

Technical Line

FASB – proposed guidance

A closer look at the new lease accounting proposal

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What you need to know

- ▶ The FASB and the IASB have proposed requiring lessees to recognize assets and liabilities arising from their involvement in most leases.
- ▶ Entities would still classify leases, but they would use different criteria for a different purpose. Lease classification would determine how entities recognize lease-related revenue and expense, as well as what lessors record on the balance sheet.
- ▶ Classification would be based on the portion of the economic benefits of the underlying asset that are expected to be consumed by the lessee over the lease term.
- ▶ The FASB is expected to devote significant effort to outreach on this project. Comments on the exposure draft are due by 13 September 2013.

Overview

The joint proposal by the Financial Accounting Standards Board (FASB or the Board) and the International Accounting Standards Board (IASB) (collectively, the Boards) would significantly change the accounting for leases and could have far-reaching implications for a company's finances and operations.

The FASB's exposure draft (ED) features a right-of-use model that would require lessees to recognize most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. Like today's standard, the proposal would require lessees and lessors to classify leases by type but the criteria for classifying leases and the related accounting would be different. Under the proposal, leases would be classified into two types (Type A and Type B) and classification would be used principally for determining the method and timing for recognizing lease revenue and expense.

The proposal would require companies to adopt the new guidance using either a full retrospective or a modified retrospective approach. An effective date has not yet been proposed.

FASB members, however, are divided on whether it is appropriate to retain multiple lease accounting models. Three of the seven FASB members voted against issuing the proposal for comment. Concerns raised included:

- ▶ The complexity in the accounting model may hinder users' ability to assess the amount, timing and uncertainty of lease-related cash flows
- ▶ The creation of two types of leases, particularly Type B leases
- ▶ The costs may exceed the benefits of the proposal

Chairman Leslie Seidman voted to issue the proposal, but her term expires at the end of June 2013. Her departure will create a vacancy on the Board that adds to the uncertainty about how the Board will proceed.

This turnover and the diversity of views among Board members make feedback on the ED from preparers and users of the financial statements critical. Comments are due by 13 September 2013. The complete ED and instructions for submitting comment letters are available on the FASB's [website](#). Interested parties should also participate in the FASB's planned outreach, which the staff has indicated will include roundtables and meetings with preparer and user groups most affected by the proposal.

We do not expect a final leases standard to be effective before 2017.

Key considerations

Scope exclusions

The proposed definition of a lease is in some respects broader than the existing definition. Today's lease accounting standard applies only to leases of property, plant and equipment (PP&E). Under the ED, the proposed accounting for leases would apply to leases of all assets except for the following leases, which would be specifically excluded under the proposal:

- ▶ Leases of intangible assets
- ▶ Leases to explore for or use natural resources (e.g., minerals, oil, natural gas, similar non-regenerative resources)
- ▶ Leases of biological assets, including timber

While the proposal would apply to leases involving assets other than PP&E, such arrangements (e.g., leases of inventory) would not likely meet the definition of a lease. Additionally, the current analogy to lease accounting for internal-use software subject to ASC 350-40, *Intangibles – Goodwill and Other – Internal-Use Software*, would be eliminated in the proposed consequential amendments.

Definition of a lease

A lease would be defined as a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) that conveys the right to use an asset (i.e., the underlying asset) for a period of time in exchange for consideration. To be a lease, an arrangement would have to meet both of the following criteria:

- ▶ Fulfillment of the contract depends on the use of an identified asset.
- ▶ The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

The proposal's identified asset criterion is generally consistent with the "specified asset" concept in the current lease standard. That is, an identified asset could be either implicitly or explicitly specified in a contract. An identified asset could be a physically distinct portion of a larger asset (e.g., a floor of a building). However, a non-physically distinct portion of an asset (e.g., 50% of a pipeline's capacity) would not qualify as an identified asset.

Illustration 1 – Example of an identified asset

Scenario A

Assume that Customer X enters into a 12-year contract for the right to use a specified capacity of a supplier's data transmission within a fiber optic cable that connects New York to London. The contract identifies three of the cable's 20 fibers. The three fibers are dedicated solely to Customer X's data for the duration of the contract term.

Analysis: The three fibers would be an identified asset because they are specific to the contract and are physically distinct from the other 17 fibers in the cable.

Scenario B

Assume the same facts as in Scenario A, except that the supplier is free to use any of the 20 fibers, at any time during the contract term, to transmit any of its customers' data, including Customer X's data.

Analysis: In this case, the fibers are not an identified asset because the contract allows the supplier to use a capacity portion of any of the cable's 20 fibers to fulfill its obligation to Customer X. That capacity portion is not physically distinct from the remaining capacity of the cable.

Some contracts give the supplier the right to fulfill its obligation using an alternative asset. If the supplier has a substantive substitution right, the contract would not depend on the use of an identified asset. A substitution right would be substantive if both of the following conditions are met:

- ▶ The supplier can substitute an alternative asset without the customer's consent
- ▶ There are no barriers (economic or otherwise) that would prevent the supplier from substituting an alternative asset, such as:
 - ▶ Substitution costs that are so high that they create an economic disincentive to substitution
 - ▶ Operational barriers (e.g., alternative assets are not available)

Contract terms that allow or require a supplier to substitute other assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available would not create a substantive substitution right.

Illustration 2 – Substitution rights

Scenario A

Assume that an electronic data storage provider (supplier) provides services, through a centralized data center, that involve the use of a specified server (server No. 9) and that the supplier also has the ability to substitute another server without the customer's consent. The supplier maintains many identical servers in a single, accessible location, and the supplier could easily substitute another server for No. 9 at a nominal cost (i.e., there are no barriers, economic or otherwise, that would prevent the substitution of the asset).

Analysis: Fulfillment of this contract would not depend on the use of an identified asset.

Scenario B

Assume the same facts as in Scenario A except that server No. 9 is customized and substitution would require the supplier to incur significant cost. For example, the server may contain the customer's confidential information, requiring the destruction of the asset's primary components if substituted.

Analysis: Such costs may represent an economic disincentive (i.e., an economic barrier) to substitute the server. If so, the supplier's substitution right would be non-substantive and server No. 9 would be an identified asset.

A contract would convey the right to control the use of an identified asset if, throughout the contract term, the customer has the ability to both:

- ▶ Direct the use of the identified asset
- ▶ Derive the benefits from the use of the identified asset

A customer's ability to direct the use of an identified asset would be demonstrated by its ability to make the decisions about the use the asset that most significantly affect the economic benefits to be derived from the asset's use over the term of the contract. Such decisions may include how and for what purpose the asset will be employed during the contract term, how it is operated or who operates it. The proposal does not clarify how to distinguish the decisions that most significantly affect the economic benefits from other decisions.

However, the proposal does contemplate that certain arrangements may have few, if any, substantive decisions to be made about the use of an asset after the commencement date. For example, the customer may have been involved in designing the asset for its own use or in determining the terms and conditions of the contract. In these cases, the customer may have the ability to direct the use of the identified asset throughout the contract term simply through the operation of the contract terms.

The ability to direct the use of the asset would require an ability to make the decisions that most significantly affect the economic benefits to be derived from the asset's use.

How we see it

In some arrangements (e.g., time charter arrangements of vessels, wet leases of aircraft, co-generation power supply arrangements) both the customer and supplier often have some involvement in, or the ability to make, significant decisions (either during the lease or before commencement) about how the asset is operated. The determination of which party can make the decisions that most significantly affect the economic benefits to be derived from the use of the asset would require significant judgment.

A customer's right to control the use of an identified asset also depends on its ability to obtain substantially all of the potential economic benefits from the use of the asset during the contract term. The customer can obtain economic benefits either directly or indirectly through the asset's primary outputs (i.e., goods or services) and any byproducts (e.g., renewable energy credits). However, other tax benefits, such as those related to the ownership of the asset, would not be considered economic benefits of use. The proposal clarifies that a customer would not have the ability to derive the benefits from the use of an asset when both of the following conditions exist:

- ▶ Those benefits can be obtained only in conjunction with additional goods or services provided by the supplier and not sold separately by the supplier or others
- ▶ The asset is incidental to the delivery of services because the asset has been designed to function only with the additional goods or services provided by the supplier (e.g., a bundle of goods and services combine to deliver an overall service for which the customer has contracted)

How we see it

It is not clear whether a good or service, such as a consumable, would be considered "sold separately" by the supplier if that good or service is available separately from the supplier but is sold only to customers that lease the related asset. Additional application guidance on the conditions that result in a customer having the ability to derive the benefits from the use of an asset may be required for this concept.

Illustration 3 – Benefits obtained in conjunction with additional goods or services

Assume that Entity Z (customer), a health care provider, enters into a three-year contract with a supplier for the use of specialized medical equipment. The equipment will be located at Entity Z's facilities and will be operated by Entity Z's personnel to provide health care services to customers. The equipment can be operated only in conjunction with a specific disposable consumable product (the consumable). The contract requires Entity Z to purchase the consumable from the supplier, although the consumable is readily available from other suppliers. The supplier also sells the consumable to customers that do not lease equipment from the supplier.

Analysis: Entity Z would be able to derive benefits from the use of the equipment on its own without the supplier's consumables. Consequently, the contract would have two separate components: the right to use the equipment and the supply of the consumables. Separation of contract components is discussed further below.

How we see it

The ED does not scope out transactions that transfer the title of the underlying asset to the customer at the end of the agreement. However, the proposal does not provide guidance on the accounting for certain aspects of these transactions (e.g., whether the right-of-use asset should be amortized over the term of the lease or the life of the underlying asset).

Cancelable leases

Certain leases, which are often referred to as “cancelable,” “month-to-month,” “at will,” “evergreen,” “perpetual” or “rolling,” would be subject to the proposal if they create enforceable rights and obligations. Any noncancelable periods in such leases would be considered part of the lease term. A contract (or a period within a contract) is not enforceable when the lessee and the lessor each have the unilateral right to terminate the lease without permission from the other party without penalty. An arrangement for which there are enforceable rights and obligations between the lessee and lessor (e.g., the lessee has a renewal option) would meet the definition of a contract.

Short-term leases

Lessees and lessors could make an accounting policy election, by asset class, to apply a method similar to current operating lease accounting to leases with a maximum possible contractual lease term, including any options to extend, of 12 months or less. Any lease that contains a purchase option would not be a short-term lease.

The short-term lease election is intended to be narrow and is designed to reduce cost and complexity. The evaluation of the maximum possible lease term therefore would not require judgments about term-extending or lease termination options (i.e., all optional periods would be included in the assessment of the maximum possible lease term). An entity that elects to account for short-term leases under this exception would disclose that fact.

Separation of lease and non-lease components

Identifying and separating lease components and non-lease components

For contracts that contain lease and non-lease components (e.g., services), the non-lease components would be separated from the lease components, except in limited cases involving lessees. The non-lease components may be accounted for as executory arrangements by lessees or as contracts subject to the proposed revenue recognition guidance by lessors (suppliers). The Boards are expected to finalize the proposed revenue recognition guidance soon (refer to the FASB project status page).

Under current lease guidance, lease-related executory costs (e.g., insurance, maintenance, taxes) are considered “lease elements” for the purpose of separating lease and non-lease elements. However, the proposal doesn’t mention lease-related executory costs. Rather, the proposed criteria for identifying lease components are intended to align with the concepts for separating performance obligations in the proposed revenue recognition guidance. Therefore, we believe that if a component of a contract (e.g., service, maintenance) does not meet the definition of a lease, it would generally be allocated a portion of the contract consideration and accounted for separately from the lease.

In most circumstances, lessees would account for non-lease contract components separately from the lease components.

How we see it

- ▶ It is unclear how certain executory costs (e.g., insurance and taxes) would be considered under the proposal. For example, would such executory costs be included in the lease component or would they be considered a non-lease component?
- ▶ Separating service payments from leases may change practice for some lessees. Today, entities may not focus on separation because the accounting treatment for operating leases and other components is often the same. Under the proposal, lessees may need more robust processes to identify and separate the lease and non-lease components of contracts.

Identifying and separating lease components

The proposal provides guidance for contracts that contain the rights to use multiple assets (e.g., a building and equipment). In such circumstances, a right to use an asset would be considered a separate lease component if both of the following criteria are met:

- ▶ The lessee can benefit from the use of the asset either on its own or together with other readily available resources (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or which the lessee has already obtained from the lessor or other transactions or events).
- ▶ The underlying asset is neither dependent on nor highly interrelated with the other underlying assets in the contract.

If both criteria above are met, the right to use each asset would be considered a separate lease component. If one or both are not met, the right to use multiple assets would be considered a single lease component and evaluated based on the primary asset (as discussed in the “Lease classification” section below).

How we see it

The meaning of “highly interrelated” is not clear. Additional guidance for applying “highly interrelated” to contracts with multiple components may be required.

Allocating contract consideration

Lessors would be required to allocate the consideration in a contract to each lease and non-lease component in accordance with the proposed revenue recognition guidance (i.e., on a relative standalone-selling-price basis). The Boards believe that lessors would be knowledgeable about their products and services and therefore would be able to allocate consideration between the lease and non-lease components.

Lessees would allocate consideration on a relative standalone-price basis if an observable standalone price for each component exists. An observable standalone price exists if there are prices that the lessor or a similar supplier would charge separately for a similar lease, good or service component of a contract (i.e., on a standalone basis). Lessees would use a residual method to allocate contract consideration when observable standalone prices are available for one or more, but not all, of the components. If one or more of the components without observable

prices are lease components, the lessee would combine the components without observable prices and account for them as a single lease component. If no observable standalone prices exist, lessees would combine all lease and non-lease components into a single lease component (i.e., in that circumstance, lessees would not separate payments between the lease and non-lease components).

How we see it

Identifying observable standalone prices would be critical to the accounting for contracts that contain multiple components. This would likely require judgment when observable prices may not be readily apparent or when a range of observable standalone prices may exist.

A leased asset with a long pre-lease construction period could have a different lease term and classification at lease commencement than what might have been expected when the lease was executed.

Changes to contracts

A substantive modification to lease terms and provisions would create a new contract at the date that the modification becomes effective. Such a modification would require an assessment of whether the new contract is, or contains, a lease. Examples of substantive modifications include changes to the contractual lease term or the amount of contractual payments when those provisions were not part of the original contract. Differences between the carrying amounts of the lease-related assets and liabilities that arise under any new lease (as compared to the previous lease) would be recognized in profit or loss. That is, the derecognition of the previous lease assets and liabilities and the recognition of the new lease assets and liabilities would affect profit and loss.

Key concepts

Certain key concepts would be used by both lessees and lessors to identify, classify, recognize and measure lease contracts.

Significant economic incentive

When evaluating a lease term and lease payments (both discussed below), the proposal would require lessors and lessees to consider economic incentives associated with exercising purchase options, lease renewal options and options to terminate a lease. The threshold against which these considerations would be evaluated is similar to but not necessarily the same as the current standard, which focuses on reasonable assurance.

The initial evaluation of whether a significant economic incentive exists would consider all contract-, asset-, entity- and market-based factors, including:

- ▶ The existence of a purchase option or lease renewal option and the related pricing (e.g., fixed rates, discounted rates, “bargain” rates)
- ▶ The existence of a termination option and the amount of payments for termination or nonrenewal
- ▶ Contingent amounts due under residual value guarantees (if any)
- ▶ Costs of returning the asset in a contractually specified condition or to a contractually specified location
- ▶ Economic penalties such as significant customization, installation costs (e.g., leasehold improvements) or relocation costs

- ▶ The importance of the leased asset to the lessee's operations
- ▶ 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 with a two-year renewal option, and the sublease term is for seven years)

Lease term

The lease term would be determined at the lease commencement date (i.e., the date the underlying asset is available to the lessee) based on the noncancelable period for which the lessee has the right to use the underlying asset, together with both of the following:

- ▶ The periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option
- ▶ The periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option

Illustration 4 – Determining the lease term

Scenario A

Assume that Entity P enters into a lease for equipment that includes a noncancelable term of four years and a two-year renewal option. There are no termination penalties or other contract-, market-, entity- or asset-based factors indicating that Entity P has a significant economic incentive to exercise the renewal option.

Analysis: At the lease commencement date, the lease term would be four years.

Scenario B

Assume that Entity Q enters into a lease for property, which provides a noncancelable term of four years and a two-year renewal option. Before it takes possession of the property, Entity Q pays for significant leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realized through continued occupancy of the leased property.

Analysis: At the lease commencement date, Entity Q may determine that a significant economic incentive to exercise the renewal option exists (i.e., the entity would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial noncancelable period). At the lease commencement date, Entity Q therefore would conclude that the lease term is six years.

Lease payments

The present value of the aggregate lease payments over the lease term would be recognized as a lease liability for lessees or a lease receivable for lessors of a Type A lease as discussed below. Lease payments would include the aggregate of:

- ▶ Fixed lease payments, less any lease incentives received or receivable from the lessor
- ▶ Variable payments that depend on an index or a rate

- ▶ In-substance fixed lease payments structured as variable payments
- ▶ Exercise price of a purchase option if the lessee has a significant economic incentive to exercise that purchase option
- ▶ Payments for penalties for terminating a lease, determined consistently with the determination of the lease term
- ▶ Amounts expected to be payable under residual value guarantees (lessee only)
- ▶ Fixed payments structured as residual value guarantees (lessor only)

Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate would be included in the lease payments. The prevailing index or rate at the measurement date would be used to determine these payments. Forward rates and forecasting techniques would not be considered.

In-substance fixed lease payments

Some lease agreements include payments that are described as variable but are in-substance fixed payments because the contract terms ensure that the payment of a fixed amount is unavoidable. Such payments would be lease payments.

Purchase options

If the lessee has a significant economic incentive to exercise a purchase option, the exercise price would be included as a lease payment.

Lease termination penalties or options

If a lessee has a significant economic incentive not to terminate a lease, the lease term would be determined assuming that the termination option would not be exercised and any termination penalty would be excluded from the lease payments. Otherwise, the early termination penalty would be included as a lease payment.

Residual value guarantees – lessees

A lessee may guarantee (to the lessor) that the value of the underlying asset returned to the lessor at the end of the lease will be at least a specified amount. The proposal would require lessees to include the amounts they expect to pay to the lessor for such guarantees as lease payments.

Residual value guarantees – lessors

Lessors' lease payments would generally exclude amounts receivable under residual value guarantees (from either the lessee or a third party). However fixed lease payments structured as residual value guarantees would be included as lease payments. For example, an in-substance fixed lease payment would be present if a lessor is required to pay, or the counterparty (typically the lessee) can retain, any difference between the selling price of the underlying asset (at the end of the lease) and an amount specified in the contract. In this circumstance, the lessor would receive a fixed amount at the end of the lease which is economically similar to a fixed balloon lease payment at the end of the lease. Consequently, the Board believes such amounts should be included as lease payments.

How we see it

It is unclear which existing lease arrangements the Board attempted to address with the proposed guidance for fixed lease payments structured as residual value guarantees. Further, it is not clear whether a partial residual value guarantee (e.g., a guarantee in which the lessee assumes the first \$85 of the loss when the selling price is less than the specified price of \$100 with the lessee receiving any appreciation above \$100) would be considered a lease payment structured as a residual value guarantee.

Variable lease payments not based on an index or rate

Variable rents not based on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage (e.g., the number of miles flown, the number of units produced) of the underlying asset, would not be included as lease payments. These payments would be recognized in the income statement when they are incurred (lessee) or earned (lessor), similar to current lease accounting.

Discount rate

Discount rates would be determined on a lease-by-lease basis and used to determine the present value of the lease payments.

Lessees

Lessees would use the rate the lessor charges the lessee if that rate can be readily determined. In practice, lessees may not know the rate the lessor charges the lessee. When the rate is not known, the lessee would use its own incremental borrowing rate.

The lessee's incremental borrowing rate would be the interest rate that the lessee would have to pay to borrow the funds necessary to purchase an asset similar to the right-of-use asset, with similar payment terms (i.e., lease term) and security (i.e., collateral) as the lease contract.

Nonpublic lessees could elect to use a risk-free interest rate, with a term comparable to the lease term, rather than the rate the lessor charges the lessee or its own incremental borrowing rate. Such an election would be an accounting policy election that would be applied to all lease contracts.

Lessors

Lessors would use the rate the lessor charges the lessee, which could be the rate implicit in the lease. The lessor would use the rate implicit in the lease whenever it is available. The rate implicit in the lease would be the rate that causes the sum of the present value of payments made by the lessee for the right to use the underlying asset and the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease to equal the fair value of the underlying asset. If the rate implicit in the lease is not available for leased property, the lessor would be permitted to use the property yield instead. The ED does not provide a definition of property yield or additional clarification on how it would be calculated.

Lease classification would be based on the lessee's expected consumption of the underlying asset.

Lease classification

The Boards determined that the underlying economics of leases vary and that these differences are best reflected by two types of leases. The principle for differentiating between the two lease types would be based on the portion of the economic benefits of the underlying asset expected to be consumed by the lessee over the lease term. To reduce complexity in the application of this principle, the ED would require entities to classify leases primarily based on the nature of the underlying asset.

Under the proposal, leases would be classified at the lease commencement date as follows:

- ▶ Leases of assets that are not property (e.g., equipment, vehicles) would be classified as Type A leases, unless one of the following two criteria is met:
 - ▶ The lease term is for an insignificant part of the total economic life of the underlying asset.
 - ▶ The present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.
- ▶ Leases of property (land, a building or part of a building) would be classified as Type B leases, unless one of the following two criteria is met:
 - ▶ The lease term is for the major part of the remaining economic life of the underlying asset.
 - ▶ The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

Classification would principally determine the method and timing for recognizing lease revenue and expense.

If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as Type A. The FASB noted that most leases of property would be classified as Type B leases and most leases of assets other than property would be classified as Type A leases. That is, the exception criteria noted above would be met for a relatively small population of leases.

Lease classification would not be reassessed after lease commencement unless a new contract is created by a substantive modification to the contract provisions.

How we see it

- ▶ Many leases of assets other than property (e.g., cars, office equipment) that are considered operating leases today would likely be classified as Type A leases under the proposal. As discussed below, classification as a Type A lease would result in accelerated expense recognition.
- ▶ Comparing the lease term of leases of assets other than property to the "total" economic life of the underlying asset (as opposed to the "remaining" economic life) may result in leases of certain older non-property assets being classified as Type B leases. For example, a two-year lease of a railcar would likely be insignificant to the total economic life of the railcar. Therefore, regardless of the age of the railcar at the lease commencement date (i.e., even very late in the economic life of the asset), such a lease would be classified as Type B.

The exception criteria for leases of property (i.e., the lease term is for the major part of the remaining economic life and the present value of the lease payments accounts for substantially all of the fair value) are similar to two of the indicators included today under IFRS to distinguish between finance (i.e., capital) and operating leases. In practice, the IFRS indicators have been interpreted as similar to the 75% of the useful life and the 90% of fair value bright-line tests in current US GAAP. However, the proposal does not provide definitions for “major part” or “substantially all” or include any bright-line guidance on how these criteria should be applied.

How we see it

The proposal does not provide a definition for “insignificant” for purposes of assessing the exception criteria for classifying leases of assets other than property. Therefore, evaluating whether a non-property lease meets either of the criteria for exceptions would likely be subjective and require careful judgment.

Illustration 5 – Lease classification

Scenario A

Assume that Entity F leases a vessel for 20 years. There are no optional renewal periods and no termination or purchase options. The total economic life of the vessel is 50 years. The lease term represents 40% of the total economic life of the vessel. The present value of the lease payments represents 45% of the fair value of the vessel at the lease commencement date.

Analysis: Entity F would conclude the lease term represents more than an insignificant part of the total economic life of the vessel. Entity F also would conclude that the present value of the lease payments is more than insignificant when compared to the fair value of the vessel. Because the underlying asset is not property and neither of the two criteria specific to assets other than property is met, the lease would be classified as Type A.

Scenario B

Entity G leases a vessel for two years. There are no optional renewal periods and no termination or purchase options. The total economic life of the vessel is 50 years. The lease term represents 4% of the total economic life of the vessel.

Analysis: Entity G would conclude that the lease term represents an insignificant part of the total economic life of the vessel. Because the underlying asset is not property and one of the two criteria specific to leases of assets other than property is met, the lease would be classified as Type B.

If a lease component contains the right to use more than one interrelated asset (e.g., such assets are dependent or highly interrelated and cannot be used on their own – refer to the “Separation of lease and non-lease components” section), the nature of the underlying asset (for purposes of classification) would be determined based on the primary asset within that lease component. The primary asset would be the predominant asset for which the lessee has contracted for the right to use. Any other assets in that lease component would facilitate the lessee’s use of the primary asset. Entities would refer to the economic life of the primary asset when making lease classification assessments. Additionally, if a lease component contains both land and a building, entities would refer to the remaining economic life of the building when classifying the lease.

How we see it

It is not clear whether certain structures that are attached to land (e.g., telecommunications towers, wind turbines and billboards), and are considered real estate assets under today's accounting would be considered buildings (i.e., property assets) or non-property assets under the proposal. The distinction could have a significant impact on the classification of leases for such assets.

Lessee accounting

The ED would require lessees to recognize all leases except short-term leases on the balance sheet. At the commencement date of the lease, lessees would recognize a liability to make lease payments (the lease liability) and an asset representing the right to use the underlying asset during the lease period (the right-of-use asset). The initial recognition of the right-of-use asset and the lease liability would be the same for Type A and Type B leases, as would the subsequent measurement of the lease liability. However, subsequent measurement of the right-of-use asset for Type A and Type B leases would differ.

Initial recognition and measurement

The lease liability would initially be measured based on the present value of the lease payments to be made over the lease term. Lessees would apply the key concepts described previously to determine the lease term, lease payments and discount rate as of the commencement date of the lease. Variable rents not based on an index or rate (e.g., performance- or usage-based payments) would be excluded from the lease liability and would be recognized in the income statement as incurred.

The right-of-use asset would initially be measured at cost, based on the measurement of the lease liability, plus lease prepayments (less any lease incentives received from the lessor) and the lessee's initial direct costs (e.g., commissions and legal fees).

Subsequent measurement

The lease liability for Type A and Type B leases would be accreted using the interest method. Lease payments would reduce the lease liability when paid. However, Type A and Type B leases would achieve different expense recognition patterns through the subsequent measurement of the right-of-use asset.

Type A leases

Lessees would amortize the right-of-use asset on a straight-line basis, unless another systematic basis better represents the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. The right-of-use asset would generally be amortized over the shorter of the lease term or the useful life of the right-of-use asset. The amortization period would be the remaining useful life of the underlying asset if the lessee has a significant economic incentive to exercise a purchase option.

The subsequent measurement of the right-of-use asset would result in different expense recognition patterns for Type A and Type B leases.

Illustration 6 – Type A lease (lessee)

Entity H (lessee) enters into a three-year lease of equipment and concludes that the agreement is a Type A lease. The entity agrees to make 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. For simplicity, there are no other elements to the lease payments (e.g., purchase options) or payments to the lessor before the lease commencement date. The initial measurement of the right-of-use asset and lease liability is \$33,000 (present value of lease payments using a discount rate of approximately 4.24%). Entity H determines the right-of-use asset should be amortized on a straight-line basis over the lease term.

Analysis: At lease commencement Entity H would recognize the lease-related asset and liability:

Right-of-use asset	\$ 33,000	
Lease liability		\$ 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	
Lease liability		\$ 1,398

To record interest expense and accrete the lease liability using the interest method (\$33,000 x 4.24%)

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

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

Lease liability	\$ 10,000	
Cash		\$ 10,000

To record lease payment

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 lease payments		\$ 10,000	\$ 12,000	\$ 14,000
<i>Lease expense recognized</i>				
Interest expense		\$ 1,398	\$ 1,033	\$ 569
Amortization expense		<u>11,000</u>	<u>11,000</u>	<u>11,000</u>
Total periodic expense		<u>\$ 12,398</u>	<u>\$ 12,033</u>	<u>\$ 11,569</u>
<i>Balance sheet</i>				
Right-of-use asset	\$ 33,000	\$ 22,000	\$ 11,000	\$ —
Lease liability	\$ (33,000)	\$ (24,398)	\$ (13,431)	\$ —

Note: Certain amounts above have been rounded.

The total periodic expense (i.e., the sum of interest and amortization expense) of a Type A lease would generally be higher in the early periods and lower in the later periods. Because a consistent interest rate would be applied to the lease liability, which decreases as cash payments are made during the lease term, more interest expense would be incurred in the early periods and less would be incurred in the later periods. This trend in the interest expense, combined with the straight-line amortization of the right-of-use asset, would result in the recognition of more total periodic expense in the early periods of a Type A lease than a Type B lease.

Type B leases

Lessees would calculate a periodic lease expense amount in a manner that is in some ways similar to today's accounting for operating leases. Throughout the lease term, the lessee would recognize periodic lease expense as the greater of:

- ▶ The remaining cost of the lease (calculated at the beginning of each period) allocated over the remaining lease term on a straight-line basis, or
- ▶ The periodic interest expense taken on the lease liability (using the interest method)

At each reporting period, the remaining cost of the lease would be calculated as:

- ▶ Lease payments (determined at the lease commence date); plus
- ▶ Initial direct costs (determined at the lease commencement date); minus
- ▶ The periodic lease cost recognized in prior periods; minus
- ▶ Any impairment of the right-of-use asset recognized in prior periods; plus or minus
- ▶ Any adjustments to reflect changes that arise from the remeasurement of the lease liability

When the remaining cost of the lease allocated over the remaining lease term is higher than the periodic interest taken on the lease liability, the change in the right-of-use asset would be calculated as the difference between the periodic straight-line expense amount and the accretion of the lease liability. If the periodic interest expense taken on the lease liability is higher, there would be no adjustment to the right-of-use asset. An example of when this circumstance may arise would be following a significant impairment of the right-to-use asset.

Illustration 7 – Type B lease (lessee)

Entity L (lessee) enters into a three-year lease of office space and concludes that the agreement is a Type B lease. The entity 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. For simplicity, there are no other elements to the lease payments (e.g., purchase options) or payments to the lessor before the lease commencement date. The initial measurement of the right-of-use asset and lease liability is \$33,000 using a discount rate of approximately 4.24%. Entity L calculates that the annual straight-line lease expense is \$12,000/year $[(\$10,000 + \$12,000 + \$14,000)/3]$.

Analysis: At lease commencement, Entity L would recognize the lease-related asset and liability:

Right-of-use asset	\$ 33,000	
Lease liability		\$ 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	
Lease liability		\$ 1,398
Right-of-use asset		\$ 10,602

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

Lease liability	\$ 10,000	
Cash		\$ 10,000

To record lease payment

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 lease payments		\$ 10,000	\$ 12,000	\$ 14,000
Lease expense recognized		\$ 12,000	\$ 12,000	\$ 12,000
Less: Accretion of lease liability ¹		(1,398)	(1,033)	(569)
Change in right-of-use asset ²		<u>\$ 10,602</u>	<u>\$ 10,967</u>	<u>\$ 11,431</u>
<i>Balance sheet</i>				
Right-of-use asset	\$ 33,000	\$ 22,398	\$ 11,431	\$ —
Lease liability	\$ (33,000)	\$ (24,398)	\$ (13,431)	\$ —

¹ Calculated using the interest method on the lease liability (same calculation as for Type A lease).

² Calculated as the difference between the straight-line expense to be recognized (i.e., \$12,000) and the accretion of the lease liability.

Note: Certain amounts above have been rounded.

Reassessment would be a significant change from today's accounting.

How we see it

While Type B leases might result in expense recognition patterns similar to today's operating leases, the recordkeeping burden for lessees could increase significantly. Lessees would have to perform additional calculations to account for the change in the right-of-use asset in each period.

Reassessment

After lease commencement, lessees would monitor leases for changes in considerations that could trigger a reassessment of the lease liability. Upon reassessment, lessees would remeasure the lease liability, using revised inputs at the reassessment date, to reflect any changes to the lease payments that result from changes in:

- ▶ Relevant factors that result in a change to the lease term, including when the lessee has or no longer has a significant economic incentive to do either of the following:
 - ▶ Exercise an existing option to extend the lease or purchase the underlying asset
 - ▶ Not exercise an existing option to terminate the lease
- ▶ Amounts expected to be payable under residual value guarantees
- ▶ An index or a rate used to determine lease payments during the reporting period, using the index or rate at the end of the reporting period

Relevant factors to consider when evaluating whether the lease term has changed include asset-, contract- and entity-based factors. Market-based factors would also be considered but would not, in isolation, be determinative when evaluating whether the lease term has changed.

Lessees would also reassess the lease term and lease liability if the lessee elects to exercise an option to renew a lease even though the lessee had previously determined that it did not have a significant economic incentive to do so. Likewise, lessees would also reassess the lease term and lease liability if the lessee elects not to exercise an option to renew a lease even though the lessee had previously determined that it had a significant economic incentive to do so. Similarly, lessees would reassess the lease term and lease liability if the lessee does not exercise a lease termination option when the lessee did not have a significant economic incentive to not terminate the lease.

When reassessment results in a change to the lease term, lessees would determine the revised lease payments based on the new lease term. Upon reassessment of the lease liability lessees would reassess the discount rate only when there is a change to any of the following (and the possibility of the change was not reflected in the previous discount rate):

- ▶ The lease term
- ▶ Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise a purchase option
- ▶ A reference interest rate used to determine variable lease payments

Lessees would record remeasurements of the lease liability as an adjustment to the right-of-use asset, except that:

- ▶ The portion of the remeasurement arising from a change in an index or a rate that is attributable to the current period would be recognized in profit or loss.
- ▶ If the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss.

How we see it

- ▶ As lease classification would not be reassessed after the commencement date, entities would not revisit the determination of whether a lease meets the exception conditions. For example, a lease with a short noncancelable period and a long renewal option (where no significant economic incentive to exercise the renewal option exists at lease commencement) might be classified as Type B. If the lessee exercises the renewal, the arrangement that if assessed including the renewal period in the lease term would have been classified as Type A would continue to be accounted for as a Type B lease.
- ▶ It is not clear how lessees would apply the proposal's reassessment provisions to contracts that contain lease and non-lease components. Additional application guidance may be required for lessees with such agreements.
- ▶ Lessees would need to establish processes to identify items (e.g., changes in lease term, relevant factors, amounts expected to be payable under residual value guarantees, indexes or rates on which variable lease payments are based) that could trigger a reassessment of the lease liability.

Other lessee matters

Impairment

Lessees' right-of-use assets, for both types of leases, would be subject to existing impairment guidance in ASC 360, *Property, Plant, and Equipment*.

How we see it

- ▶ While lessees would apply existing impairment guidance in the same manner that they currently use for assets held under capital leases, the analysis would be new for current operating leases. For leases that are not currently on the balance sheet, the requirement to test right-of-use assets for impairment could accelerate expense recognition (i.e., if an impairment occurs).
- ▶ When performing an impairment test (assuming the asset group consists solely of the lease), we believe lessees would consider the fair value of the remaining right-of-use asset without regard to the lease payments.

Lease incentives

Lessees often receive incentives (e.g., an upfront cash payment for leasehold improvements) for entering into a new lease. ASC 840's operating lease model requires lessees to recognize a separate liability, which is amortized over the lease term as a reduction of lease expense, when they receive a lease incentive.

Under the proposal, lease incentives that are receivable from the lessor at the commencement date would be deducted from the fixed lease payments. Separately, lease incentives that a lessee receives from the lessor at or before commencement would reduce the initial measurement of the right-of-use asset. Similar to what happens under current operating lease accounting, lease incentives would reduce lease expense over the lease term.

Presentation

The proposal would change lessee financial statement presentation. The following table summarizes how lease-related activity would be presented in lessees' financial statements:

Financial statement	Lessee presentation
Balance sheet	<ul style="list-style-type: none"> ▶ Both types of leases: <ul style="list-style-type: none"> ▶ Right-of-use assets and lease liabilities for each type of lease (Type A and Type B) would be presented separately from other assets and liabilities, or disclosed separately for each type of lease in the notes with disclosure of the balance sheet line items that include right-of-use assets and lease liabilities. ▶ If right-of-use assets are presented together with other non-lease assets, right-of-use assets would be presented within the same line item as if the underlying assets were owned.
Income statement	<ul style="list-style-type: none"> ▶ Type A leases: Lease-related amortization and interest expense would be presented separately (i.e., lease-related amortization and interest expense cannot be combined). ▶ Type B leases: Lease-related expenses would be presented as a single line of lease or rent expense.
Statement of cash flows	<ul style="list-style-type: none"> ▶ Type A leases: Cash payments for the principal portion of the lease liability would be presented within financing activities and cash payments for the interest portion would be presented in accordance with the requirements relating to interest paid in ASC 230, <i>Statement of Cash Flows</i>. ▶ Type B leases: Cash payments for lease payments would be presented within operating activities. ▶ Both types of leases: <ul style="list-style-type: none"> ▶ Short-term lease and variable lease payments (not included in the lease liability) would be presented within operating activities. ▶ Noncash activity (e.g., initial recognition of the lease at commencement) would be disclosed as a supplemental noncash item.

The proposal would expand lessee disclosures about the judgments and assumptions used to account for leases.

How we see it

For companies that have a significant amount of equipment operating leases, or other leases of assets other than property, EBITDA would likely increase under the Type A lease model because today's rent expense would be presented as amortization expense and interest expense. Operating cash flow would also increase because cash payments related to principal would be classified as financing activities. Companies would have to consider the effects of these changes when developing key performance metrics and communicating them to stakeholders.

Disclosure

The proposal would require new quantitative and qualitative disclosures to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows, including the amount of lease-related assets and liabilities recognized, significant judgments and assumptions about leases, the existence of residual value guarantees and options to extend or terminate the lease and restrictions or covenants imposed by leases. The proposed quantitative disclosures would include separate reconciliations of the opening and closing balances of Type A and Type B lease liabilities, which wouldn't be required for nonpublic entities, and a maturity analysis of the lease liability balance at the reporting date.

Entities would also provide a maturity analysis of commitments for the lease liability and non-lease components (e.g., services) of contracts that contain a lease.

Lessor accounting

Lessors would account for Type A leases using an approach that is similar to today's accounting for sales-type leases. Type B leases would be accounted for using a method similar to current operating lease accounting. There would be no special accounting guidance for leveraged leases under the proposal.

Type A leases

Initial recognition and measurement

Upon commencement of a Type A lease, lessors would:

- ▶ Derecognize the carrying amount of the underlying asset
- ▶ Recognize a lease receivable and a residual asset
- ▶ Recognize in net income any profit or loss on the lease

Lessors would derecognize the carrying amount of the underlying asset and allocate that amount between the portion related to the right to use granted to the lessee (i.e., the cost of sales) and the portion that is retained (i.e., the residual asset). A lease receivable for the right to receive lease payments during the lease term would also be recognized. The profit related to the right of use granted to the lessee would be recognized in net income at lease commencement.

Lease receivable

The lease receivable would be measured as the present value of the lease payments to be received during the lease term. Any initial direct costs incurred by the lessor would be included in the measurement of the receivable. At the lease commencement date, lessors would apply the key concepts described previously to determine the lease term, lease payments and discount rate.

Variable payments that are not based on an index or rate (e.g., variable rents based on usage or performance) would be recognized in profit and loss as they are earned. Additionally, residual value guarantees would generally be excluded from the lease receivable. Instead, such amounts would be recognized at the end of the lease. However, fixed lease payments that are structured as residual value guarantees would be included in the lease receivable.

Residual asset

The carrying amount of the derecognized underlying asset would be allocated between the portion leased and the newly recognized residual asset. The ED describes the initial measurement of the residual asset as:

- ▶ A + B – C, where:
 - ▶ A is the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term, discounted using the rate the lessor charges the lessee (gross residual asset)
 - ▶ B is the present value of variable lease payments, which the lessor expects to receive and which have been reflected in the rate the lessor charges the lessee, but which are not included in the lease receivable (e.g., variable lease payments linked to performance)
 - ▶ C is any unearned profit

The portion leased (or cost derecognized) would be calculated as the ratio of the present value of the lease payments to the fair value of the underlying asset multiplied by the previous carrying amount of the underlying asset. Consequently, the initially recognized residual asset also could be calculated as follows:

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

If a lessor expects to receive variable lease payments that are not included in the lease receivable (e.g., variable lease payments linked to performance) and reflected that expectation in the rate the lessor charges the lessee (i.e., the lessor's discount rate), the present value of those variable payments would also be included in the initial measurement of the residual asset.

The present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term would be referred to as the gross residual asset. The gross residual asset would not be recognized on the balance sheet. The difference between the gross residual asset and the recognized residual asset would be the aggregate of the deferred profit and the present value of any variable payments included in the initial measurement of the residual asset. The recognized residual asset would be subsequently accreted, as discussed below.

Illustration 8 – Allocation of the carrying amount of the underlying asset

Entity X leases an asset to a lessee under a Type A lease. Assume that the present value of the lease payments is \$42,000, the fair value of the underlying asset is \$60,000 and the carrying value of the underlying asset is \$50,000.

Analysis: Using the allocation method described above, the present value of the lease payments is 70% of the fair value of the underlying asset (70% = \$42,000 ÷ \$60,000). At lease commencement, Entity X derecognizes the \$50,000 carrying amount of the underlying asset. Of the derecognized amount, \$35,000 (70% x \$50,000) is recorded in profit and loss (e.g., as cost of sales assuming the lessor presents lease-related income statement activity on a gross basis) and the remaining \$15,000 (\$50,000 - \$35,000) is recorded as the residual asset.

Profit

A lessor would have a profit if the fair value of the underlying asset is greater than its carrying amount immediately before commencement of the lease. In such cases, the profit at commencement would be the product of multiplying the total profit (i.e., underlying asset fair value, less its carrying amount at lease commencement) by the ratio of the present value of the lease payments to the fair value of the underlying asset.

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

Alternatively, profit recognized at lease commencement could be calculated as the difference between the present value of the lease payments and cost derecognized.

Illustration 9 – Profit recognized at lease commencement

Entity X leases an asset to a lessee under a Type A lease. Assume that the present value of the lease payments is \$42,000, the fair value of the underlying asset is \$60,000 and the carrying value of the underlying asset is \$50,000. Therefore, the portion of the underlying asset granted to the lessee is 70% (\$42,000/\$60,000).

Analysis: Total profit would be \$10,000 (\$60,000 – \$50,000). Entity X would recognize \$7,000 of profit (70% of \$10,000) upon commencement of the lease.

Alternatively, the profit (\$7,000) recognized at commencement could be calculated as the difference between the present value of the lease payments (\$42,000) and cost derecognized (70% x \$50,000 = \$35,000).

Subsequent measurement

After lease commencement, lessors would:

- ▶ Recognize interest income on the accretion of the lease receivable using the interest method at the interest rate that would produce a constant periodic discount rate on the remaining balance of the receivable (taking into consideration the reassessment and impairment requirements, as discussed below)
- ▶ Reduce the lease receivable for lease payments received
- ▶ Recognize interest income on the accretion of the gross residual asset using the rate the lessor charges the lessee (taking into consideration the reassessment, impairment and variable lease payments, as discussed below)
- ▶ Recognize income from variable lease payments that are not included in the lease receivable (e.g., performance- or usage-based variable rents) in the period in which that income is earned and derecognize the portion of the residual asset associated with the variable lease payments

The interest rate used to accrete the lease receivable could differ from the rate the lessor charges the lessee (e.g., when the lease receivable includes initial direct costs).

Lessors would increase the carrying amount of the recognized residual asset in each period by accreting the gross residual asset to its expected value at the end of the lease term using the rate the lessor charges the lessee. The deferred profit, which is a component of the residual asset, would effectively be deferred until the sale or re-lease of the underlying asset following the lease term.

After commencement of a Type A lease, a lessor would recognize interest income on the lease receivable and for the accretion of the residual asset.

Illustration 10 – Type A lease (lessor)

Assume Entity Z manufactures a machine for \$75,000 and enters into a three-year lease of the machine with a lessee. There are no options for the lessee to purchase the asset or to extend or terminate the lease. The lease is classified as a Type A lease. Entity Z incurs no initial direct costs to execute the lease. At lease commencement, the machine has a fair value of \$100,000. The annual rent is \$24,000, due at the end of each year. The amount that Entity Z expects to derive from the machine following the end of the lease term is \$47,700. The present value of the lease payments discounted at the interest rate implicit in the lease (7.87%) is \$62,000. The present value of the amount that Entity Z expects to derive from the underlying asset following the end of the lease term, discounted at the interest rate implicit in the lease (7.87%), is \$38,000. Entity Z presents lease-related income statement activity on a gross basis.

Analysis: Upon lease commencement, Entity Z records the following:

Lease receivable	\$ 62,000	
Revenue		\$ 62,000

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

Cost of sales (\$75,000 x (\$62,000/\$100,000))	\$ 46,500	
Residual asset (\$75,000 – \$46,500)	\$ 28,500	
Underlying asset		\$ 75,000

To derecognize the underlying asset and to recognize a residual asset and cost of sales for the portion of the underlying asset leased

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

Period	Lease receivable	Gross residual	Deferred profit ²	Residual asset	Profit recognized ⁴	Cash received
Initial	\$ 62,000	\$38,000 ¹	\$(9,500)	\$28,500 ³	\$15,500	\$ –
Year 1	\$ 42,880	\$40,990	\$(9,500)	\$31,490	7,870	24,000
Year 2	\$ 22,250	\$44,220	\$(9,500)	\$34,720	6,600	24,000
Year 3	\$ –	\$47,700	\$(9,500)	\$38,200	5,230	24,000
				Total	\$35,200	\$72,000

¹ Although referred to as the gross residual, this amount is a discounted amount (i.e., the present value of the expected value of the underlying asset at the end of the lease term: \$47,700 discounted at 7.87%).

² Deferred profit is the portion of the total profit (\$25,000) related to the portion of the underlying asset that was retained (i.e., the residual asset). Deferred profit would be the difference between the gross residual asset and the recognized residual asset (e.g., \$38,000 – \$28,500).

³ The residual asset is initially measured based on the formula described above [\$75,000 – \$75,000 x (\$62,000/\$100,000)].

⁴ Represents profit on the right of use transferred, accretion income from the gross residual asset and interest income on the lease receivable. See calculation of profit recognized below.

Illustration 10 – Type A lease (lessor) (continued)

Profit recognized is comprised of the following:

Period	Interest on receivable ¹	Accretion income ²	Profit on right of use transferred	Profit recognized
Initial	\$ –	\$ –	\$15,500 ³	\$15,500 ³
Year 1	4,880	2,990	–	7,870
Year 2	3,370	3,230	–	6,600
Year 3	<u>1,750</u>	<u>3,480</u>	<u>–</u>	<u>5,230</u>
	<u>\$10,000</u>	<u>\$ 9,700</u>	<u>\$15,500</u>	<u>\$35,200</u>

¹ Interest income on the lease receivable recognized over the lease term is calculated using the interest method. For example, year one interest is calculated as \$4,880 (\$62,000 x 7.87%).

² Accretion income on the gross residual asset recognized over the lease term is calculated as gross residual multiplied by the rate the lessor charges the lessee (i.e., in this case the rate implicit in the lease). For example, year one the accretion is calculated as \$2,990 (\$38,000 x 7.87%).

³ At commencement, profit is recognized for the difference between the revenue recognized from the present value of the lease payments (\$62,000) and the portion of the carrying amount of the underlying asset derecognized (underlying asset of \$75,000 less residual asset of \$28,500 or \$46,500).

Note: Certain amounts above have been rounded.

If at the end of the lease, Entity Z sells the machine for \$47,700, as originally estimated, it would derecognize the \$38,200 residual asset and recognize \$9,500 of profit.

Reassessment

After lease commencement, lessors would monitor leases for changes in considerations that could trigger a reassessment. Upon reassessment, the lessor would remeasure the lease receivable using updated inputs at the reassessment date to reflect any change to the lease payments that result from a change in:

- ▶ Relevant factors that result in a change to the lease term, including changes when the lessee has or no longer has a significant economic incentive to do either of the following:
 - ▶ Exercise an existing option to extend the lease, or purchase the underlying asset
 - ▶ Not exercise an existing option to terminate the lease
- ▶ An index or a rate used to determine lease payments during the reporting period, using the index or rate at the end of the reporting period

Relevant factors to consider when evaluating whether the lease term has changed include asset-, contract- and entity-based factors. Market-based factors would also be considered but would not, in isolation, be determinative when evaluating whether the lease term has changed.

Lessors would also reassess the lease term and lease receivable if the lessee elects to exercise an option to renew a lease even though the lessor had previously determined that the lessee did not have a significant economic incentive to do so. Likewise, lessors would also reassess the lease term and lease receivable if the

lessee elects not to exercise an option to renew a lease even though the lessor had previously determined that the lessee had a significant economic incentive to do so. Similarly, lessors would reassess the lease term and lease receivable if the lessee does not exercise a lease termination option when the lessee did not have a significant economic incentive to not terminate the lease.

When reassessment results in a change to the lease term, lessors would determine the revised lease payments, including any changes in the amounts payable under renewal options or termination options, based on the new lease term. Upon reassessment of the lease receivable lessors would reassess the discount rate only when there is a change to any of the following (and the possibility of the change was not reflected in the previous discount rate):

- ▶ The lease term
- ▶ Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise a purchase option
- ▶ A reference interest rate used to determine variable lease payments

Upon remeasuring the lease receivable, lessors would:

- ▶ Adjust the carrying amount of the residual asset to reflect the amount that the lessor expects to derive from the underlying asset following the end of the lease term if there is a change in the lease term or the assessment of whether the lessee has or no longer has a significant economic incentive to exercise a purchase option
- ▶ Recognize any difference between carrying amounts of the lease receivable and residual asset before and after the remeasurement in profit or loss

Impairment of lease receivables

Lessors would apply the impairment guidance in ASC 310, *Receivables*, to determine whether lease receivables are impaired. When determining the loss allowance for a lease receivable, lessors would consider the collateral related to the receivable. The collateral would be considered because it represents cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (excluding the cash flows the lessor would expect to derive from the asset following the end of the lease). The Boards are separately developing new impairment guidance for financial assets, including lease receivables.

How we see it

- ▶ The guidance on reassessment of the lease receivable would not apply when a substantive modification is made to the provisions of a lease contract. Instead, such a modification would be accounted for as a new lease.
- ▶ Lessors would need to establish processes to identify items (e.g., changes in lease term, relevant factors, indexes or rates on which variable lease payments are based) that could trigger a reassessment of the lease receivable.

Subsequent measurement of the residual asset

Lessors' residual assets would be subject to the impairment guidance in ASC 360. ASC 360 requires an analysis of impairment indicators at each reporting period. Under ASC 360, if any indicators are present, a recoverability test is performed. If an asset fails the recoverability test, an impairment loss is recognized, if present. After an impairment, the adjusted carrying amount of a residual asset would be its new accounting basis.

When performing the impairment test, lessors would consider amounts expected to be received from residual value guarantees. Although such amounts are excluded from the lease payments (and thus the lease receivable), they would be considered in the impairment test for the residual asset because they may represent part of the future cash flows the lessor expects to receive relating to the underlying asset (i.e., the recovery assessment).

How we see it

It is not clear how lessors would reflect a decline in the expected fair value of the underlying asset at the end of a lease when applying the impairment guidance for residual assets. For example, it is not clear whether they would use the original expected value at the end of the lease or the current carrying amount of the residual asset when applying the impairment guidance.

For Type B leases, lessors would not record a lease receivable, even though lessees would record a payable for such leases.

Type B leases

Lessors would account for Type B leases in a manner similar to today's operating leases. That is, they would continue to recognize the underlying asset and, at lease commencement, would not recognize a lease receivable (or residual asset) on the balance sheet or profit on the income statement. The underlying asset would continue to be accounted for in accordance with applicable accounting standards.

Lessors would recognize lease payments from Type B leases over the lease term on either a straight-line basis or another systematic basis that better represents the pattern in which income is earned from the underlying asset. The lessor in a Type B lease would also recognize initial direct costs as an expense over the lease term, on the same basis as lease income.

Presentation

Lessors would have to change the way they present leases in their financial statements, except for short-term leases and current operating leases that would be classified as Type B leases under the proposal. The following table summarizes how lease-related activity would be presented on lessors' financial statements:

Financial statement	Lessor presentation
Balance sheet	<ul style="list-style-type: none"> ▶ Type A leases: <ul style="list-style-type: none"> ▶ Lease assets (i.e., the sum of the carrying amount of lease receivables and residual assets) would be presented separately from other assets. ▶ Lease receivables and residual assets could be presented separately from each other, or if presented together, separately disclosed in the notes. ▶ Type B leases: Underlying assets would be presented in accordance with applicable guidance.
Income statement	<ul style="list-style-type: none"> ▶ Both types of leases: Income arising from leases would be presented separately from other activity, or disclosed in the notes (along with the corresponding line item(s) in the income statement), although when leasing activity is material public companies would be required to present such activity separately. ▶ Type A leases: <ul style="list-style-type: none"> ▶ Profit or loss recognized at the commencement date would be presented on either a gross or net basis, based on the lessor's business model. ▶ Lessors that use leasing as an alternative means of realizing value from goods they would otherwise sell would present lease revenue and cost of goods sold gross (i.e., revenue and costs in separate line items). ▶ Lessors that use leases for the purpose of providing finance would present the gain or loss on a net basis (i.e., in a single line item). ▶ Interest on the lease receivable and the accretion of the gross residual asset would be presented as interest income.
Statement of cash flows	<ul style="list-style-type: none"> ▶ Both types of leases: Cash lease payments received would be presented within operating activities.

Disclosure

The proposal would require new quantitative and qualitative disclosures for lessors to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows, including the amount of lease-related assets and liabilities recognized, significant judgments and assumptions about its lease terms, payments, existence of residual value guarantees and options to extend or terminate a lease. A discounted lease payment maturity analysis, by lease type, would also be required.

New quantitative disclosures for Type A leases would include reconciliations of the opening and closing balances of both lease receivables and residual assets, as well as a tabular disclosure of lease income recognized in the reporting period. Lessors of Type A leases would also provide information about how they manage the risks associated with the residual assets.

Other considerations

Subleases

Lessees often enter into arrangements to sublease an underlying leased asset to a third party while the original lease contract (i.e., the head lease) remains in effect. The proposal would require the original lease and the sublease to be accounted for as separate transactions. To classify a sublease, the original lessee would consider the same principles as any lessor by assessing whether the sub-lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset (i.e., the asset subject to the original lease, as opposed to the original lessee's right-of-use asset) over the lease term.

Business combinations

An acquirer would classify acquired leases (as Type A or Type B) using the contractual terms and conditions at the commencement date of the lease. If the contractual terms and conditions are modified and would result in a substantive change to the original lease (i.e., the modified lease becomes a new contract) the acquirer would classify the new lease based on the contractual terms and conditions at the commencement date of the new lease (which might be the acquisition date). The proposal specifies initial measurement guidance for leases that are acquired in a business combination. However, subsequent measurement guidance for an acquired lease liability and right-of-use asset would be the same as the guidance for any other existing lease arrangement.

Virtually all sale-leaseback transactions would result in an obligation on the balance sheet.

How we see it

It is unclear whether an acquirer would always classify an acquired lease (as a Type A or Type B lease) in the same way as the acquiree had previously classified the lease. For example, an acquirer may have different relevant entity-specific factors that may result in a different determination of the lease term (and potentially a different lease classification) than that determined by the acquiree.

Sale and leaseback transactions

The determination of whether a sale and leaseback transaction is accounted for as a sale and a lease or a financing transaction would be based on the control criteria in the proposed revenue recognition standard.

The leases proposal clarifies that the existence of the leaseback does not, by itself, prevent the transaction from being accounted for as a sale and a leaseback.

The proposal further notes that if the seller/lessee has the ability to direct the use of and obtain substantially all of the remaining benefits from the underlying asset, a sale has not occurred (i.e., the buyer/lessor does not obtain control of the asset). This would be the case if either of the following conditions is met:

- ▶ The lease term is for the major part of the remaining economic life of the underlying asset.
- ▶ The present value of the minimum lease payments accounts for substantially all of the fair value of the underlying asset.

If the transferee (buyer/lessor) obtains control of an underlying asset, the transaction would be accounted for as a sale and a lease. However, if the transferee (buyer/lessor) does not obtain control of the underlying asset, the transaction would be accounted for as a financing.

Today's lease standard provides accounting guidance for a lessee's involvement in the construction of an asset that the lessee will use when construction is complete (i.e., build-to-suit arrangements). Such transactions are often accounted for using guidance for sale-leasebacks. The proposal would not carry forward any of that guidance. Instead, if a lessee incurs costs for the construction or design of an underlying asset, it would account for those costs in accordance with other applicable accounting guidance. Payments for the right to use the underlying asset would be lease payments (regardless of the timing of payment) and would be excluded from construction costs. If the lessee controls the underlying asset before the commencement date, the transaction would be accounted for as a sale and leaseback transaction under the proposal.

The Board's outreach activities are expected to include roundtables, fieldwork and meetings with preparers and user groups.

How we see it

- ▶ Because lessees would recognize all leases on the balance sheet (except for certain short-term leases), sale and leaseback transactions would no longer be a source of off-balance sheet financing.
- ▶ Assuming that specific requirements for sales of real estate are not included in the final revenue recognition standard, there would be no unique criteria for sale and leaseback transactions of real estate. This would be a major change from today's standard. We would generally expect more transactions involving property to be accounted for as sales and leasebacks under the proposal than under today's standard.

Effective date and transition

Effective date

The proposal does not specify an effective date. The Boards will consider feedback on the ED before determining one.

The proposal would require the transition provisions to be applied as of the beginning of the earliest comparative period presented in the year of adoption (i.e., the year of the effective date). The beginning of the earliest period presented would be the date of initial application. As an example, assuming an effective date of 1 January 2017, a calendar-year company that includes three years of comparative information would use 1 January 2015 as its date of initial application.

The proposal would require entities to evaluate all existing arrangements at the date of initial application to determine whether the arrangements are leases or contain leases. No leases would be grandfathered. If an existing arrangement is a lease, it would be evaluated to determine whether it would have been classified as Type A or Type B.

Transition approaches

The Boards have proposed that a modified retrospective approach could be used as an alternative to a full retrospective approach to transition. Entities applying the modified retrospective approach would use certain “shortcut” calculations to initially measure the lease-related assets and liabilities. They also would be able to use hindsight to determine the lease term or whether an existing arrangement contains a lease at all. This modified retrospective approach is intended to approximate a full retrospective approach but at a lower cost and with less effort than full retrospective adoption.

Following either transition approach, entities would adjust the balance sheet (e.g., a lessee would recognize a lease liability and right-to-use asset) and each affected component of equity at the beginning of the earliest comparative period presented. The subsequent comparative periods presented would also be adjusted, as if the entity had always applied the proposed guidance.

For capital leases (ASC 840) existing at the date of initial application, lessees and lessors would be permitted to use the existing carrying amounts of lease-related assets and liabilities as the initial measurements under the proposal.

Next steps

We encourage interested parties to send comments by the 13 September 2013 deadline to help the FASB develop a high-quality standard. Entities also may want to participate in the FASB’s outreach process, which is expected to be extensive.

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