sale of the entire asset, not just the portion leased. The receivable and residual approach would result in lower initial profits being recognized for these types of leases.

Residual asset components

The residual asset, which would be initially measured using the allocation method described previously, would be considered to consist of two components:

- Gross residual — The present value of the expected fair value of the underlying asset at the end of the lease discounted using the rate the lessor charges the lessee
- Deferred profit — The difference between the gross residual and the recognized residual asset

The deferred profit conceptually represents the portion of the total profit not recognized. For example, the deferred profit for the lease in Illustration 13 would be $30 (30% of $100). However, deferred profit may include other aspects of the lease arrangement that were not recognized as part of the receivable (e.g., residual value guarantees and variable payments based on usage).

The separate components are necessary for purposes of calculating accretion income to be recognized over the lease term. The separate treatment of the two residual asset components ensures that the accretion over the lease term and the gross residual at the end of the lease term are the same regardless of whether the lessor has any total profit upon commencement (e.g., whether the lessor is a manufacturer/dealer or a financial institution).

Subsequent measurement under the receivable and residual approach

Over the term of the lease, the lessor would:

- Recognize interest income on the lease receivable using the interest method (i.e., a level effective rate throughout the lease term)
- Reduce the receivable for lease payments received
- Accrete the gross residual using the rate the lessor charges the lessee

Because the initial direct costs are included in the lease receivable, the effective interest rate on the lease receivable would be lower than the rate the lessor charges the lessee.

The deferred profit on the residual would not be accreted during the lease. Therefore, at the end of the lease, the residual asset would be equal to the originally estimated expected fair value of the underlying asset less the deferred profit.

The deferred profit would be part of the carrying value of the residual asset that would be derecognized upon sale or re-lease of the underlying asset.

For leases unaffected by other potential changes (e.g., residual value guarantees), the accounting treatment and measurement of the gross residual would be very similar to the accounting for the residual assets in current direct financing and sales-type lessor accounting. However, the deferred profit component represents a significant change.

How we see it

The Boards decided accretion of the residual asset would be appropriate to be consistent with the underlying economics. The lessor is financing the purchase of the entire asset and incorporates a return on the entire asset as part of the lease pricing. In other words, the lessor sold the underlying asset and obtained a right of return. Some may question whether this view is contrary to the right-of-use model, under which the unit of account is the right of use.

Illustration 14 — Receivable and residual approach

Assume a lessor manufactures a machine for $7,500 and enters into a three-year lease of the machine with a lessee. At lease commencement, the machine has a fair value of $10,000; the annual rent is $2,400, due at the end of each year. The lessor estimates that the machine's expected fair value at the end of the lease term will be $4,770. The present value of the lease payments discounted at the interest rate implicit in the lease (7.866%) is $6,200. The expected fair value of the underlying asset at the end of the lease discounted at the interest rate implicit in the lease (7.866%) is $3,800.

Upon lease commencement, the lessor records the following (assume gross presentation on the income statement):

Lease receivable	$	6,200		
Revenue			$	6,200

To initially recognize the revenue and related lease receivable at the present value of the lease payments

Cost of sales ($7,500 * ($6,200/$10,000))	$	4,650		
Residual asset ($7,500 − $4,650)	$	2,850		
Underlying asset			$	7,500

To reclassify a portion of the underlying asset as a residual asset and derecognize the portion of the underlying asset leased

Illustration 14 — Receivable and residual approach (continued)

The following table illustrates the amounts recognized throughout the lease (assuming no changes due to reassessment):

Period	Lease receivable	Gross residual	Deferred profit	Residual asset	Profit recognized[D]	Cash received
Initial	$ 6,200	$ 3,800[A]	$ (950)[B]	$ 2,850[C]	$ 1,550	$ –
Year 1	$ 4,288	$ 4,099	$ (950)	$ 3,149	787	2,400
Year 2	$ 2,225	$ 4,422	$ (950)	$ 3,472	660	2,400
Year 3	$ –	$ 4,770	$ (950)	$ 3,820	523	2,400
				Total	$ 3,520	$ 7,200

[A] Although referred to as the "gross" residual, this amount is actually a discounted amount (i.e., the present value of the estimated fair value of the underlying asset at the end of the lease term: $4,770 discounted at 7.866%).

[B] Deferred profit is the portion of the total profit ($2,500) related to the portion of the underlying asset that was retained (i.e., residual). Deferred profit could be calculated by the difference between the gross residual and the recognized residual asset ($3,800 − $2,850).

[C] Residual asset is initially measured based on the allocated cost approach [$7,500 − $7,500 * ($6,200/$10,000)].

[D] Represents profit on right of use transferred, accretion income from the gross residual and interest income on the receivable. See calculation of profit recognized in the following table.

Profit recognized is comprised of the following:

Period	Interest on receivable[A]	Accretion income[B]	Profit on right of use transferred	Profit recognized
Initial	$ –	$ –	$ 1,550[C]	$ 1,550[C]
Year 1	488	299	–	787
Year 2	337	323	–	660
Year 3	175	348	–	523
	$ 1,000	$ 970	$ 1,550	$ 3,520

[A] Interest income on the receivable recognized over the term of the lease calculated using the interest method. For example, year one interest is calculated as $488 ($6,200 * 7.866%).

[B] Accretion income on the gross residual recognized over the term of the lease calculated as gross residual multiplied by the rate the lessor charges the lessee. For example, year-one accretion is calculated as $299 ($3,800 * 7.866%) and year-two accretion is calculated as $323 ($4,099 * 7.866%).

[C] At commencement, profit is recognized for the difference between the present value of the lease payments recognized ($6,200) and the portion of the carrying amount of the underlying asset derecognized (underlying asset of $7,500 less residual asset of $2,850 or $4,650).

If at the end of the lease, the lessor sells the machine for $4,770, as originally estimated, the lessor would derecognize the $3,820 residual asset and recognize $950 of profit.

Reassessment

Lessors applying the receivable and residual approach would be required to reassess certain key considerations throughout the life of the lease.

It is unclear whether reassessment requirements would apply to operating leases.

Once a fact pattern requires a reassessment, the lessor would determine the revised inputs and remeasure the lease receivable as of the reassessment date. The lessor would adjust the receivable to reflect the change in the calculation with the offset to residual asset or net income. The following table summarizes the lessor reassessment requirements and the offsetting adjustment to the receivable.

Consideration	Indicator to reassess	Accounting treatment
Lease term and purchase options	A significant change in factors (except market factors) relevant to determining whether a significant economic incentive exists	‣ Adjust the lease receivable ‣ Offset to the residual asset and net income
Discount rate	Change in lease payments due to a change in lease term	
Lease payments that depend on an index or rate	When the index or rate changes	‣ Adjust the lease receivable ‣ Offset to net income

Illustration 15 — Lessor reassessment

A lessor enters into a five-year lease of equipment with $1,000 in annual base rent due at the beginning of each year. The rent is adjusted by the change in CPI at the end of each year. CPI is 100 at lease commencement. At the end of year one, CPI is 102. The lessor concludes that the lease is an accelerated lease and the receivable and residual approach should be applied.

At lease commencement, the lessor receives a $1,000 fixed payment for the first year's rent. The lease receivable is measured using the current index (i.e., CPI of 100). The lease payments included in the measurement of the lease receivable would be $1,000 for years two through five (i.e., no escalation).

At the end of year one, the lessor reassesses the lease payments using the current rate of 102 (i.e., a 2% increase from the base rent). Therefore, the updated receivable calculation includes annual lease payments of $1,020 ($1,000 base payment * 102%) for years two through five. The increase in lease payments increases the lease receivable at the end of year one by $75 (i.e., the present value of $20 each year) with the corresponding adjustment recognized in net income.

How we see it

The reassessment requirement would be a significant change from current standards. The reassessment requirement would potentially introduce more volatility to the lessor's financial statements.

Variable lease payments

Some leases are priced to include a significant amount of variable lease payments based on usage or performance. For example, a lease could require a fixed payment plus an additional payment per mile for every mile driven. Other leases include variable lease payment provisions that are not included in the lease pricing (i.e., the lessor uses the provisions for other reasons such as to minimize residual asset risk). For instance, a lease could require a payment per mile for every mile driven in excess of 10,000 miles per year when the expected annual mileage is 8,000.

When a lessor prices a lease contract with the expectation of receiving variable lease payments, the interest rate implicit in the lease would reflect that assumption. That is, when the lessor expects to achieve its desired yield on the underlying asset through the combination of both fixed and variable payments, the rate the lessor charges the lessee (i.e., the discount rate used to measure the lease receivable) reflects an expectation of variable lease payments. When a lessor prices a lease contract based on only the fixed payments and expected residual value (i.e., the lessor does not anticipate receiving variable lease payments in order to achieve its desired yield on the underlying asset), the rate the lessor charges the lessee does not reflect an expectation of variable lease payments.

Variable lease payments based on usage or performance are excluded from the lease receivable and recognized in net income as accruable. Because the lease receivable is used to allocate the carrying amount of the underlying asset, contracts with variable lease payments based on usage or performance would have a higher residual asset than if the payments were fixed.

If the rate the lessor charges the lessee does not reflect an expectation of variable lease payments, the lessor would not make any adjustments to the residual asset when variable lease payments are recognized (i.e., the lessor would recognize lease income and no corresponding cost).

If the rate the lessor charges the lessee does reflect an expectation of variable lease payments, the lessor would reduce the residual asset and recognize a related expense when variable lease payments are recognized. The amount of the residual asset derecognized would be based on the same pricing expected at lease commencement (i.e., use the carrying amount and fair value of the underlying asset at commencement and the expected variable lease payments for the period) using the same allocation method described previously (i.e., amount derecognized = carrying amount of underlying asset at lease commencement * (expected variable lease payments for period/fair value of underlying asset at lease commencement)). Any differences between the expected and actual variable lease payments would not result in any further adjustment to the residual asset.

Impairment

The receivable would be subject to impairment guidance for receivables (ASC 310, *Receivables*). However, the guidance within ASC 310 may be changing based on the Boards' ongoing Financial Instruments project. The FASB is still deliberating the impairment model, so the future accounting treatment is unclear.

Residual assets would be subject to the impairment guidance for long-lived assets (ASC 360, *Property, plant and equipment*). ASC 360 requires an impairment indicator analysis at each reporting period and, if any indicators are present, a test for recoverability using undiscounted cash flows. If the recoverability test fails, the standard requires a fair value test. After an impairment loss is recognized, the adjusted carrying amount of the residual asset would be its new accounting basis. The Boards decided that while residual value guarantees would not be recognized until the end of the lease term, residual value guarantees (from the lessee and third parties) would be considered in the impairment assessment. Subsequent reversal of a previously recognized impairment loss is prohibited.

Current accounting requires an annual other-than-temporary impairment review of lease residuals. The proposed impairment approach would not have a similar annual review requirement.

How we see it

Certain aspects of applying the impairment guidance in ASC 360 to residual assets remain unclear. For example, the Boards have not discussed how a lessor would assess a decline in the expected fair value of the underlying asset at the end of the lease (e.g., whether the decline would be assessed relative to the original expected fair value or the current carrying amount) or how a lessor would consider the prospective accretion of the gross residual asset to its original expected fair value at the end of the lease when assessing the residual asset for impairment. Also, the Boards have not described exactly how a lessor would consider a residual value guarantee when assessing the residual asset for impairment (e.g., whether to include amounts expected to be received under a residual value guarantee in both the recoverability and fair value assessments).

Presentation under the receivable and residual approach

The following table summarizes how amounts recognized by lessors would be presented on the financial statements:

Financial statement	Lessor presentation
Statement of financial position	Either: 1. Lease receivables and residual assets (i.e., the gross residual net of deferred profit) presented separately and summing to a total lease assets on the balance sheet, or 2. Lease assets (i.e., sum of lease receivables and residual assets) presented on the balance sheet and amounts for lease receivables and residual assets disclosed in the notes
Income statement	‣ Lease revenue and related costs (i.e., portion of underlying asset derecognized) presented either gross or net based on lessor's business model ‣ Interest income from the lease receivable and accretion of the gross residual presented as interest income ‣ Amortization of initial direct costs presented as an offset to interest income ‣ Lease-related income statement items (e.g., lease revenue, interest income) either presented separately from other activity or disclosed along with the line item in the income statement
Statement of cash flows	‣ All cash inflows from leases (e.g., interest, lease payments, short-term payments) presented as operating activities

Comparison of proposed lessor model to current accounting

The Boards' decisions on lessor accounting create two types of leases for lessors instead of the four types of leases we have today. The following table compares today's accounting with the approach that lessors would most likely apply under the revised proposal. Other changes could occur from adoption of the proposed guidance (e.g., determination of lease term, reassessment).

<table>
<tr><th>Current</th><th>Proposed</th><th>Effect</th></tr>
<tr><td colspan="3">Property (land, buildings, part of a building)</td></tr>
<tr><td>Operating</td><td>Operating</td><td>Generally similar</td></tr>
<tr><td>Direct financing</td><td rowspan="3">Receivable and residual approach</td><td>Generally similar</td></tr>
<tr><td>Sales-type</td><td>Lower profit upon commencement
Residual asset reduced by deferred profit</td></tr>
<tr><td>Leveraged leases</td><td>Introduces profit unevenness instead of a consistent rate of return
Excludes tax effects when calculating return
Gross up of balance sheet (i.e., present lease-related assets, third-party debt separately)</td></tr>
<tr><td colspan="3">All other leases (e.g., vehicles and equipment, including integral equipment)</td></tr>
<tr><td>Operating</td><td>Receivable and residual approach assuming practical expedient exception conditions not met</td><td>Introduces profit unevenness
Balance sheet composition changes some tangible assets to financial assets</td></tr>
<tr><td>Direct financing</td><td rowspan="3">Receivable and residual approach</td><td>Generally similar</td></tr>
<tr><td>Sales-type</td><td>Lower profit upon commencement
Residual asset reduced by deferred profit</td></tr>
<tr><td>Leveraged leases</td><td>Introduces profit unevenness instead of a consistent rate of return
Excludes tax effects when calculating return
Gross up of balance sheet (i.e., present lease-related assets, third-party debt separately)</td></tr>
</table>

Most leases that would be classified as direct financing, sales-type or leveraged leases under current accounting would likely be accounted for under the receivable and residual approach under the revised proposal. However, these leases could be subject to operating lease accounting under the revised proposal in certain circumstances. For example, consider a lease of a building for less than a major part of its economic life under which the lessor obtains a residual value guarantee (from either the lessee or a third party) that the building's value at the end of the lease term will equal the current fair value of the building. Such a lease may be classified as a direct financing lease under current accounting, but may be accounted for an as operating lease under the revised proposal.

Many leases of land, buildings or parts of buildings currently accounted for as operating leases would remain operating leases under the revised proposal. However, as described earlier, the proposed classification criteria are different than today's criteria and not all of today's operating leases of land, buildings and parts of buildings would qualify for operating lease accounting under the revised proposal. In particular, longer-term leases (e.g., 99-year leases) as well as leases that begin in the later stages of the leased asset's estimated economic life that are operating leases today may be subject to the receivable and residual approach under the revised proposal.

Many equipment (including integral equipment) and vehicle leases that are classified as operating leases under current accounting would be subject to the receivable and residual approach.

In comparison to operating lease accounting, the receivable and residual approach would result in a different profit recognition pattern (including possible day-one profit on what today would be an operating lease), a portion of the underlying asset being derecognized and a receivable being recognized on the balanced sheet.

Sale-leaseback transactions would no longer provide off-balance sheet financing.

Specialized accounting for leveraged leases would no longer exist. Instead, the lease-related assets and liabilities would be recognized in accordance with the lessor accounting model. The debt, interest and income tax–related amounts would be subject to other applicable accounting guidance (e.g., ASC 470, *Debt*; ASC 740, *Income taxes*).

Other

Sale and leasebacks

Sale-leaseback transactions would no longer provide off-balance sheet financing because lessees would recognize all leases (other than short-term leases) on the balance sheet. The determination of whether sale-leaseback transactions are accounted for as a sale and a lease, or as a financing transaction, would be based on the control criteria developed in the joint revenue recognition project. That is, no special criteria would exist for assessing sale-leaseback transactions.

If the consideration exchanged (i.e., sales price for the sale of the asset and rental rate for the lease) is at fair value, the seller-lessee would recognize a gain or loss when the sale occurs on a sale transaction that qualifies as a sale-leaseback. When the consideration is not at fair value, the assets, liabilities, gain or loss would be adjusted to reflect current market rentals. Under current accounting, the seller-lessee is required to defer and amortize some or all of the profit on a sale for many sale-leaseback transactions.

A transaction that does not meet the sale criteria would be accounted for as a financing transaction by the seller-lessee.

How we see it

The Boards' decision to use revenue recognition guidance for sale-leaseback transactions represents a major change from existing US GAAP for sale-leaseback transactions involving real estate. We expect that many transactions that do not qualify for sale-leaseback accounting under current real estate sale-leaseback guidance due to its restrictive criteria would meet the transfer of control guidance under the revenue recognition proposal and be accounted for as sales and leases instead of financing transactions. However, it is not clear how the seller-lessee retaining the right to use the asset or features in the lease (e.g., purchase options) would affect the sale evaluation.

A lessee may be involved with the construction of an asset that will be leased to the lessee when construction is completed. Under current US GAAP, special rules govern the assessment of a lessee's involvement in asset construction to determine whether the lessee should be considered the owner of the asset during the construction period. If the lessee is deemed the owner during construction, a deemed sale and leaseback of the asset would occur when construction of the asset is complete and the lease term begins.

Under the revised proposal, special accounting guidance would not be provided for a lessee's involvement in the construction of the underlying leased asset. Instead, these arrangements would be accounted for based on the specific facts and circumstances of each arrangement and there would be no "special provisions" for imputing ownership during the construction period. For example, if the lessee provided a guarantee for the construction loan and paid for certain construction costs, the lessee would assess the need to recognize a guarantee liability by applying guarantee accounting guidance (ASC 460, *Guarantees*) and recognize a lease deposit or prepayment for the construction costs paid prior to lease commencement.

Subleases

In a sublease arrangement, one party will act as both the lessor and lessee of the same asset. That is, one party will obtain the right to use the underlying asset under the head lease and it will act as the lessor in the sublease under which it conveys the right to use the underlying asset to a different party for the same or a shorter term. The head lease and sublease arrangements would be accounted for as separate transactions and unique measurement criteria for subleases would not exist. The lessee accounting model would be applied to the assets and liabilities that arise in the head lease, and the lessor accounting model would be applied to the assets and liabilities that arise in the sublease.

For example, when the sublease is an accelerated lease, the sublessor would allocate the carrying amount of the head lease's right-of-use asset to the portion derecognized and the residual asset, recognize a lease receivable and any profit. Alternatively, when the sublease is a straight-line lease, the sublessor would apply operating lease accounting (i.e., retain the head-lease right-of-use asset on its balance sheet, amortize it over the head-lease term and recognize sublease income over time).

Disclosure

Lessee and lessor disclosure requirements cover both quantitative and qualitative information. Significant new quantitative disclosures include a reconciliation of the opening and closing balances for the:

- Lessee's liability to make lease payments by type of lease
- Lessor's receivable
- Lessor's residual asset

> ### How we see it
> Entities would likely need to track and compile information on leases that they haven't previously collected.

Business combinations

The Boards would provide an exception to the fair value measurement premise in business combination accounting for leases. Instead, lessees would measure the liability to make lease payments, and lessors (applying the receivable and residual approach) would measure the lease receivable in accordance with the proposed leases guidance as if the lease is a new lease at the acquisition date (i.e., they would measure the liability to make lease payments and the lease receivable at the present value of the remaining lease payments using the discount rate and determination of other key terms as of the acquisition date).

The lessee's right-of-use asset would be adjusted for any off-market terms in the contract (i.e., the difference between the recorded liability to make lease payments and the present value of the lease payments that the acquirer would expect to pay if, at the acquisition date, it entered into an identical lease for the remaining period).

Illustration 16 — Acquisition of a lessee

Assume as part of a business combination, Company A acquires an equipment lease with a remaining contractual lease term of three years. Contractual monthly payments are $1,000. As of the acquisition date, the market monthly rate for the equipment is $900 and Company A's incremental borrowing rate is 8%.

To recognize the lease at the acquisition date, Company A:

- Determines that the remaining lease term is three years (no renewal options exist)
- Calculates the liability to make lease payments to be $32,125 (the present value of $1,000/month for 36 months using a discount rate of 8%)
- Calculates the amount it would pay if it entered into an identical lease to be $28,912 (the present value of $900/month for 36 months using a discount rate of 8%)
- Calculates the off-market term adjustment to be a $3,213 reduction in the right-of-use asset ($32,125 − $28,912)
- Recognizes a right-of-use asset of $28,912 and a liability to make lease payments of $32,125

Lessors applying the receivable and residual approach would measure the residual asset as the difference between the fair value of the underlying asset at the acquisition date and the lease receivable. Lessors applying operating lease accounting would continue to apply current business combination accounting guidance (i.e., they would recognize the underlying asset at fair value and an asset or liability for any off-market provisions of the lease).

Separate assets or liabilities (e.g., off-market provisions) would not be recognized for acquired short-term leases (i.e., leases that, at the acquisition date, have a maximum possible lease term of 12 months or less).

How we see it

The proposed accounting for leases acquired in a business combination would approximate fair value, particularly for simple leases but at a reduced cost to the preparer. However, differences from fair value would exist because certain aspects of the lease could be measured differently (e.g., determination of discount rate).

Transition

Transition would be a modified retrospective approach and no leases would be grandfathered.

Due to the long-term nature of many leases and the significance of the accounting changes proposed, and the desire to achieve consistency with the revenue recognition project retrospective approach, the Boards decided against a prospective approach. The Boards proposed a "modified retrospective approach" for transition to the new leases standard. Certain optional relief would be available. Full retrospective application would also be permitted. Retrospective application would be required for leveraged leases.

No leases would be grandfathered, including arrangements previously grandfathered under EITF 01-8. However, for today's capital, sales-type and direct financing leases, preparers would be able to use the carrying amount of the lease asset and liability under the current accounting model for their initial measurement of lease-related assets and liabilities.

A preparer would recognize lease-related assets and liabilities as of the beginning of the earliest comparative period presented (referred to as the date of initial application in the 2010 ED). The effective date has not yet been determined. But if the leases standard were to be effective for calendar year 2016, a calendar-year company that prepares a three-year comparative income statement would have a date of initial application of 1 January 2014 and an effective date of 1 January 2016.

Subsequent to the date of initial application, lessees and lessors would follow the accounting described in the lessee and lessor accounting sections, respectively.

How we see it

The modified retrospective approach is intended to approximate a fully retrospective approach but at a lower cost and with less effort than full retrospective.

Lessee

As of the date of initial application, lessees applying the modified retrospective approach would:

- Recognize the liability to make lease payments measured at the present value of the remaining lease payments discounted using the lessee's incremental borrowing rate as of the effective date for the preparer's portfolio of leases with reasonably similar characteristics (e.g., similar remaining lease terms)
- Recognize the right-of-use asset that is calculated to estimate what the right-of-use asset would have been had it been retrospectively determined and subsequently accounted for using the revised proposal
- Record any difference between the liability and the right-of-use asset to retained earnings

The right-of-use asset as of the date of initial application is calculated differently based on the type of lease.

For straight-line leases, the right-of-use asset recognized upon transition would equal the liability to make lease payments adjusted for any uneven lease payments as of the date of initial application (i.e., any prepaid or deferred rent balance from the straight-line lease expense calculation under current operating lease accounting).

For accelerated leases, the lessee would perform up to three steps to calculate the right-of-use asset for each lease after calculating the liability to make lease payments as of the date of initial application:

- Step #1: If the remaining lease payments are uneven, calculate the periodic (i.e., fixed) payment amount necessary to reduce the liability to make lease payments as of the date of initial application to zero at the end of the lease.
- Step #2: Calculate the estimated liability to make lease payments at the lease commencement date (the present value of the previously calculated periodic payments determined in Step #1 for the total lease term). The total lease term would be determined as of the date of initial application as the sum of the term incurred to date and the remaining lease term.
- Step #3: Calculate the right-of-use asset by multiplying the estimated liability to make lease payments at lease commencement (determined in Step #2) by the portion of the lease remaining (i.e., remaining lease term/total lease term), adjusting for prepaid or accrued lease payments if necessary.

After the date of initial application, lessees would follow the same accounting treatment as described in the lessee accounting section.

Illustration 17 — Lessee transition — accelerated lease

Company A is a calendar-year public company required to apply the new leases standard in its annual financial statements for periods beginning on or after 15 December 2015. The date of initial application for Company A is 1 January 2014 (the beginning of the first comparative period presented in its 2016 annual financial statements) and the effective date is 1 January 2016.

Company A has a lease of equipment that commenced on 1 January 2013 with a five-year term and annual payments of $1,000 due at the beginning of each year. The lease is currently accounted for as an operating lease and will be accounted for as an accelerated lease upon adoption.

Company A determines the following:

- The incremental borrowing rate for this lease and other similar leases is 7.5% as of 1 January 2016
- As of 1 January 2014, the remaining lease term is four years and lease payments will be $1,000 annually

The present value of the liability to make lease payments (before the 2014 lease payment) as of 1 January 2014 is $3,600 using a discount rate of 7.5%.

The right-of-use asset is calculated in the following manner:

1. Because the lease payments are fixed, $1,000 annual payments would be used in the estimated liability to make lease payments at commencement
2. The present value of $1,000 for five years using a discount rate of 7.5% is $4,348
3. The right-of-use asset is $3,478 ($4,348 * (four years remaining/five years total lease term))

Since no amount was prepaid or accrued as of 1 January 2014, no additional adjustment to the right-of-use asset is required.

The amount recorded to retained earnings for this lease would be $122 ($3,600 – $3,478).

While the opening balance sheet is not presented in the 2016 financial statements, Company A presents the 2014 income statement effect based on the 1 January 2014 measurement as follows:

- Recognizes amortization expense of $870 ($3,478/4 years)
- Recognizes interest expense on the liability to make lease payments of $195 [($3,600-$1,000) * 7.5%]

Alternatively, assume that the asset is office space and the lease is a straight-line lease. Company A would recognize a liability of $3,600. Because the lease payments are even throughout the lease term (i.e., no prepaid or deferred rent as of the date of initial application), Company A would recognize a right-of-use asset of $3,600.

Lessor

As of the date of initial application, lessors applying the receivable and residual approach would:

- Recognize the lease receivable measured at the present value of the remaining lease payments, subject to any adjustments required to reflect impairment
- Recognize a residual asset consistent with the initial measurement of the residual asset under the receivable and residual approach, using information (e.g., fair value of the underlying asset, cost of the underlying asset) available at the date of initial application
- Derecognize the portion of the underlying asset leased
- Record any difference between the receivable and residual asset recognized and underlying asset derecognized to retained earnings

Any recognized prepaid or accrued lease payments would be adjusted to the underlying asset that is derecognized and therefore would affect the amount recorded to retained earnings.

Transition would likely involve a significant effort for many preparers.

The discount rate used would be the rate charged in the lease determined at the date of commencement of the lease.

Illustration 18 — Lessor transition — receivable and residual approach

Assume the same facts as in the previous illustration, except that the preparer is the lessor.

The lessor determines the following:

- The lease's commencement date was 1 January 2013 and the total lease term is five years
- The rate the lessor charged the lessee as of 1 January 2013 (the commencement date) was approximately 8%
- As of 1 January 2014, the remaining lease term is four years and lease payments will be $1,000 annually
- The fair value of the piece of equipment at 1 January 2014 is $7,700
- The underlying asset's carrying amount at 1 January 2014 was $7,550

The present value of the lease receivable as of 1 January 2014 before the 2014 lease payment is $3,577 (the present value of the $1,000 lease payments over four years discounted at approximately 8%).

The residual asset is $4,043 and is calculated as $7,550 – [$7,550 * ($3,577/$7,700)]. The lessor would record a receivable of $3,577 and a residual asset of $4,043, derecognize the underlying asset of $7,550 and recognize $70 as a credit to retained earnings.

How we see it

The transition requirements are currently unclear for lessors with operating leases that would continue to quality for operating lease accounting. In addition, the Boards have not discussed transition accounting for leases that are currently classified as direct financing and sales-type leases and would apply operating lease accounting upon adoption.

Other transition considerations

Certain optional relief would be provided:

- Use of hindsight — Allowed in comparative reporting periods including the determination of whether a contract is or contains a lease
- Initial direct costs — Not required to evaluate initial direct costs for contracts that began before the effective date

The relief would be optional, but a preparer that elects to use it would be required to disclose this fact. Additional transition disclosures would be required.

The revised proposal will include additional transition guidance for specific circumstances, such as sale and leaseback transactions.

Next steps

Entities should carefully review the revised proposal when it is issued and consider providing feedback to the Boards. The revised proposal would require significant accounting and process changes for many entities.

Endnote:

[1] FASB Proposed Accounting Standards Update, *Leases*. For additional detail about the 2010 exposure draft, refer to Financial Reporting Developments, *Proposed accounting for leases* (SCORE No. BB2012) or Technical Line, *Proposed leases guidance exposed* (SCORE No. BB1990).

Appendix: Summary of significant changes since 2010

	Exposure draft	Redeliberations	Effect
Lease term definition	Longest possible lease term that is more likely than not to occur (i.e., greater than 50% probability)	Noncancelable period plus any options when there is a significant economic incentive to extend or not terminate the lease	Typically shortens the lease term and reduces amounts recognized on the balance sheet
Contingent rent based on performance or usage	Include contingent rent based on performance or usage in lease-related assets and liabilities using an expected outcome technique	Contingent rent based on performance or usage recognized as expense as incurred	Reduces amounts recognized on the balance sheet; affects timing of expense recognition
Residual value guarantees — lessors	Include as lease payment an estimate of amounts receivable from the lessee under residual value guarantees	Do not account for residual value guarantees until the end of the lease	Reduces receivable and related profit upon commencement
Short-term leases — lessees	Recognize on balance sheet without discounting	Accounting policy to apply current operating lease accounting	Reduces amounts recognized on the balance sheet
Right to control the use of a specified asset	Based on meeting any one of three conditions; consistent with current US GAAP	Based on ability to direct the use and receive the benefit from use of a specified asset	Changes could scope out certain contracts that are accounted for as leases today
Purchase options	Not included in amounts recognized as: ‣ Arrangements with bargain purchase options excluded from lease standard ‣ Other purchase options accounted for only when exercised	If the lessee has a significant economic incentive to exercise the option: ‣ Include exercise price in the measurement of the lease liability or lease receivable ‣ For lessees, amortize the right-of-use asset over the life of the underlying asset Other purchase options accounted for when exercised	Provides for consistent treatment of purchase options and lease renewal options; no change for purchase options that the lessee does not have a significant economic incentive to exercise
Scope	Excluded in substance purchase/sales from leases scope	No in substance purchase/sale exclusion	Change aligns with current US GAAP
Separation of lease and non-lease components	Separate services if distinct. If not distinct, account for the entire contract as a lease. Accounting treatment for executory costs unclear.	Separate all non-lease components (including services and executory costs) except in limited circumstances in which the lessee is unable to determine the allocation	More non-lease components would be accounted for separately; reduces amounts recognized on the balance sheet and reduces conflicts with accounting for other executory contracts
Initial measurement date	Date of inception of the lease	Date of commencement of the lease	Discount rate is determined as of the commencement date instead of inception date

	Exposure draft	Redeliberations	Effect
Discount rate	Rate can be determined using multiple alternatives	The rate implicit in the lease is used when known	Removed some subjectivity for lessor's rate
Lessee model	Apply a single approach that results in an accelerated lease expense recognition pattern	Two types of leases based primarily on the nature of the underlying asset	Some leases (primarily property leases) would have a straight-line lease expense recognition pattern
Lessor model	Use either performance obligation or derecognition approach based on whether lessor retains significant risks and benefits of underlying asset	Apply operating lease accounting or the receivable and residual approach based primarily on the nature of the underlying asset	Many property leases would be accounted for similar to current operating lease accounting; all other leases would have partial derecognition of underlying asset and possible day-one profit
Residual asset subsequent measurement	No accretion (derecognition approach)	Accrete gross residual asset to the estimated expected residual asset; no change to deferred profit	Increases total lease income; concept of accretion of gross residual is consistent with current accounting
Lessor balance sheet presentation — receivable and residual approach	Receivable presented separately, residual asset presented separately within PP&E (under the derecognition approach)	Present separately, or together as a single line item with receivable and residual asset amounts disclosed in the notes	Conforms to current accounting
Overall presentation	Specified lease-related items need to be on face of financial statements	Face or disclosures	Allows more flexibility, reduces requirement/volume on face of financial statements
Sale-leasebacks	Restrictive criteria required to be met to recognize a sale	Sale treatment based on revenue recognition guidance in the joint revenue project	Sale treatment achieved more frequently
Lease incentives	Not addressed	Reduce the right-of-use asset (only addressed for lessees)	Clarified accounting treatment for lessees
Transition approach	Simplified retrospective	Modified retrospective with option of full retrospective	Reduces lease expense for accelerated leases in years following transition (more recorded to retained earnings); additional complexity to transition calculations
Transition "relief"	Simple capital leases would be recorded at existing carrying amounts for initial measurement	Optional: ▸ All capital, sales-type and direct financing leases would be recorded at existing carrying amounts for initial measurement ▸ Use of hindsight ▸ Evaluation of initial direct costs	Reduces the preparer's cost of implementation; some financial statements would not be comparable due to the transition options provided