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Issues In-Depth®

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Contents

Implications of the Revised FASB and IASB Exposure Drafts on Lease Accounting

The FASB and IASB (the Boards) recently issued revised joint exposure drafts (2013 EDs) on proposed changes to the accounting for leases that, if finalized as proposed, would significantly change how lessees and lessors account for and report leasing arrangements in their financial statements.[1] The Boards received nearly 800 comment letters on their original 2010 joint exposure drafts (2010 EDs).[2] After lengthy redeliberations, the Boards made extensive modifications to their 2010 lease accounting proposals in response to the comments and other input received from constituents.

Comments on the 2013 EDs are due by September 13, 2013. The Boards plan to hold public roundtable meetings after the comment period and hope to issue a final standard in 2014. Organizations that want to participate in one of the roundtable meetings should contact the FASB or IASB.

This edition of *Issues In-Depth* includes some of our observations about the 2013 EDs' key proposals and highlights their more significant implications and potential application issues. The observations, examples, and the impact of these potential changes to current practice are based on our current understanding and interpretation of the 2013 EDs and are subject to change as the Boards continue their deliberations on the proposed standard in response to input received from comment letters, roundtable participants, and other outreach activities. The appendix at the end of this publication provides a series of decision trees that are designed to facilitate an understanding of the interaction of selected aspects of the proposals.

Executive Summary

The 2013 EDs propose a dual-model approach for both lessee and lessor accounting. The pattern of noncontingent lease income and expense would be accelerated under one model, consistent with the income statement impact under U.S. GAAP and IFRS (collectively, GAAP) for other financing transactions, and generally straight-line under the other. New lease classification tests based on the extent to which the lessee consumes the economic benefits of the leased (underlying) asset during the lease term and whether the underlying asset is property (i.e., land and buildings, including parts of buildings) or non-property would be used to determine the pattern and presentation of lease income and expense over the lease term. Leases accounted for under the accelerated income and expense model (like financings) would be

[1] FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org.

[2] FASB Proposed Accounting Standards Update, Leases, August 17, 2010, available at www.fasb.org, and IASB ED/2010/9, Leases, August 2010, available at www.ifrs.org. For more information about the Boards' 2010 proposals, see KPMG's Defining Issues No. 10-34, Proposed Changes to Lease Accounting, and Issues In-Depth No. 10-5, Potential Implications of the FASB, IASB Joint Exposure Draft on Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network.

referred to as Type A leases and those accounted for under the generally straight-line income and expense model would be referred to as Type B leases. Lessees and lessors would apply the same classification tests.

Lessees would account for all leases, other than some short-term leases, on-balance sheet by recognizing a lease liability and a right-of-use (ROU) asset. However, lessees would be permitted to account for short-term leases (i.e., leases without a purchase option and with a *maximum* possible term, including optional renewal periods, of 12 months or less), off-balance sheet similar to current operating lease accounting.

For on-balance-sheet leases, at lease commencement lessees would recognize a lease liability equal to the present value of the estimated future noncontingent lease payments the lessee is obligated to make over the lease term and a ROU asset equal to the lease liability plus any prepaid rent and initial direct costs incurred to enter into the lease less any lease incentives received from the lessor. The lease liability would be amortized using the effective interest method, with lease payments apportioned between interest expense and a reduction of the remaining liability. Lessees would be required to reassess the estimates that affect the initial measurement of the lease liability after lease commencement and remeasure the remaining liability based on changes in the factors affecting the original estimate. Changes in the lease liability due to reassessments after lease commencement generally would also result in an offsetting adjustment of the ROU asset.

Lessees would measure the ROU asset after initial recognition in one of two ways depending on the lease classification. For Type A leases, lessees would amortize the ROU asset in the same manner as owned property, plant, and equipment or intangible assets (i.e., generally on a straight-line basis over the estimated lease term). For Type B leases, lessees would amortize the ROU asset each period generally in an amount that, combined with periodic interest on the lease liability, would produce a straight-line pattern of total noncontingent lease expense over the lease term. The measurement approach for Type A leases generally would result in an accelerated (i.e., front-loaded) pattern of total noncontingent lease expense over the lease term, consistent with the income statement impact under GAAP for other financing transactions.

For Type A leases, the lessee would present the interest expense on the lease liability and the amortization of the ROU asset separately in the statement of comprehensive income as interest expense and amortization expense, respectively. For Type B leases, lessees would present interest expense and amortization of the ROU asset in the statement of comprehensive income together as a combined amount.

If the lease includes a purchase option that the lessee has a significant economic incentive to exercise, it would be classified as a Type A lease. If not, lessees and lessors would apply the following lease classification tests:

- Leases of property would be Type B leases *except* where: (a) the lease term is for a major part of the property's *remaining* economic life, or (b) the present value of the estimated noncontingent lease payments is substantially all of the fair value of the underlying asset, in which case they would be Type A leases.
- Leases of non-property assets (including integral equipment) would be Type A leases *except* where: (a) the lease term is insignificant in relation to the *total* economic life of the underlying asset, or (b) the present value of the estimated noncontingent lease payments is insignificant in relation to the fair value of the underlying asset, in which case they would be Type B leases.

Lessors would account for Type A leases using a receivable and residual (R&R) model. Under the R&R model, at lease commencement lessors would recognize a lease receivable for the right to receive noncontingent lease payments from the lessee over the lease term and a residual asset for the right to the return of the underlying asset at the end of the lease term. If the fair value of the underlying asset is not equal to its carrying amount at lease commencement, lessors applying the R&R model would recognize profit or loss related only to the right-of-use transferred to the lessee and not to the residual asset retained by the lessor. No upfront profit or loss would be recognized in circumstances in which the fair value and carrying amount of the underlying asset are the same at lease commencement.

The lease receivable would be amortized using the effective interest method, with lease payments apportioned between interest income and a reduction of the remaining receivable. Lessors would be required to reassess the estimates that affect the initial measurement of the lease receivable after lease commencement and remeasure the remaining receivable based on changes in the factors affecting the original estimate. Changes in the lease receivable due to reassessments after lease commencement generally would also result in an adjustment of the residual asset and some amount of profit or loss.

The residual asset would be accreted to its estimated future value at the end of the lease term and adjusted for reassessments after lease commencement. The carrying amount of the residual asset would be reduced by unearned profit or loss (i.e., the fair value less the carrying amount of the underlying asset at lease commencement less upfront profit or loss recognized). If the lease includes contingent (variable) lease payments that affect the lessor's discount rate, the lessor would be required to derecognize a portion of the residual asset each period and recognize a corresponding reduction of lease income for the period. Unearned profit on the residual asset generally would be recognized only when a reassessment occurs that affects the measurement of the residual asset, the underlying asset is either sold or re-leased, or an impairment of the residual asset is recognized.

Lessors that use lease arrangements for financing purposes would present commencement date lease income under the R&R model net of lease expense in a single line item on the statement of comprehensive income. Lessors that use leases as an alternative to selling (e.g., many manufacturers and dealers) would present commencement date lease income and expense under the R&R model as separate line items in the statement of comprehensive income.

For short-term leases to which the lessor elects not to apply the R&R model and Type B leases, the lessor would apply an operating lease model similar to operating lease accounting under current GAAP in which the lessor would continue to recognize the underlying asset and would recognize lease income over the lease term generally on a straight-line basis.

The final leases standard is not expected to have an effective date before January 1, 2017 for calendar-year-end companies. Financial statement preparers generally would be required to apply a transition approach in which the new requirements would be reflected as of the beginning of the earliest comparative financial statements included with the first financial statements issued after the effective date.

Background

The Boards undertook their project on lease accounting in July 2006 partly in response to criticisms that current GAAP inappropriately permits some leases to remain off-balance sheet, is overly complex, and, particularly in the case of U.S. GAAP, based on arbitrary rules. While lessor accounting has received less criticism, the Boards decided to address it in their project to avoid the potential for inconsistencies with the revised requirements on lessee accounting and revenue recognition.[3]

The Boards attempted to respond to criticisms of current lease accounting requirements by proposing in the 2010 EDs that rights and obligations in lease arrangements that meet the definitions of assets and liabilities in their respective conceptual frameworks be recognized in lessees' and lessors' statements of financial position. The proposals in their 2010 EDs included a set of principles that would replace most of the arbitrary rules in current GAAP. However, constituents expressed numerous concerns about the feasibility of applying the proposals in the 2010 EDs. These included concerns about the:

- *Complexity and cost* of implementing the proposals, specifically the initial and subsequent measurement of lease assets and liabilities. Many constituents were particularly concerned about the 2010 EDs' proposed reassessment requirements as well as the proposed requirement to estimate variable lease payments using a probability-weighted methodology and the lease term utilizing a more-likely-than-not threshold for recognition.
- *Extent of estimates and judgments* required by the proposals, and the reduced comparability that could arise as a result of differing evaluations entities might make for similar lease agreements (e.g., in estimating the lease term and variable lease payments).
- *Definition of a lease*, and whether all arrangements meeting the proposed definition should be accounted for in accordance with the proposals.
- *Lessor accounting proposals*, particularly the proposed performance obligation approach, which many viewed as inappropriately grossing up the lessor's statement of financial position by reflecting assets and liabilities that would be inconsistent with the relevant concepts in the Boards' respective conceptual frameworks. Many constituents also expressed the view that lessor accounting under current GAAP did not need to be revised and suggested that the Boards focus solely on revising lessee accounting.

Financial Statement User Feedback. Financial statement users provided mixed feedback on the 2010 EDs, contributing to the challenge the Boards have faced in developing the revised proposals in the 2013 EDs. Users generally favored the proposed on-balance-sheet recognition of leases by lessees under the right-of-use lessee model because they believe leases create rights and obligations for the lessee. Currently many users have proprietary financial statement models that estimate the lessee's assets and liabilities based on disclosures in the notes to the lessee's financial statements and other information obtained from the lessee. However, users indicated that the proposals in the 2010 EDs would likely still require them to rely on proprietary financial statement models to make adjustments to the lessee's reported assets, liabilities, and results of operations based on how the users interpret the effect of the leasing transactions entered into by the lessee. The exact nature of those adjustments would vary depending on the user's modeling, the nature of the lessee's business, and the leasing transactions the user was analyzing. Users also provided mixed feedback on other areas of the 2010 EDs' proposals, including the following:

- Some users indicated that they would prefer the amounts recorded in the lessee's statement of financial position in connection with leasing transactions be only the fixed, contractual minimum payments the lessee is obligated to

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[3] Refer to the summary of Revenue Recognition – Joint Project of the FASB and IASB, available at www.fasb.org. Also see KPMG's Defining Issues and Issues In-Depth publications on the joint revenue recognition project, all available at www.kpmginstitutes.com/financial-reporting-network.

make (with additional information provided in the notes to the financial statements). Other users indicated that estimates are important to a business enterprise and that including a lessee's best estimates in its financial reporting provides the most relevant information (as long as users also are provided information about the underlying judgments and assumptions). Some users indicated that certain contingencies (e.g., performance- and usage-based contingencies) should not be reflected in a lessee's liabilities while others (e.g., those linked to an index) should be estimated and reflected in the lessee's accounting.

- Users had mixed views about how lease expense should be recognized for lease contracts. Some users were supportive of the approach proposed in the 2010 EDs where the right-of-use asset would be amortized on a straight-line basis and interest expense on the lease liability would be recorded using the effective interest method (resulting in an accelerated or front-loaded pattern of noncontingent lease expense over the lease term). Others expressed a preference for lessees to recognize total noncontingent lease expense on a straight-line basis over the lease term.

Financial Statement Preparer Feedback. Financial statement preparers expressed varying levels of concern about many aspects of both the lessee and lessor proposals. However, their feedback generally was more consistent than feedback from financial statement users. Many preparers were not supportive of applying one model to all leases in which the entity is the lessee. These preparers do not view all leases as financed acquisitions of an asset; they view some as no different in substance from other executory contracts (e.g., maintenance or other service contracts). Like some users, preparers generally supported the proposed effective interest method for amortization of the lease liability, but many (particularly from the real estate lessee community) expressed the view that the combined interest expense on the lease liability and amortization of the right-of-use asset should, at least for many leases, result in straight-line noncontingent lease expense over the lease term consistent with operating lease accounting under current GAAP.

With respect to lessor accounting, the majority of preparers did not support the 2010 EDs' proposals. They did not view the proposals as an improvement to lessor accounting under current GAAP principally because they viewed them as more complex than current GAAP. In addition, preparers questioned retention of a complex dual model for lessors, although it would be different from the dual model applied currently, versus the proposed single model for lessees. Further, preparers were concerned about the differences between the proposed lessor accounting model, which focused on transfer or retention of exposure to significant risks and rewards, and the proposed revenue recognition standard, in which revenue recognition is based on the transfer of control of goods or services rather than exposure to significant risks and rewards of ownership.

There was relatively broad preparer support for the proposed derecognition approach to lessor accounting, under which the lessor would derecognize the underlying asset and recognize a lease receivable equivalent to the lessee's lease liability and a residual asset for its retained interest in the underlying asset. Many preparers viewed that approach as the natural counterpoint to the lessee right-of-use model. However, despite support for the proposed derecognition approach, preparers still expressed specific concerns about its application. These included concerns about the subsequent accounting for the residual asset (e.g., many constituents believed that the residual asset should be accreted), as well as application of the approach to certain types of leases (e.g., a two-year lease of a floor of an office building), and whether derecognition of part of an underlying asset is appropriate when the lessor retains title to the asset. In addition, preparers commented that further clarifying guidance was necessary for the proposals to be applied consistently.

Preparers and most other constituents were *not* supportive of the performance obligation approach that would be applied when the lessor retains exposure to the significant risks and benefits of the underlying asset. Under the performance obligation approach the lessor would recognize a lease receivable and performance obligation liability for the present value of the estimated lease payments but would not derecognize the underlying asset. The majority of preparers viewed the performance obligation approach as inconsistent with the proposed revenue recognition standard and inappropriately grossing up the lessor's statement of financial position. However, preparers and some other constituents, principally in the real estate industry, viewed the performance obligation approach as preferable to the derecognition approach because it would produce a pattern of income consistent with income recognition for operating leases under current GAAP.

Preparers also raised the following key concerns:

- *Definition of a lease* – The definition of a lease should be refined, particularly to address those scenarios in which it is unclear whether the contract contains a lease or solely a service arrangement. In addition, preparers indicated that the proposed in-substance purchase/sale definition was confusing and unnecessary if the Boards appropriately defined a lease in the leases project and a sale in the revenue recognition project. Lastly, preparers and other constituents raised concerns about the proposed guidance on separating lease and non-lease components (they indicated the proposed guidance would require many service components to be accounted for as part of the lease), as well as the lack of guidance on accounting for contracts with multiple underlying assets.

- *Lease term* – Most preparers disagreed with the proposal that the lease term should be defined as the longest possible term that is more likely than not to occur. A number of preparers and other constituents expressed the view that amounts aligned to periods that were more likely than not to occur, but not *probable* of occurring, would not meet the conceptual definition of a liability, and therefore should not be recognized.

- *Lease payments* – Preparers strongly disagreed with the proposed requirement to estimate variable lease payments, term option penalties, and amounts that would be owed under residual value guarantees using a probability-weighted approach. Preparers expressed the view that this would be costly and complex, and would create issues with both volatility (i.e., due to changes in estimates) and comparability.

- *Disclosures* – Preparers generally expressed concern about the volume of the proposed disclosures. While understanding users' need for financial information, many preparers viewed the proposed disclosure requirements as being overly burdensome and too prescriptive with respect to some of the quantitative requirements (e.g., the roll-forward requirements).

- *Transition and effective date* – Many preparers requested an extended lead-time before any final standard would become effective. Others requested the option to apply the final standard on a fully retrospective basis.

Redeliberations of 2010 EDs. In their redeliberations of the 2010 EDs, the Boards attempted to address many of these concerns. As a result, the 2013 EDs eliminate or modify significantly many of the proposals in the 2010 EDs. Some of the most significant changes from the proposals in the 2010 EDs are:

- *Introduction of a dual-model approach for lessee accounting* – The 2010 EDs proposed a single lessee accounting model, while the 2013 EDs propose a dual-model approach under which leases would be accounted for in one of two ways depending on the extent of the lessee's consumption of the economic benefits of the underlying asset over the lease term and whether the underlying asset is property or non-property. One of the models would require recognition of lease expense on an accelerated basis through the combination of interest on the lessee's liability to make lease payments along with amortization of its right to use the underlying asset, consistent with the proposals in the 2010 EDs and GAAP for other financing transactions. Leases accounted for under this model would be referred to as Type A leases. The other model would require recognition of noncontingent lease expense generally on a straight-line basis over the lease term. This would be accomplished by amortizing the lessee's right to use the underlying asset by the difference between the total straight-line periodic expense from noncontingent lease payments and the amount of interest expense on the lease liability. Interest and amortization expense would be combined in the income statement as a single lease expense amount. Leases accounted for under this model would be referred to as Type B leases. Both Type A and Type B leases would be on-balance sheet for lessees.

- *Significant revisions to the lessor accounting model* – The 2010 EDs proposed a dual-model lessor accounting approach in which the applicable model would depend on the extent of the lessor's exposure to risks or benefits associated with the underlying asset. Under the 2013 EDs' proposals lessors would apply the same lease classification tests as lessees to determine which model to apply. For Type A leases, lessors would derecognize the underlying asset and recognize a lease receivable and a residual asset. This is similar to the derecognition approach proposed in the 2010 EDs. However, lease income for Type A leases would include accretion of the lessor's residual asset whereas the 2010 EDs proposed that the residual asset recognized under the derecognition approach would not be accreted. The 2010 EDs' performance obligation approach, under which the lessor would have recognized a lease receivable and a performance obligation liability in addition to keeping the underlying asset on its balance sheet, was eliminated from the 2013 EDs. Instead, lessor accounting for Type B leases would be substantially equivalent to lessor accounting for operating leases under current GAAP.
- *Changing the estimated lease term* – The 2010 EDs proposed that the estimated lease term would be the longest possible term that is more likely than not to occur. The 2013 EDs propose that the lease term include the non-cancelable term together with any optional periods for which the lessee has a significant economic incentive to extend or not to terminate the lease. The 2013 EDs' proposals likely would result in lease terms for accounting purposes that are more consistent with current GAAP than the 2010 EDs' proposals.
- *Accounting for variable lease payments* – The 2010 EDs proposed that the lessee's obligation to make lease payments (i.e., lease liability) and the lessor's right to receive lease payments (i.e., lease receivable) would include estimated variable lease payments using a probability-weighted expected outcomes approach. The 2013 EDs propose to exclude all variable lease payments, other than those that are in-substance fixed lease payments or those that are based on an index or rate, from the lessee's lease liability and lessor's lease receivable.

The Boards decided to reexpose the proposed leases standard because leasing affects virtually all business entities and they wanted to identify potential unintended consequences of applying the proposed standard before it is finalized. They are seeking input on whether the proposed standard is clear and can be applied in a way that effectively communicates to financial statement users the economic substance of an entity's lease contracts.

The Boards have specifically requested feedback on whether constituents agree with the 2013 EDs' proposals on:

- The definition of a lease and the guidance for determining whether a contract contains a lease;
- A dual-model approach for lessee and lessor accounting and the related lease classification tests;
- Determining the lease term, including the reassessment requirements after lease commencement;
- The measurement of variable lease payments, including reassessment requirements after lease commencement;
- The disclosure requirements for leases;
- The practical expedients available to nonpublic entities applying U.S. GAAP, including: (a) the option to use a risk-free discount rate to measure the lease liability, and (b) the exclusion from the requirement to provide a reconciliation of the opening and closing balance of the lease liability; and whether these practical expedients will adequately reduce nonpublic entities' cost of implementing the new lease accounting requirements without unduly sacrificing information that is important to their financial statement users;
- Leases between related parties, specifically, that it is not necessary to provide unique recognition, measurement, and disclosure requirements for these leases; and
- Transition requirements.

Scope

Contracts that meet the definition of a lease

Within scope	In scope with exceptions	Outside scope
• Leases of assets • Long leases of land • Sale-leasebacks • Subleases • In-substance purchases / sales • Leases of inventory	• Leases with service components • Short-term leases (≤ 12 months)	Leases of: • Intangibles (other than ROU assets) • Natural resources and exploration • Biological assets

The 2013 EDs would apply to all leases, including subleases, except for:

- Leases of intangible assets (other than right-of-use assets);[4]
- Leases to explore for or use non-regenerative resources (e.g., minerals, oil, natural gas);
- Leases of biological assets (e.g., crops), including, for U.S. GAAP only, timber;
- Service concession arrangements within the scope of IFRIC 12 (for IFRS only);[5] and
- Leases of internal-use software (U.S. GAAP only).

[4] Lessees of intangible assets other than right-of-use assets applying IFRS would be permitted to apply the lease accounting requirements to those leases.

[5] IFRIC 12, Service Concession Arrangements.

KPMG Observations

Under current U.S. GAAP, arrangements not accounted for as leases under the provisions of FASB Statement No. 13, *Accounting for Leases*, that were committed or agreed to before reporting periods beginning after May 28, 2003 and not subsequently modified or acquired in a business combination, were grandfathered from determining whether the arrangement is or contains a lease. Because the 2013 EDs do not carry forward those grandfathering provisions, these contracts would need to be assessed to determine whether they are within the scope of the new standard on its adoption.

Under current U.S. GAAP, arrangements in which the seller of an asset provides a guarantee of the asset's future residual value to the buyer are accounted for as leases by the seller, irrespective of whether the buyer has to return the asset to the seller to receive a guarantee payment.[6] Under the 2013 EDs' proposals and the Boards' forthcoming revenue recognition standard, these arrangements would be excluded from the scope of the leases guidance. The Boards have decided that a residual value guarantee provided by a seller to the buyer of an asset would not, in isolation, prevent the seller from concluding that it had transferred control of the asset to the buyer and, therefore, accounting for the arrangement as a sale rather than a lease.

Expansion Beyond Land and Depreciable Assets. The proposed scope of the 2013 EDs generally is consistent with current GAAP for leases. However, current lease accounting standards generally apply only to leases of land and depreciable assets such as property, plant, and equipment while the 2013 EDs would apply to all leases of tangible assets. Based on this definition, leases of non-depreciable tangible assets such as inventory or construction-in-progress would fall within the EDs' scope. If the guidance is finalized in its current form, companies would need to review their arrangements to determine if arrangements previously not considered leases would be within the scope of the new standard.

Scope Exceptions. The Boards' decision to exclude leases of intangible assets from the scope of the leases standard appears to have been made primarily to expedite completion of the project. The Boards indicated that there is little conceptual basis for this exclusion and it is possible that they will address leases of intangible assets in the future. The inclusion of a specific exception for leases of internal-use software appears redundant with the broader exclusion of leases of intangible assets because software is generally considered an intangible asset. However, the FASB wanted to ensure there was no confusion about the scope of the proposed standard as compared to the internal-use software accounting guidance in current U.S. GAAP, which requires entities to analogize to the current U.S. GAAP lease accounting requirements when determining the asset acquired in a licensing arrangement for internal-use software.[7] The 2013 EDs' proposed consequential amendments to the FASB Accounting Standards Codification eliminate that guidance.

The proposed scope exception for leases to explore for or use natural resources is

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[6] FASB ASC paragraphs 840-10-55-12 through 55-25 (formerly EITF Issue No. 95-1, Revenue Recognition on Sales with a Guaranteed Minimum Resale Value), available at www.fasb.org.

[7] FASB ASC paragraph 350-40-25-16, available at www.fasb.org.

due to other GAAP guidance on the accounting for these arrangements and the IASB's current project on extractive industries.[8] The 2013 EDs propose to exclude biological assets from the scope of the leases standard to ensure that their accounting requirements remain in one place within GAAP.[9]

Finally, current U.S. GAAP explicitly includes heat supply contracts for nuclear fuel within the scope of the lease accounting requirements while the guidance proposed in the 2013 EDs does not.[10]

Example 1: Lease of Spare Parts

Amazing Airways agrees to lease inventory comprising spare parts for aircraft and engines from Enormous Aircraft Developer. The lease is for a term of five years but may be terminated by Amazing Airways with 30 days notice. Each month, Amazing Airways will pay Enormous Aircraft Developer rent equal to the product of the sales price of the parts inventory and the annualized London Interbank Offered Rate (LIBOR) + 3.25%. Amazing Airways has the right to purchase any of the parts inventory at any point during the arrangement at its current sales price.

This arrangement would likely be within the scope of the 2013 EDs (as discussed in more detail in the sections that follow). If so, Amazing Airways would recognize an asset and a liability for the right to use the parts inventory for the estimated lease term, which may be less than five years (as discussed in more detail in the sections that follow), without consideration of its rights to purchase the inventory. Measurement would be based only on the carrying cost of the inventory. Because the inventory is equipment, Enormous Aircraft Developer would likely recognize a lease receivable for its right to receive lease payments from Amazing Airways and a residual asset for its right to the return of the inventory at the end of the lease term (refer to section on *Lessor Accounting and Financial Statement Presentation*). Profit would be recognized at lease commencement for any excess of fair value over carrying amount of the inventory multiplied by the ratio of the present value of estimated noncontingent lease payments divided by the fair value of the inventory.

Example 2: Lease of Inventory Components

Auto Manufacturer and Supplier agree that Auto Manufacturer will have the right, during a five-year period, to use a specified quantity of platinum and palladium in completed and installed catalytic converters but will only purchase the metals once the vehicle (with the completed and installed catalytic converter) is sold. Any amount of the metals not used by Auto Manufacturer is returned to Supplier who retains legal ownership of the metals before the point of sale to Auto Manufacturer's customer. The payments to Supplier by Auto Manufacturer are determined in a manner similar to Example 1.

This arrangement likely would be within the scope of the 2013 EDs and, if so (as discussed in more detail in the sections that follow), would require Auto Manufacturer to recognize an asset and a liability for the right to use the metals (the amount would be less than what would be recognized if Auto Manufacturer

[8] FASB ASC Topic 930, Extractive Activities—Mining, and FASB ASC Topic 932, Extractive Activities—Oil and Gas, both available at www.fasb.org; Discussion Paper DP 2010/1, Extractive Activities, April 2010, available at www.ifrs.org, and IFRS 6, Exploration for and Evaluation of Mineral Resources.

[9] FASB ASC Topic 905, Agriculture, available at www.fasb.org, and IAS 41, Agriculture.

[10] FASB ASC paragraph 840-10-15-9, available at www.fasb.org.

purchased the metals outright). Because the precious metals are non-property assets, Supplier also likely would be required to account for the lease in the same manner as Enormous Aircraft Developer in Example 1.

Non-Core Assets

Leases of non-core assets (i.e., assets that are not used in a company's primary operations, such as a corporate jet) are specifically included within the scope of the 2013 EDs. Some believe that non-core assets should not be within the scope as they are not essential to the entity's primary operations and the cost of accounting for these assets under the proposed requirements would outweigh the benefits. However, the Boards concluded that it was appropriate to include these assets within the scope of the proposed standard because neither IFRS nor U.S. GAAP distinguish core and non-core purchased assets for purposes of recognition, which would make defining core and non-core extremely difficult. As a result, there could be wide disparity in application, which would reduce comparability in financial statements of similar entities. Therefore, the Boards could not justify distinguishing a right-of-use asset relating to a core asset from one that relates to a non-core asset.

Long-Term Leases of Land

The scope of the 2013 EDs includes long-term leases of land. Some constituents view long-term leases of land (e.g., 99-year leases) as economically similar to the purchase or sale of the land and believe they should be excluded from the scope of the proposed standard. However, the Boards concluded that they should be within the 2013 EDs' scope because:

- There is no conceptual basis for differentiating long-term leases of land from other leases, and inevitably, any definition of a long-term lease of land would be arbitrary. If the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term, the contract is a lease and should be accounted for as one.
- A very long-term lease of land (e.g., a 99-year or 999-year lease) could be classified as a Type A lease because the present value of lease payments may represent substantially all of the fair value of the land. In this case, the accounting applied by the lessee and lessor would be similar to accounting for a purchase or sale of the land.

KPMG Observations

Under the 2013 EDs a lease of land together with other property or non-property assets may also be classified as a Type A lease if the land and other assets are accounted for as a single lease component even if the lease is not long term. For example, consider a 30-year lease of land and a building, which would be accounted for as a single lease component. The lessee and lessor would be required to consider the remaining economic life of the building to be the economic life of the underlying asset in determining the classification of the lease. If 30 years represents a major part of the remaining economic life of the building, or if the present value of the estimated noncontingent lease payments is substantially all of the fair value of the land and building, the entire lease (including the land element) would be classified as a Type A lease. For additional information, refer to sections on *Identifying Lease Components* and *Lease Classification*.

Short-Term Leases

Short-term leases are defined in the 2013 EDs as leases that do not contain a purchase option and, at the commencement date, have a maximum possible term under the contract, including any options to extend, of 12 months or less. Short-term leases are within the scope of the 2013 EDs; however, a simplified form of accounting would be allowed. Entities would be permitted, as an accounting policy election by class of underlying asset, not to apply the recognition, measurement, and presentation requirements of the proposed standard to short-term leases. Lessees could elect to recognize lease expense for short-term leases on a straight-line basis over the lease term, while lessors could elect to recognize lease income either on a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which income is earned from the underlying asset.

KPMG Observations

Evergreen agreements, agreements with continuous renewal options, and agreements with no stated duration would not be eligible for the short-term lease exemption if the lessee has a unilateral right to extend the term. The lessee's intentions are not taken into consideration because the exemption is based on the maximum possible lease term.

The 2013 EDs define a contract as "[a]n agreement between two or more parties that creates enforceable rights and obligations." In general, enforceability is a matter of law, and contracts can be written, oral, or implied by an entity's customary business practices. As a result, entities would be required to consider whether there are any implied renewal or purchase options in the contract that would preclude application of the short-term lease guidance in addition to any such options written into the contract.

The Boards concluded that when a lessee cannot extend the term of a contract without the lessor's agreement, the maximum lease term would include the non-cancelable period plus any notice period. The Boards do not believe this will provide an incentive for entities to include a clause making a lease cancelable at any point, even though there is no need for, or intention to exercise, the cancelation option, because they believe that type of clause is likely to affect the pricing of the lease.

Example 3: Short-Term Leases

Lessee X enters into a contract with Lessor W to lease a truck; the lease term is 12 months and there are no renewal options. Lessee Y enters into a contract with Lessor W to lease a car; the lease term is nine months and Lessee Y has the option to renew the lease for another six months. Lessee Z enters into a contract with Lessor W to lease a trailer; the lease term is 12 months and there are no renewal options, but Lessee Z can elect to purchase the trailer at fair market value any time during the last month of the lease term.

Lessee X's lease qualifies as a short-term lease because the longest possible lease term under the contract is not more than 12 months.

- Both Lessor W and Lessee X can elect to apply the simplified requirements for short-term leases if they have not already elected a policy to not apply the simplified requirements to similar leased assets (i.e., those within the same class of underlying asset). If Lessor W or Lessee X elects to apply the simplified requirements to the lease, then it will be required to do so for all other short-term leases within that class of underlying assets going forward. If Lessor W or Lessee X has previously elected to apply the simplified requirements for short-term leases to leased assets within the same class of underlying asset as the truck, it must apply those requirements to the lease of the truck.

- If Lessor W elects the simplified option, it would recognize the total lease income for the lease with Lessee X either on a straight-line basis over the lease term or on another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset.
- If Lessee X elects the simplified option, it would recognize the total lease expense for the lease on a straight-line basis over the lease term.

Lessee Y's lease does not qualify as a short-term lease because the longest possible lease term is 15 months, even if Lessee Y considers the likelihood of exercising the renewal option to be remote. Therefore, Lessee Y and Lessor W could not apply the simplified requirements to this lease.

Despite the fact that the lease has a maximum possible term of 12 months or less, Lessee Z's lease also does not qualify as a short-term lease for either Lessee Z or Lessor W because there is a purchase option in the contract. It does not matter whether the exercise price of the option is at, above, or below fair market value.

Example 4: Leases Cancelable by Lessee and Lessor

Lessor A enters into a contract with Lessee B to lease a jackhammer; the lease term is 10 months and is automatically renewed after 10 months unless terminated by either the lessee or the lessor. A one-month notice is required for termination by either the lessee or the lessor.

The lease qualifies as a short-term lease because the non-cancelable period together with the cancelation notice period is not more than 12 months. Both Lessor A and Lessee B can elect to apply the simplified requirements for short-term leases if they have not already elected a policy to not apply the simplified requirements to similar leased assets (i.e., those within the same class of underlying asset). If Lessor A or Lessee B elects to apply the simplified requirements to the lease, it will be required to do so for all of its other short-term leases within that class of underlying assets going forward. If Lessor A or Lessee B has previously elected to apply the simplified requirements for short-term leases to leased assets within the same class of underlying asset as the jackhammer, it must apply those requirements to the lease of the jackhammer.

Definition of a Lease

The 2013 EDs define a lease as "[a] contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration."

When evaluating whether a contract includes a lease, entities would need to determine whether:

- Fulfillment of the contract, or an element of the contract, depends on the use of an identified asset or assets; and
- The contract conveys to the lessee the right to control the use of the identified asset(s) for a period of time in exchange for consideration.

Determining if There Is an Identified Asset. An asset generally would be considered identified if it is explicitly specified in the contract (e.g., by serial number). Consistent with current GAAP, an asset would be considered implicitly specified if the supplier does not have a substantive right to substitute other assets for it in fulfilling the contract. Even if an asset is explicitly specified, the contract would not depend on the use of an identified asset if the supplier has a substantive right to substitute other assets for it (*other than* for reasons of malfunction or availability of a technical upgrade – i.e., to replace an obsolete asset with an updated model) in fulfilling the contract. An explicitly or implicitly specified asset would include a physically distinct portion of an asset (e.g., floor of a building or individual fiber strand in a fiber-optic cable).

A supplier's substitution right, whether explicit or otherwise, would be considered substantive if:

- The supplier can exercise its right without the customer's consent; *and*
- There are no barriers (economic or otherwise) that would prevent the supplier from substituting alternative assets during the contract term. Examples of barriers include (a) costs of such significance that they create an economic disincentive for the supplier to substitute alternative assets, and (b) operational barriers that would prevent or deter the supplier from substituting the asset (e.g., alternative assets are neither readily available, nor could the supplier source alternative assets within a reasonable time frame or without incurring significant costs).

If a supplier has an obligation or a substantive right to substitute another asset for any reason on or after a specified date, fulfillment of the contract could be considered to depend on the use of an identified asset until the effective date of the substitution right or obligation.

Contracts that convey the right to a certain amount of capacity from an explicitly or implicitly identified asset (e.g., a contract conveying a right to use a specified amount of the capacity of an identified pipeline), but not the right to use a physically distinct portion of a specified asset, would not be considered dependent on the use of an identified asset. However, a contract that conveys the right to use substantially all of the capacity of an explicitly or implicitly identified asset would be considered dependent on the use of an identified asset.

KPMG Observations

The 2013 EDs' concept of an identified asset is similar to a specified asset in current GAAP, including the concept that an asset is implicitly identified if the supplier does not have a substantive substitution right. The Boards decided not to revise this concept because it works well in practice.

However, the Boards do not illustrate how to determine whether substitution costs are so significant that they create an economic disincentive for the supplier to substitute alternative assets or discuss their views on it in the Basis for Conclusions. Given the added level of sensitivity to whether an arrangement contains a lease that is likely to result from the 2013 EDs' proposal to require lessees to account for most leases on-balance sheet, this is an area where diversity in practice could develop. For example, some suppliers might evaluate whether costs create an economic disincentive based on whether they significantly affect the contract's margin. Conversely, other suppliers might evaluate whether costs create an economic disincentive based on whether they are significant in terms of their absolute monetary value.

Example 5: Evaluating Substitution Rights in Determining if There Is an Identified Asset

Mocha Liquid enters into an arrangement for a storage service that involves the use of a refrigerator for coffee beans. The supplier has the right to substitute the refrigerator without Mocha Liquid's consent. The supplier has many identical refrigerators that are maintained in a single, accessible location and the supplier could easily substitute another unit for the refrigerator in the contract at a nominal cost.

Fulfillment of the contract would not be considered dependent on an identified asset because the substitution right is substantive. Therefore, this contract would not contain a lease.

Conversely, if the refrigerator unit in the contract were significantly customized and located in an isolated area, the substitution right would not be substantive if the cost of similarly customizing and delivering an alternative unit would create an economic and operational barrier to substitution. In that case, fulfillment of the contract would be considered dependent on an identified asset and an evaluation of whether the customer has the right to control the use of the identified asset would need to be performed.

Right to Control the Use of an Identified Asset. A contract would convey the right to control the use of an identified asset when the customer has the ability to *both*:

- Direct the use of the asset throughout the contract term; and
- Derive substantially all of the potential economic benefits from use of the asset throughout the contact term.

In other words, control over the use of an asset would be obtained only when an entity is both entitled to receive substantially all of the benefits from the asset during the contract term and entitled to decide how those benefits are derived. For example, an entity leasing a railcar would need to have not only the right to determine who receives economic benefits from the railcar over the contract term (e.g., through possession of the railcar), but also the right to determine the manner of its operation (e.g., where and when the railcar will travel and what it will carry) to have control over its use.

An entity would have the ability to direct the use of an identified asset when the contract gives that entity the right to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from its use throughout the contract term. The 2013 EDs provide the following examples of these decisions:

- How and for what purpose the asset is used during the contract term;
- How the asset is operated during the contract term; and
- Who operates the asset.

Sometimes there may be few, if any, substantive decisions to be made about the use of an asset after commencement of a contract. The 2013 EDs suggest that in those situations a customer may obtain the ability to direct the use of the asset at or before contract commencement. If a customer is involved in designing an asset for its use or in determining the terms of the contract so that the decisions that most significantly affect the economic benefits to be derived from use of an asset are predetermined, the 2013 EDs propose that the customer would be considered to have the ability to direct the use of the asset as a result of the decisions it made at or before commencement of the contract.

Suppliers may impose restrictions on the use of assets to protect their investment. Protective rights that restrict the customer's use of an asset would not, in isolation, prevent the customer from having the ability to direct the use of the asset. For example, a vehicle lease may contain maximum mileage restrictions (e.g., 36,000 miles for three years) to protect the supplier's interest in the asset. However, this would not preclude the customer from having the ability to direct the use of the vehicle.

Rights that give a customer the ability to specify the output of an asset (such as the amount and/or type of goods or services produced by the asset) would not necessarily give the customer the ability to direct the use of that asset. The 2013 EDs propose that if a customer has the ability to specify the output of an asset but has no other decision-making rights relating to the use of the asset, the customer would be considered to have the same rights as any customer that purchases services.

An entity's ability to derive substantially all of the potential economic benefits from use of an identified asset throughout the contact term would refer not only to direct benefits obtained from use of the asset, but also to indirect benefits such as those resulting from by-products of the asset, including economic benefits such as renewable energy credits that could be realized from using the asset but excluding tax benefits.

KPMG Observations

The proposal that an entity controls the use of an identified asset only if it directs the use of that asset and obtains substantially all of its economic benefits throughout the contract term substantially aligns the concept of control in the 2013 EDs with the control concept in the Boards' forthcoming revenue recognition standard. The 2013 EDs' proposed control concept differs conceptually from existing lease accounting standards because it requires not just the right to obtain benefits from the asset, but also that the customer be able to direct the use of the asset.

Under current GAAP, the right to control the use of a specified asset is conveyed if (1) the purchaser has the ability to operate the asset in a manner it determines while obtaining or controlling more than a minor amount of the asset's output, (2) the purchaser has the ability or right to control physical access to the asset while obtaining or controlling more than a minor amount of the asset's output, or (3) it is remote that one or more parties other than the purchaser will take more than a minor amount of the output and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.[11] In other words, under either criterion (2) or (3) of current GAAP, control over the use of a specified asset does not require that the customer have the ability to direct the use of the asset. The control concept in the 2013 EDs also differs from criterion (1) of current GAAP because not only must the customer be able to direct the use of the asset, the customer also must have the right to obtain *substantially all* of the potential economic benefits from use of the asset over the contract term (rather than only more than a minor amount).

Contractual Restrictions on Use. While the Boards indicated that the presence of contractual restrictions intended to protect the supplier's interest in an asset would not, by themselves, preclude a customer from having the ability to direct the use of an identified asset (a maximum-use restriction was given as an

[11] FASB ASC paragraph 840-10-15-6, available at www.fasb.org, and paragraph 9 of IFRIC 4, Determining whether an Arrangement contains a Lease.

example), they did not indicate how they would view other contractual restrictions potentially limiting the customer's ability to direct the use of an asset. For example, a contract may limit the maximum distance a customer could drive a vehicle during a three-year term and also stipulate the maximum distance the vehicle could be driven in each month or year of the contract or stipulate that the vehicle could only be used for certain purposes (e.g., to transport lumber). The Boards did not indicate whether those restrictions would mean the customer could not direct the use of the asset. Ostensibly, these restrictions prevent the customer from determining how it consumes the benefits of the right of use in the contract and specify aspects of how the asset must be operated.

Contractual restrictions of this nature are known to the customer at contract inception and are an inherent part of the contract pricing (i.e., the contractual consideration reflects the economic substance of the right of use). Accordingly, the analysis of whether the customer has the ability to direct the activities that most significantly affect the economic benefits to be derived from use of an asset throughout the contract term while deriving substantially all of the potential economic benefits from its use appears somewhat circular. We understand the Boards hold the view that these types of restrictions do not preclude a customer from having the ability to direct the use of an identified asset. Conversely, we understand that the Boards believe the customer generally does not have the ability to direct the use of an identified asset in arrangements in which the supplier maintains operational control of the asset (e.g., the supplier or its designee operates the asset on behalf of the customer and has discretion over the inputs used in the operations). It is unclear what substantive differences the Boards see in these contrasting arrangements given the fact that the economic impact of the restrictions could be the same regardless of whether they are imposed by the supplier operating the asset on the customer's behalf or by contractually limiting the actions the customer is permitted to take in operating the asset itself.

Substantially All of the Asset's Potential Economic Benefits. An entity would have the right to obtain substantially all of the asset's potential economic benefits during the contract term even if it intended to let the asset sit idle for that entire period so long as the decision was its own. The entity may not realize any economic benefits from use of the asset, but it solely had the right to obtain those benefits and, therefore, had the ability to derive the benefit from the use of the asset.

Throughout the Term of the Contract. The criteria governing whether the customer has the right to control the use of an identified asset refer to rights that exist *throughout the term of the contract*. It is unclear whether this would offer entities an opportunity to elect not to be subject to the lease accounting requirements by including in the contract term periods during which the customer cannot (a) make decisions about the use of an identified asset that most significantly affect the economic benefits to be derived from its use, and/or (b) derive substantially all of the potential economic benefits from use of an identified asset. For example, a contract involving the use of an explicitly identified vehicle could be structured to include a period during which the customer would be required to return the vehicle to the supplier so that during that period the customer either fails to have the right to make decisions that most significantly affect the economic benefits to be derived from the use of the vehicle and/or fails to derive substantially all of the potential economic benefits from its use. Assuming the period is significant, the EDs' reference to *throughout the term of the contract* could be interpreted to result in a conclusion that the contract does not meet the definition of a lease. However, it is not clear whether that is the Boards' intent.

Assets Inseparable from a Good or Service. The 2013 EDs include guidance stating that a customer would not have the ability to derive the benefits from use of an asset if:

- The customer can obtain those benefits only in conjunction with other goods or services provided by the supplier that are not sold separately by the supplier or other suppliers; and
- The asset is incidental to the delivery of the services because it is designed to function only with the other goods or services provided by the supplier (i.e., the customer receives a bundle of goods or services that combine to deliver the overall service for which the customer has contracted).

KPMG Observations

Constituents that commented on the 2010 EDs were concerned that the proposed definition of a lease might capture assets integral to service contracts in which the service involved using assets that could be viewed as being under the customer's control, such as seats at a sporting venue or cable television boxes. The Boards decided the 2013 EDs should clarify that when the use of an asset is an inseparable or non-distinct part of an overall service being provided to a customer that the customer does not obtain the right to control the asset's use. We understand that the Boards intended for the guidance on assets inseparable from a good or service to be narrowly applicable.

Interplay with guidance in forthcoming revenue recognition standard. Current GAAP requires lease elements to be separated from non-lease elements.[12] Under the 2013 EDs, rights to use identified assets would not be considered lease elements within the scope of the proposals unless they were separable from the associated good or service. The 2013 EDs' proposed criteria for making that determination appear to be derived from the Boards' forthcoming revenue recognition standard. However, the 2013 EDs' proposed test for evaluating whether an asset is inseparable from a good or service diverges from the forthcoming revenue recognition standard. The revenue recognition standard's guidance requires a good or service not to be considered a separate unit of account if *either* the good or service does not provide benefit to the customer on its own or together with other readily available resources, *or* the good or service is highly dependent upon, or interrelated with, another good or service in the contract. Conversely, under the 2013 EDs' proposed guidance, an identified asset would not be a lease element only if it fails to meet *both* of those criteria. As a result, more arrangements would be considered to contain a lease compared to the conclusion that would result if the forthcoming revenue recognition standard's guidance were applied.

Contractual restrictions. With respect to the first criterion above, it is our understanding that the presence of contractual restrictions on the customer's access to otherwise available goods or services (e.g., those sold by another supplier) would not impact the assessment of whether the customer is able to derive benefit from use of the underlying asset. Nevertheless, the 2013 EDs' proposed test to distinguish whether an identified asset is inseparable from another good or service likely would produce dissimilar accounting for some transactions that are economically similar based solely on factors unrelated to the underlying asset or the customer's right of use, such as the supplier's sales model or the availability of complementary goods or services.

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[12] FASB ASC paragraphs 840-10-15-16 through 15-19, available at www.fasb.org, and IFRIC 4, Determining whether an Arrangement contains a Lease.

Example provided by the Boards. The 2013 EDs contain an example involving an arrangement in which a customer enters into a contract for a supplier to provide coffee services for two years. The supplier places coffee machines in the customer's premises that function only together with the beverage products provided by the supplier and have no use to the customer other than when used in conjunction with those beverage products (i.e., neither the coffee machines nor the beverage products are sold separately by the supplier or any other supplier). The Boards' analysis of the example indicates that the arrangement does not contain a lease (even though the customer controls access to the machines and the customer's personnel operate the machines by selecting the beverage they wish the machines to produce). The Boards concluded that the customer does not control the use of the machines because it cannot derive the benefits from using them on their own – they function only with the supplier's beverage products. The machines are incidental to the coffee services provided by the supplier.

Effectiveness of the criteria. It is unclear whether the proposed guidance on assets inseparable from a good or service will fully achieve its desired objective. As indicated above, the Boards selected criteria to be used in the evaluation that appear to be derived from their forthcoming revenue recognition standard. However, the Boards' accounting objective in using those criteria in the revenue recognition standard is different than the objective of identifying situations in which an asset's only possible function is to facilitate the delivery of a service to a customer. The Boards' selection of these criteria may therefore result in a conclusion that some arrangements meet the definition of a lease even though that appears to be contrary to their objective.

For example, it appears that the Boards intend for cable or satellite television set-top boxes supplied by cable/satellite TV companies to their customers to not meet the definition of a lease. However, in cases where these companies sell their set-top boxes to customers (even if only in a minority of arrangements), they also sell their entertainment services separately (e.g., in service renewal periods or to customers who obtain their set-top box through an alternative supplier such as a retailer). Therefore, in these cases, a set-top box would not meet the first criterion of this analysis because the customer can benefit from the set-top box together with the entertainment services that the supplier sells separately. In addition, FCC rules require cable television providers to deliver linear content (i.e., channels other than on-demand) through the use of a CableCARD to customers that wish to use their own CableCARD-enabled device. As a result, it is not clear that a customer's right to use a cable/satellite set-top box supplied by the cable/satellite TV company would be excluded from meeting the 2013 EDs' proposed definition of a lease based on the Boards' proposed criteria.

As a result of the considerations noted above, it is likely that the Boards will need to revise the criteria used to identify assets inseparable from a good or service.

Example 6: Time Charter[13]

Customer enters into a time charter contract with Shipowner for transportation of cargo on a named ship for a period of 5 years. Customer determines the cargo to be transported (i.e., its own cargo or cargo of third parties), and the timing and location of delivery (i.e., Customer determines when and to which ports the ship sails). Customer pays a daily hire rate for the use of the ship and navigation and cargo management services (including the use of the ship's captain, crew, and equipment such as the ship's cranes and loading gear). Customer does not pay for

[13] Based on examples in IASB Agenda Paper 1D – appendix, available at www.ifrs.org (FASB Memo 158 – appendix, available at www.fasb.org), from the April 12-13, 2011, IASB/FASB meeting.

hire when the ship is off-hire (i.e., unavailable for use due to maintenance or repairs, unavailability of crew, or safety reasons). Customer can decide when the ship is off-hire if the specified conditions for doing so under the time charter are met.

Shipowner pays for the costs of the ship when it is off-hire and remains responsible for the navigation and condition of the ship. Shipowner is also responsible for maintenance and overhaul, cleaning services relating to the cargo space, regulatory compliance on matters of ship safety, and for the cargo when it is onboard its ship (including its safe management while the cargo is in its care and custody). Shipowner pays for all operating expenses of the ship, while Customer pays for the fuel used by the ship, except when the ship is off-hire, and for the port costs. Customer is leasing the ship because all of the following conditions are met:

- There is an identified asset in the form of the named ship in the contract;
- Customer directs the use of the ship because it determines when it is on- or off-hire, and the ship's crew is under Customer's control when on-hire, meaning Customer can determine when and where the ship carries cargo; and
- Customer has the right to obtain substantially all of the potential economic benefits from use of the ship during the contract term because no other party can utilize the ship during the contract term (e.g., Shipowner cannot use the ship to transport another customer's cargo when Customer is not using the ship or when it is off-hire).

Example 7: Tractor Trailer Lease

Truck and Trailer provides Customer a truck and three trailers for its exclusive use for a period of three years. Truck and Trailer cannot substitute the truck or any of the trailers except for servicing or repair. Customer keeps the truck and trailers at its location when not in transit or at a delivery point (i.e., at a drop-off location where Customer made a delivery), such that it can use the trailers that are not in transit (e.g., Customer can load one of the trailers that is not in-transit for transport upon return of the truck) and could use the truck with a trailer not provided by Truck and Trailer and vice versa. Customer is responsible for providing a driver for the truck and can decide when and where the truck and the trailers go. The contract limits Customer's use of the truck to 120,000 miles over the three-year contract term and prohibits Customer from using any trailers larger than those provided by Truck and Trailer or hauling loads above a certain weight.

The contract contains a lease of the truck and the trailers because they are specifically identified assets that cannot be substituted except for reasons of servicing or repair. Customer has the ability to direct the use of the truck and each of the three trailers during the contract term and, because it has exclusive use of these assets, Customer also has the right to obtain substantially all of the potential economic benefits from their use during the contract term. The contractual limits on usage of the truck are inherent features of the right of use in the contract; they do not restrict Customer's ability to direct how it consumes the agreed-upon right of use.

Example 8: Identifiable Asset Inseparable from Supplier's Services[14]

Supplier enters into a contract to provide beverage services to Customer for two years. Supplier puts beverage machines in Customer's offices that only work with the beverage products provided by Supplier. The machines cannot be used by Customer to produce beverages other than those Supplier provides. Supplier is responsible for keeping the machines in working order. In addition, Supplier does not provide the beverage products separately from an arrangement in which it concurrently provides the beverage machines, and the beverage products cannot be obtained from other suppliers. Customer's personnel operate the machines by selecting the beverage they wish to drink, after which the machines prepare the beverage.

The contract does not contain a lease. Although the beverage machines are explicitly identified, the contract does not give Customer the right to control their use. That is because Customer does not have the ability to derive the benefits from use of the machines on their own—the machines function only with the beverage products that are provided by Supplier in an arrangement in which Supplier also provides the machines. Therefore, the machines are incidental to the delivery of the beverage services. The machines and the beverage products combine to deliver beverage services to Customer over the two-year term of the contract.

Conversely, assume the same facts as above *except that* the machines are capable of being used to prepare beverages using beverage products from other suppliers. Even though the contract requires Customer to use Supplier's beverage products, because the machines are capable of producing beverages using other suppliers' beverage products, Customer would be able to derive the benefits from their use without Supplier's beverage products. Therefore, a lease would exist because the customer controls the use of the beverage machines.

Example 9: Source of Other Goods Stipulated by Contract[15]

Supplier A enters into a contract with Customer to provide specified manufacturing equipment. The manufacturing equipment will be located at Customer's premises for its sole, exclusive use over the contract term. Supplier A cannot substitute the equipment unless it malfunctions, in which case Supplier would provide an equivalent replacement. Customer cannot utilize the equipment without consistent supplies of the specialized plastic that the equipment will mold into Customer's products. This specialized plastic can be obtained from a number of different suppliers; however, as part of the contract, Customer must purchase its supplies of the plastic from Supplier A.

The contract contains a lease of the manufacturing equipment based on the following:

- The equipment is identified because it is explicitly specified and Supplier A does not have a right to substitute alternative equipment unless it malfunctions.
- Customer controls access to the equipment and can direct the use of the equipment over the contract term, including (but not limited to) when it is used, how much it produces, who operates the equipment, and where the

[14] Based on Examples 2 and 3 in proposed FASB ASC Subtopic 842-10 of the 2013 FASB ED and Examples 2 and 3 of the 2013 IASB ED.

[15] Based on Example 3 in proposed FASB ASC Subtopic 842-10 of the 2013 FASB ED and Example 3 of the 2013 IASB ED.

equipment is located in its facilities.

- Customer has the right to obtain substantially all of the potential economic benefits from use of the equipment during the contract term because it has sole, exclusive rights to utilize the equipment. No other party can obtain the potential economic benefits from the use of the equipment during the contract term.

The contractual requirement for Customer to purchase the requisite specialized plastic to operate the equipment from Supplier A does not prevent a conclusion that there is a lease because supplies of plastic are available from other suppliers.

Identifying Lease Components

If an entity determines that a contract contains a lease, it would be required to make two further separate determinations: (a) whether the contract contains any non-lease components (e.g., services), and (b) whether there are multiple underlying assets leased under the contract. The 2013 EDs propose different guidance to address each situation.

Arrangements with Lease and Non-lease Components. The guidance proposed in the 2013 EDs would apply to contracts that contain lease and non-lease components such as an arrangement to lease a machine and provide maintenance services for the machine or a lease of office space with the lessor responsible for common area maintenance. The 2013 EDs propose requirements that would be used to determine whether to separately account for the lease and non-lease components and how to allocate the consideration in the contract to the lease and non-lease components that qualify for separate accounting.

	Lessee	Lessor
When there is an observable standalone price for each component	Separate and allocate based on relative standalone price of components	Always separate and allocate using the revenue recognition standard's guidance (i.e., on a relative selling price basis)
When there is an observable standalone price for one or more, but not all, components	Separate and allocate using the residual method	
When there is not an observable standalone price for any of the components in the arrangement	All lease	
An observable standalone price is a price that the lessor or similar supplier charges for a similar lease, good, or service component on a standalone basis.		

Lessors would be required to separately account for non-lease components of the contract in all cases and to allocate consideration between the lease and non-lease components using the forthcoming revenue recognition standard.

The 2013 EDs' proposed separation and allocation model for lessees is as follows:

- If there are observable standalone prices (i.e., prices that the lessor or similar suppliers charge for similar lease, good, or service components on a standalone basis) for the lease and non-lease components of the contract, the lessee would account for the non-lease components separately from the lease components and allocate consideration to lease and non-lease components on a relative standalone price basis.
- If there are observable standalone prices for *some*, but not *all*, of the components of the contract, the lessee would account for the components with observable standalone prices separately from the components without

observable standalone prices. The lessee would first allocate consideration equal to the observable standalone price to each component for which there is one and then allocate the remainder of the consideration to the component(s) of the contract without an observable standalone price (i.e., using the residual method). If the component(s) without an observable standalone price includes a lease, the lessee would account for the component(s) as a single lease component.

- If there are no observable standalone prices for any components of the contract, the lessee would account for all of the components on a combined basis as a single lease.

The 2013 EDs' proposed requirements would apply in accounting for the lease component(s) and the forthcoming revenue recognition standard (lessor) or other GAAP (lessee) would apply in accounting for any non-lease components, including those without an observable standalone price that do not contain a lease.

If a revision to the contractual terms and conditions of a lease results in a substantive change to the existing lease, the modified contract would be accounted for as a new contract at the date the modifications become effective. This would include a new evaluation of whether to separate lease and non-lease components as well as how to allocate consideration to components that qualify for separate accounting. The 2013 EDs do not contain any proposed guidance about how to attribute other subsequent changes in contract consideration to lease and non-lease components that qualify for separate accounting.

KPMG Observations

Many arrangements contain service and lease components. Current GAAP requires lease components of an arrangement to be accounted for separately from non-lease components. Under the 2013 EDs' proposals, this would no longer necessarily be the case for lessees. These proposed requirements would provide a strong incentive for lessees to obtain standalone prices for lease and non-lease components of an arrangement, as not being able to do so would cause the entire arrangement to be accounted as a lease (i.e., both lease and non-lease components of the arrangement would be on-balance sheet).

The evaluation of whether to separately account for the lease and non-lease components of an arrangement that contains both would be different than the evaluation of whether the right to use an asset is inseparable from another good or service (which is discussed in the section on *Definition of a Lease*). The evaluation of whether to separately account for components would be performed only once a conclusion is reached that an arrangement contains a lease because the customer has the ability to derive the benefits from use of an asset separately from other goods or services provided in the arrangement. Having reached that conclusion, the arrangement would be subject to the 2013 EDs' proposed lease accounting requirements even though the lessee may be precluded from separately accounting for the lease and non-lease components of the arrangement.

The difference in the 2013 EDs' lessor and lessee allocation models is based on the Boards' view that a lessor should always be able to separate payments made for lease and non-lease components because it would need to have information about the value of each component to price the contract. In addition, the Boards decided that application of the forthcoming revenue recognition guidance would ensure consistency for entities that are both a lessor and a seller of goods or services within the same contract.

Conversely, a lessee would not be required (or permitted) to separate contract components in all circumstances. If a contract has one or more lease components without an observable standalone price along with one or more other components without an observable standalone price, the lessee would account for all of the components without an observable standalone price on a combined basis as a single lease. This guidance could potentially require lessees and lessors to consider the lease component(s) of the same contract to be different.

There are differences between the 2013 EDs' proposals and the guidance in the forthcoming revenue recognition standard that could have practical measurement implications in the case of contracts with lease and non-lease components. Some examples of those differences and their implications are discussed below.

The forthcoming revenue recognition standard refers to allocating the "transaction price" while the 2013 EDs refer to allocating the "consideration in the contract." Under the forthcoming revenue recognition standard, the Boards have decided the transaction price would be the probability weighted or most likely amount of consideration that a company expects to be entitled to receive from a customer in exchange for transferring goods or services, excluding amounts collected on behalf of third parties (e.g., sales taxes). Any variable consideration that, if recognized, would carry the risk of a significant revenue reversal would be excluded from the estimated transaction price (i.e., constrained). While the 2013 EDs provide a proposed definition of lease payments, they do not provide a proposed definition of consideration in the contract. There are differences between the definition of transaction price and lease payments. Lease payments would be based on the noncontingent amounts and any estimated residual value guarantee payments the lessee is obligated to pay over the non-cancelable lease term plus any optional periods for which the lessee has a significant economic incentive to exercise its renewal option. The transaction price as defined in the proposed revenue recognition standard generally would not include amounts for optional goods or services. It is not clear how contingent (i.e., variable) lease payments and other variable consideration (e.g., related to non-lease components) would factor into determining consideration in the contract for allocation purposes. An entity's lease accounting could differ significantly depending on whether the entity includes estimates of variable consideration (e.g., on a probability-weighted or most likely basis) in its determination of the consideration in the contract, excludes these amounts entirely, or includes these amounts only if they can be estimated with a relatively high degree of confidence.

The forthcoming revenue recognition standard requires companies to estimate the standalone selling price of a good or service if standalone selling prices are not directly observable while maximizing the use of observable inputs in developing those estimates. It identifies three suitable estimation methods including: (a) the adjusted market assessment approach; (b) an expected cost-plus-margin approach; and (c) a residual approach, which can only be utilized with respect to performance obligations whose standalone selling prices are highly variable or uncertain.[16] Conversely, lessees would be *required* to utilize a residual approach to allocate consideration in the contract with respect to any lease or non-lease components that do not have observable standalone prices.

The 2013 EDs' proposed guidance on separation of lease and non-lease components is likely to create practice issues when these components are not separable. For example, there are likely to be issues around the level of significance that a lease component would need to have to the overall arrangement for the arrangement to be within the scope of the leases guidance.

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[16] A selling price is highly variable when a vendor sells the same good or service to different customers at or near the same time for a broad range of consideration. A selling price is uncertain when a vendor has not yet established a price for a good or service and the good or service has not previously been sold.

Issues also are likely to arise with respect to the accounting for a non-separable arrangement as a lease in its entirety because it includes an insignificant lease component when the pattern of overall performance under the arrangement differs significantly from the pattern of income or expense recognition that would result from applying the guidance in the 2013 EDs to the entire arrangement.

Because the 2013 EDs do not propose how to allocate changes in consideration after commencement of the contract, it is unclear whether those changes would be allocated on the same basis as at contract commencement or whether they could be allocated to one or more specific components. The forthcoming revenue recognition standard allows changes in the transaction price to be allocated solely to one or some of the performance obligations in the contract under certain circumstances; however, because the 2013 EDs do not contain similar proposed guidance, it is unclear whether it would be acceptable for an entity to allocate such changes to only one or some of the components in the contract.

Example 10: Allocation of Consideration Between Lease and Non-Lease Components (Lessor and Lessee)

Lessor leases a bulldozer to Lessee to be used in Lessee's mining operations. Lessor also provides maintenance services for the bulldozer for the entire lease term. Total consideration for the use of the bulldozer and the maintenance services for the term of the contract is $125,000. There is no contingent consideration.

Lessor regularly leases bulldozers separately for comparable lease terms. Therefore, both Lessee and Lessor have access to observable standalone prices for the lease component and, while Lessor does not provide maintenance services separately from its equipment leases, there are many other service providers that do. As a result, Lessee also can determine observable standalone prices for the maintenance services. Lessor utilizes the rates charged by other service providers to estimate a standalone selling price for the maintenance services (e.g., a market assessment approach).

Therefore, in this contract, both Lessor and Lessee would separately account for the lease and non-lease components. The allocation of consideration would be based on observable standalone prices and the total, fixed contract consideration of $125,000:

Component	Observable Standalone Price	Allocated Consideration
Bulldozer lease	$100,000	$ 89,286
Maintenance	40,000	35,714
	$140,000	$125,000

Example 11: Lack of Observable Standalone Prices

Lessor leases a specialized machine for two years, and provides consulting services to help Lessee effectively use the machine in its production processes. The machine is not sold or leased separately by Lessor and there are no similar machines for sale or lease from other suppliers. The contract is for fixed consideration of $100,000 for the first year and $80,000 for the second year. The lower second-year price is based on the assumption that Lessor will provide more consulting services in the first year.

Lessor

Because Lessor does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, Lessor would separate the lease and non-lease components and allocate the consideration in the contract based on estimated selling prices. Lessor determines that it will utilize an expected cost-plus-margin approach with respect to the machine because its specialized nature precludes the use of a market assessment approach (i.e., there are no similar machines for sale or lease to assess). Lessor will utilize a market-based assessment approach for the services based on similar services offered in the consulting marketplace. Lessor allocates contract consideration as follows:

Component	Estimated Standalone Price	Allocated Consideration
Machine lease	$160,000	$144,000
Consulting services	40,000	36,000
	$200,000	$180,000

Lessee

Because the machine is specialized (i.e., there are no similar machines sold or leased by other suppliers) and Lessor does not sell or lease the machine on a standalone basis, Lessee does not have an observable standalone price for the leased machine. Similar consulting services are sold on a standalone basis by alternate service providers; therefore, Lessee is able to obtain an observable standalone price for the services, which is $40,000 (i.e., assume Lessee has access to the same market-based pricing data for these services that Lessor used in its estimated selling price above). Therefore, Lessee would allocate $40,000 to the consulting services (i.e., the observable standalone price) and $140,000 to the machine lease.

Leases of Multiple Underlying Assets. In some lease contracts, there is only one underlying asset. In others, such as a lease of a building and equipment, the contract conveys the right to use multiple underlying assets. The 2013 EDs propose a separation model that would be used to identify the separate lease components in a contract that contains a lease of multiple underlying assets. A leased asset (or bundle of leased assets) would be a separate lease component if *both* of the following criteria are met for it to be considered distinct:

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

Irrespective of meeting the separation criteria, *lessees* would be prohibited from separately accounting for leases of multiple underlying assets in a contract when there is not an observable standalone price for the use of at least one underlying asset. For example, if three items of leased equipment in a lease with multiple underlying assets meet the separation criteria, but there is an observable standalone price for only one of those three leases, the lessee would be required to account for the lease of the other two items of equipment on a combined basis as a single lease component. Conversely, if there were an observable standalone price for two of the three leases, the lessee would separately account for each of the three leases because there is only one underlying asset for which a standalone price is not observable. In that case, the consideration would be allocated to the lease of the underlying asset without an observable standalone price using the residual method described previously in the discussion about arrangements with lease and non-lease components.

If the right to use multiple underlying assets is required to be accounted for on a combined basis as a single lease component, the 2013 EDs propose that the applicable lease classification test would be determined based on the nature of the primary asset within the lease component. The primary asset would be the predominant asset for which the lessee entered into the lease contract. The economic life of the primary asset would be considered the economic life of the underlying asset when applying the lease classification guidance.

KPMG Observations

The Boards' proposed separation model in the 2013 EDs is intended to be aligned with the separation model in their forthcoming revenue recognition standard. However, the separation model in the forthcoming revenue recognition standard includes the following specific factors for entities to evaluate in determining whether two or more goods or services are highly dependent upon, or highly interrelated with, each other:

- The vendor does not provide a significant service of integrating the good or service (or bundle of goods or services) into the bundle of goods or services for which the customer has contracted. In other words, the vendor is not using the good or service as an input to produce the output specified in the contract.
- The customer was able to purchase, or not purchase, the good or service without significantly affecting the other promised goods or services in the contract.
- The good or service does not significantly modify or customize another good or service promised in the contract.
- The good or service is not a part of a series of consecutively delivered goods or services promised in the contract that meets both of the following conditions:
  - The goods or services transfer to the customer over time; and
  - The vendor uses the same method for measuring progress to depict the transfer of each of those goods or services to the customer.

The 2013 EDs do not include these factors, or any other additional proposed guidance to assist entities in making the determination of whether two or more leased assets are highly dependent upon, or highly interrelated with, each other. However, given the Boards' expressed intent to align the separation model in the 2013 EDs to that of the forthcoming revenue recognition standard, it is possible that entities would apply the separation models similarly.

Lessees may conclude that lease elements meeting the two separation criteria that apply to both lessors and lessees cannot be separated because they do not have observable standalone prices. As a result, lessors and lessees may not always have the same separate lease components in a contract. In addition, lessees may account for leases of similar items differently based on whether or not the underlying asset is included in a lease contract with multiple underlying assets. Where a lessee must combine a property and a non-property lease element (e.g., a building and equipment), the lease classification for one of the otherwise separable lease elements may be different from that determined by the lessor. For example, assume that the equipment lease would be classified as a Type A lease and the building lease would be classified as a Type B lease if the lease components are accounted for separately. If the lease components are accounted for on a combined basis, depending on which asset is determined to be the primary asset, either the building will be classified and accounted for as part of a Type A lease or the equipment will be classified and accounted for as part of a Type B lease.

The determination of the primary asset may require judgment in some lease contracts. However, the Boards believe this determination would usually be straightforward. If an entity is unable to determine the primary asset, in the Boards' view this may indicate that one or more of the underlying assets in the component should be accounted for as a separate lease component, and that the entity should revisit its identification of separate components.

Current U.S. GAAP requires separate accounting for the land and building elements of a lease when the fair value of the land is 25% or more of the total fair value of the property at lease inception. It also requires the equipment element(s) of a lease of both real estate and equipment to be accounted for separately from the real estate element(s). However, lessees and lessors generally account for leases of multiple underlying assets of the same nature (i.e., buildings or equipment) in the aggregate if the separate leased assets are functionally interdependent (e.g., a mainframe computer system, associated terminals, servers, and other peripheral and output devices may be considered functionally interdependent). Conversely, under current GAAP lessees and lessors generally account for leases of multiple underlying assets of the same nature separately if the separate leased assets are functionally independent (e.g., a manufacturing facility and an office building typically would be considered functionally independent).

The 2013 EDs' separation model may produce a pattern of expense/income that differs from current GAAP in leases that contain real estate and equipment elements. The Boards' decision to align the criteria for the identification of separate lease components in the 2013 EDs to those for identifying separate performance obligations in the revenue recognition project is designed to minimize structuring opportunities that otherwise might exist due to differences between the revenue recognition and lessor accounting guidance. However, the 2013 EDs do not provide guidance on when to combine separate lease contracts for accounting purposes consistent with the guidance the Boards have developed in the forthcoming revenue recognition standard on when to combine contracts for revenue recognition purposes. Therefore, the classification and accounting for separate leases of individual underlying assets may be different than if the underlying assets were leased under a single contract.

Example 12: Separable Leases of Multiple Underlying Assets

Lessor leases a bulldozer, a truck, and an excavator to Lessee to be used in Lessee's mining operations.

Lessee can benefit from each of the three machines on its own or together with other readily available resources (e.g., Lessee could readily lease or purchase an alternative truck or excavator to use with the bulldozer).

Despite the fact that Lessee is leasing all three machines for one purpose (i.e., to engage in mining operations), the machines are not highly dependent upon, or highly interrelated with, each other because the machines are not inputs to a combined single item for which Lessee is contracting, and none of the machines is significantly modifying or customizing another.

Therefore, Lessor would conclude that the lease of each underlying machine is a separate component for accounting purposes (i.e., there are three lease components). Lessee would reach the same conclusion provided that there are observable standalone prices for *at least* two of the three equipment leases. If not, Lessee would account for those lease elements for which there are not observable standalone prices on a combined basis. In that case, Lessee also would be required to determine the primary asset in the lease component and to perform the applicable lease classification test using that asset's economic life.

Example 13: Inseparable Leases of Multiple Underlying Assets[17]

Lessor leases a gas-fired turbine plant to Lessee so that Lessee can produce electricity for its customers. The plant includes the turbine, a building that exists only to house the turbine, and the land on which the building sits. The building has been designed for use only with the turbine, has a similar useful life, and has no alternative use.

Lessee can benefit from the turbine on its own or together with other readily available resources. Lessee can benefit from the turbine together with other readily available resources because the turbine could be housed in a different building on other land and the land and building together provide benefit to Lessee as a single unit (i.e., Lessee cannot benefit from the building without the land on which it is constructed). In addition, the manufacturer of the turbine regularly sells turbines separately, indicating that the turbine can provide benefit to Lessee on its own.

However, the turbine, the building, and the land are highly interrelated because each is an input to the customized combined item for which Lessee has contracted (i.e., a gas-fired turbine plant that can produce electricity for distribution to Lessee's customers).

Therefore, the lease of the turbine, building, and land would be treated as a single lease component for accounting purposes.

Example 14: Determination of the Primary Asset in a Single Lease Component[18]

Assume the same facts as the previous example. The lease of the turbine, building, and associated land is considered a single lease component.

The main purpose of the lease is for Lessee to obtain the power-generation capabilities of the gas-fired turbine; the building and land enable Lessee to obtain those capabilities from the turbine. Therefore, the turbine would be considered the primary asset in the component.

As discussed further in the section on *Lease Classification*, because the turbine is an equipment asset (i.e., non-property), the lease expense/income would be recognized on a straight-line basis only if the lease term is for an insignificant portion of the turbine's total economic life or the present value of the estimated lease payments is insignificant in relation to the total fair value of the underlying

[17] Based on Example 10 in proposed FASB ASC Subtopic 842-10 of the 2013 FASB ED and Example 10 of the 2013 IASB ED.

[18] Based on Example 10 in proposed FASB ASC Subtopic 842-10 of the 2013 FASB ED and Example 10 of the 2013 IASB ED.

assets in the component (i.e., the land, building, and turbine).

Example 15: Lessor and Lessee Allocation of Variable Lease Payments to Lease Components

Lessor leases a building and a machine to Lessee for three years. The machine is physically separate from the building and they each function independently from the other (i.e., each can be used on its own without the other). Lessor concludes that the building and the machine are separate lease components based on the 2013 EDs' separation criteria. The contractual lease payments for the building are fixed at $300,000 per year, while the contractual lease payments for the machine are entirely based on the level of use; $50 for each hour the machine is operated. Assume Lessor and Lessee both have significant predictive experience to support an expectation that the machine will be operated for 2,000 hours per year over the three-year lease term. Therefore, Lessor expects to earn $300,000 in variable lease payments on the machine, resulting in total expected fixed and variable consideration of $1,200,000 over the three-year lease term. Both the $300,000 per year building rent and the $50 per hour variable payment for the use of the machine are considered to be market rental rates.

Lessor

Based on the forthcoming revenue recognition standard's allocation model, Lessor would allocate the $900,000 in fixed consideration entirely to the building lease and the $300,000 in expected variable consideration entirely to the equipment lease. Lessor would conclude that this is appropriate because the contingent amounts relate entirely to Lessee's use of the equipment and because the allocation reasonably depicts the amounts to which Lessor expects to be entitled for each lease component. The present value of lease payments used by Lessor in its evaluation of lease classification for the machine would be $0 because only contingent (variable) consideration would be allocated to the lease of the machine (i.e., variable lease payments that are not in-substance fixed payments and are not based on an index or rate are excluded from the definition of lease payments).

Lessee

It is unclear whether Lessee would (1) allocate consideration in the same manner as Lessor, or (2) allocate the same proportion of the fixed and variable portions of the total consideration to both lease components. Under the first approach, Lessee would not recognize a lease liability for the machine regardless of the lease classification (because only contingent (variable) consideration would be allocated to the machine). Under the second approach, the allocation between the building and machine lease components would be:

	Fixed	Variable	Total
Building	$675,000	$225,000	$ 900,000
Machine	225,000	75,000	300,000
	$900,000	$300,000	$1,200,000

Under the second approach Lessee would recognize a lease liability for each lease component at lease commencement regardless of lease classification. This approach would result in measurement of a liability for the building that is less than the observable price, and recognition of a liability for the machine notwithstanding that the contract identifies a usage-based payment at a market rate.

Lease Classification

After issuing the 2010 EDs, the Boards received diverse feedback from constituents about the merits of a single right-of-use model for lessee accounting in which the pattern of lease expense would be accelerated or front-loaded due to the combined effect of interest expense on the lease liability and generally straight-line amortization of the right-of-use asset. While constituents generally agreed with the 2010 EDs' proposal to require lessees to recognize all leases other than some short-term leases on-balance sheet, and some constituents agreed with the single ROU model for lessee accounting proposed in the 2010 EDs, many constituents asserted that a single ROU model would not appropriately depict the economics of all lease transactions. However, constituents did not broadly agree on how to distinguish some leases from others or what accounting to apply to leases that they asserted should not be subject to the 2010 EDs' proposed ROU model.

In developing the 2013 EDs' proposals, the Boards decided that the nature of a lessee's obligations under a lease does not justify accounting for some lease liabilities differently than others. However, the Boards decided that the pattern of total noncontingent lease expense recognized by lessees should not be the same for all leases and opted to use a dual-model approach for both lessee and lessor accounting. The pattern of noncontingent lease income and expense would be accelerated under one model, consistent with the income statement impact under GAAP for other financing transactions, and generally straight-line under the other. Leases accounted for under the accelerated income and expense model (like financings) would be referred to as Type A leases and those accounted for under the generally straight-line income and expense model would be referred to as Type B leases. Lessees and lessors would apply the same classification tests. The proposed accounting requirements for Type A and Type B leases are discussed in further detail in the sections on *Lessee Accounting and Financial Statement Presentation* and *Lessor Accounting and Financial Statement Presentation*.

Definitions to Be Applied by Lessees and Lessors

To perform the lease classification tests, lessees and lessors would need to determine the nature of the underlying asset, how long the lease term is in relation to the economic life of the underlying asset, and how significant the present value of the lease payments is in relation to the fair value of the underlying asset. Lessees and lessors would need to determine the following items, each of which is discussed in more detail below:

- Lease term;
- Lease payments;
- Discount rate;
- Economic life of the underlying asset; and
- Fair value of the underlying asset.

Lease Term. In response to feedback received from constituents about the 2010 EDs, the Boards proposed in the 2013 EDs that the lease term would be the non-cancelable period of the lease, together with:

- The period(s) covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; or
- The period(s) covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

Under the 2013 EDs' proposals, the non-cancelable period of the lease is intended to represent the period for which the lease contract is enforceable. The 2013 EDs clarify that a lease would not be considered enforceable when both the lessee and the lessor have the unilateral right to terminate it with no more than an insignificant penalty. Furthermore, the lease term would begin at the lease commencement date and include any rent-free periods provided to the lessee after that date.

The 2013 EDs propose that in making an assessment of whether the lessee has a significant economic incentive to either exercise an option to extend a lease, or not exercise an option to terminate a lease, an entity would consider contract-based, asset-based, entity-based, and market-based factors.

Type of factor	Examples
Contract-based	• Amount of lease payments in any secondary period • Existence and amount of any contingent payments • Existence and terms of renewal options • Costs associated with an obligation to return the leased asset in a specified condition or to a specified location
Asset-based	• Location of the asset • Existence of significant leasehold improvements that would be lost if the lease were terminated or not extended • Non-contractual relocation costs • Costs associated with lost production • Costs associated with sourcing an alternative item
Entity-based	• Financial consequences of a decision to extend or terminate a lease • Nature of the leased asset (specialized/non-specialized; the extent to which the asset is crucial to the lessee's operations, etc.) • Tax consequences of terminating or not extending the lease
Market-based	• Statutory law and local regulations • Market rentals for a comparable asset
Note that the EDs do not map the examples against the type of factor. The only practical impact of the mapping is that an entity does not subsequently reassess the lease term for changes in market-based factors.	

These factors would be considered together and the existence of any one factor would not necessarily indicate that a lessee has a significant economic incentive to exercise the option. Examples of factors to consider would include, but not be limited to:

- Contractual terms and conditions that apply to the optional periods as compared to current market rates, such as:
  - The amount of noncontingent lease payments;
  - The amount of variable lease payments or other contingent payments such as payments under termination penalties and residual value guarantees; and
  - The terms and conditions of options (e.g., purchase options) that are exercisable after initial optional periods, including the exercise price of those options in relation to market rates;
- Whether leasehold improvements (if any) are expected to have significant economic value to the lessee when the option to extend or terminate the lease or purchase the asset becomes exercisable;
- Costs that would be incurred by the lessee to terminate the lease and sign a new lease, such as negotiation and relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a specified condition and/or to a specified location; and

- The importance of the underlying asset to the lessee’s operations, considering, for example, its location and whether it is a specialized asset.

KPMG Observations

The 2010 EDs proposed that the lease term would be the longest possible term that is more likely than not to occur, which would have required a probability-weighted assessment by lessees and lessors. Constituents expressed concerns about the 2010 EDs’ proposed definition of lease term, including concerns that determining the lease term using its proposed requirements would be complex and costly. In response to those concerns, the Boards decided that the 2013 EDs’ proposed definition of lease term would not require such an assessment. The Boards concluded that including optional periods in the lease term on the basis of an entity having a significant economic incentive to exercise the option would address constituents’ concerns about cost and complexity.

Under current GAAP, the lease term is the fixed non-cancelable period plus any additional periods for which the lessee has the right to extend the lease and for which, at inception of the lease, it is *reasonably assured* (U.S. GAAP) or *reasonably certain* (IFRS) that the lessee will exercise its option. The Boards believe the *significant economic incentive* threshold proposed in the 2013 EDs will result in lease term conclusions that will be more closely aligned with the *reasonably assured / reasonably certain* concepts in current GAAP than the 2010 EDs’ proposed *more likely than not* threshold, which generally would have resulted in longer lease terms.

Although the 2013 EDs’ proposed definition of lease term is more similar to current GAAP than the definition proposed in the 2010 EDs, there still may be differences from current GAAP. In some cases this might result in a lease term for accounting purposes that is longer than under current GAAP. However, the Boards have indicated that in evaluating whether an optional period should be included in the lease term for accounting purposes, the lessee would need to have a significant *economic* incentive to exercise the option. An expectation of exercise alone (i.e., based solely on management intent) without any economic incentive to do so would not be a sufficient basis for including an optional period in the lease term for accounting purposes.

Under the 2013 EDs’ proposals, cancelable (at the lessee’s option), evergreen (i.e., automatically renewed), and daily (i.e., where the lessee has an option to continually renew) leases would be accounted for under the right-of-use model and would create assets and liabilities on the lessee’s balance sheet. In contrast, under current GAAP, these leases usually would be classified as operating leases and would be off-balance sheet for lessees.

Current U.S. GAAP requires all extensions controlled by the lessor to be included in the lease term. However, that requirement was not included in the 2013 EDs’ proposed definition of lease term. It is unclear whether lessees and lessors would be expected to include all extensions controlled by the lessor in the lease term for accounting purposes. If not, the accounting term for leases whose maximum term is controlled solely by the lessor may be shorter under the 2013 EDs’ proposals than it is under current U.S. GAAP.

Similar to current GAAP, lessees and lessors may make different assessments about whether there is a significant economic incentive for a lessee to exercise a renewal option or not to exercise a termination option in a lease. As a result, lessees and lessors may reach different conclusions about the lease term for the same lease.

Lease Payments. The 2013 EDs propose that lessees and lessors would be required to estimate lease payments for the use of the underlying asset during the lease term (as described above). Under the 2013 EDs' proposals, undiscounted lease payments during the lease term would include the following:

- Fixed payments, less any lease incentives provided by the lessor to the lessee;
- Variable lease payments that are in-substance fixed payments;
- Variable lease payments that are based on an index or rate (such as the Consumer Price Index or a market interest rate), initially measured using the applicable index or rate in effect at the lease commencement date;
- For lessees only, amounts expected to be payable by the lessee under residual value guarantees;
- Penalty payments for terminating the lease unless the lessee has a significant economic incentive not to do so; and
- The exercise price of a purchase option that the lessee has a significant economic incentive to exercise.

Variable Payments

The 2013 EDs' proposals on variable lease payments represent a significant change from the proposals in the 2010 EDs. Under the 2010 EDs' proposals, lease payments included in the estimated lease term would have included all estimated variable payments owed to the lessor during the estimated lease term, determined using a probability-weighted expected outcomes approach. In response to feedback received from constituents, the Boards agreed that the cost and complexity of estimating and measuring all variable lease payments would outweigh the benefits.

The 2013 EDs propose to include in the measurement of lease payments only those variable lease payments that are in-substance fixed payments and those that depend on an index or rate using the applicable index or rate in effect at lease commencement.

Consistent with the proposals in the 2010 EDs, the Boards reasoned that in-substance fixed lease payments should be included in the measurement of lease payments because such payments are unavoidable and, thus, economically indistinguishable from fixed lease payments.

Example 16: Variable Lease Payments Based on Sales that Are In-substance Fixed Lease Payments[19]

Lessee enters into a 10-year lease of property from Lessor, with annual payments determined as 4% of Lessee's sales generated from the leased property. The annual lease payment must be at least $80,000 ($2,000,000 × 4%) in each year of the lease.

Lessee's lease payments would include its annual fixed payments of $80,000 because Lessee is required to make those payments even if sales from the property are less than $2,000,000. Therefore, those payments are in-substance fixed lease payments. Additional variable lease payments based on sales over $2,000,000 per year would be excluded from lease payments and recognized as expense by Lessee or income by Lessor as the sales occur.

[19] Based on Example 4 in proposed FASB ASC Subtopic 842-20 of the 2013 FASB ED and Example 17 of the 2013 IASB ED.

Example 17: Variable Lease Payments Based on Multiple Variables that Are In-substance Fixed Lease Payments[20]

Lessee enters into a 5-year lease of property, with annual fixed lease payments of \$100,000 and variable lease payments that are determined as 5% of Lessee's sales from the property. At the end of the 5-year period, if sales from the property are at least \$1,000,000 in each of the 5 years, Lessee has the option to purchase the property for \$275,000 (at the lease commencement date, Lessee does not have a significant economic incentive to exercise the purchase option). However, if sales from the property are less than \$1,000,000 in any of the 5 years of the lease, Lessee is required to purchase the property for \$275,000 at the end of the 5-year period.

Lessee's lease payments would include either the yearly payment of \$150,000 (the fixed \$100,000 annual payment plus the \$50,000 variable payment assuming sales are at least \$1,000,000) or the fixed annual payment of \$100,000 plus the \$275,000 purchase price payable at the end of year 5, depending on which has the lower present value. The exercise price of the purchase option of \$275,000, or the annual payments of \$50,000 for 5 years, are considered to be in-substance fixed payments because Lessee is required to pay at least the lower of the present value of these two amounts, regardless of the level of sales during the 5-year lease term.

Example 18: Variable Lease Payments Based on an Index that Are In-substance Fixed Lease Payments

Lessee enters into a 10-year lease of retail space from Lessor. Lease payments are initially \$20,000 per month in arrears. The lease payments increase by 1% annually for every 0.1% increase in CPI from the prior year (resulting in a leverage factor of 10 times the change in CPI), limited to a maximum increase of 2% per year. Once variable lease payments increase they cannot decrease under the provisions of the lease. The CPI increase has exceeded 1% in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than 0.2% during the term of the lease.

The 2013 EDs propose that payments based on an index or rate would be included in the measurement of the lessee's lease liability and lessor's lease receivable using prevailing (spot) rates or indices at lease commencement. In this example, if payments under the CPI escalation provision were considered variable lease payments, that would result in no increase in rents over the lease term being included in the measurement of the lease payments because the measurement would be performed using the CPI index value at lease commencement (not the most recent or expected change in that value) – i.e., lease payments would be considered \$20,000 per month over the 10-year lease term at lease commencement. However, the facts in this example are such that the payments under the CPI escalation provision likely would be considered in-substance fixed payments rather than variable lease payments, given the remote likelihood that the change in CPI would be less than 0.2%. If so, Lessee and Lessor would include a 2% annual increase in the measurement of lease payments.

The Boards also decided to include variable lease payments that depend on an index or a rate in the measurement of lease payments because the Boards consider them to be unavoidable. However, unlike the 2010 EDs, which proposed the use of a

[20] Based on Example 4 in proposed FASB ASC Subtopic 842-20 of the 2013 FASB ED and Example 17 of the 2013 IASB ED.

forward rate, the 2013 EDs propose that an entity would determine the lease payments using the index or rate that exists at the lease commencement date. In principle the Boards believe that using the forward rate would be most appropriate, however, they concluded that the costs of obtaining a forward rate would not be justified given the usefulness of the information derived from using it.

KPMG Observations

The 2010 EDs proposed that an entity would be required to make a probability-weighted estimate of all variable lease payments, including contingent rentals, in the determination of lease payments. The 2013 EDs' proposed definition of lease payments would exclude most variable lease payments and thereby would reduce the level of judgment as well as the cost and complexity of applying the proposed standard compared to the proposals in the 2010 EDs. However, as discussed in the section on *Identifying Lease Components*, entities may still need to estimate expected variable lease payments in some situations in order to allocate contract consideration in contracts that contain lease and non-lease components or multiple lease components.

Under the 2013 EDs' proposals, leases with only contingent rentals would not give rise to a lease liability or right-of-use asset for the lessee upon lease commencement. As a result, lessees may wish to include a greater proportion of contingent rentals in their lease agreements to minimize the balance sheet impact of the proposed standard. In addition, increasing the proportion of contingent rentals would make it more likely that a lease would be classified as a Type B lease, as discussed below, thereby increasing the likelihood that lessees and lessors would recognize lease expense and income on a straight-line basis.

The Boards' proposal to exclude variable lease payments that meet a high threshold (e.g., a percentage of sales that are highly likely to occur) from the measurement of the lessee's lease liability and the lessor's lease receivable was undertaken as a practical expedient. They were persuaded by feedback received from financial statement preparers and users that recognition of lease assets and liabilities for these variable lease payments could result in unreliable measurements in the financial statements. As a result, the Boards decided that disclosing information about variable lease payments would be more useful to financial statement users than estimating and including the payments in recognized assets and liabilities. However, the Boards' decision to exclude from the measurement of lease payments variable lease payments other than those that are in-substance fixed payments and those based on an index or rate is inconsistent with the requirements of the forthcoming revenue recognition standard with respect to variable consideration. The forthcoming revenue recognition standard is expected to require the estimated transaction price to include variable consideration to which the vendor has a relatively high level of confidence that it will ultimately be entitled.

The 2013 EDs' proposals on variable lease payments are similar to current GAAP on accounting for contingent rents and in-substance minimum lease payments for both lessees and lessors. Most non-index- or rate-based variable lease payments would be recognized by lessees when incurred rather than being estimated at lease commencement and included in the lessee's right-of-use asset and lease liability.

Residual Value Guarantees and Early Termination Penalties

Consistent with the 2010 EDs' proposals, the 2013 EDs propose that amounts expected to be payable by the lessee under residual value guarantees would be included in lease payments. In the Boards' view, these payments meet the definition of a liability because the lessee has an unconditional obligation to pay the lessor if the market price of the underlying asset moves in a particular way. Any uncertainty with respect to the liability relates to the amount to be paid and not whether the lessee has an obligation. In reaching this conclusion, the Boards analogized residual value guarantee payments to variable lease payments that depend on an index or rate; variability in the case of a residual value guarantee being driven by movements in the market price for the underlying asset.

Unlike the proposals in the 2010 EDs, the 2013 EDs propose that lessors would exclude residual value guarantees provided by lessees or other parties from lease payments unless the guarantees are lease payments that are structured as guarantees. In the Boards' view, when a lessor enters into a contract in which the lessor will be paid by the counterparty (typically the lessee) for any deficiency in the market value of the underlying asset below a specified amount and will pay to the counterparty any excess of the market value of the underlying asset over the specified amount at the end of the lease term, that specified amount is economically a fixed lease payment. Consequently, the Boards decided that such payments should be considered part of lease payments. However, the Boards decided to exclude other residual value guarantees from lease payments because they believe it would be inappropriate for the lessor to recognize profit related to those guarantees at lease commencement, which could occur if the guarantees were included in lease payments and the lease was classified as a Type A lease. Instead, the Boards decided that lessors should include such guarantees in their impairment analysis for the residual asset in Type A leases or the underlying asset in Type B leases as discussed in the section on *Lessor Accounting and Financial Statement Presentation.*

Example 19: Lease Payment Structured as a Residual Value Guarantee

Lessor leases a machine to Lessee for 4 years for annual payments of $10,000, paid in arrears. The lease contract guarantees a residual value of $30,000 at the end of the 4-year lease term, while also stipulating that if the machine is sold for more than $30,000 after the lease term, Lessor will pay Lessee any surplus.

In this example, $30,000 would be considered a fixed lease payment structured as a residual value guarantee; therefore, Lessor would include $30,000 in lease payments for purposes of classifying and accounting for the lease.

If the lease contract did not require Lessor to pay Lessee any surplus amount earned from resale of the machine above the guaranteed residual amount, Lessor would exclude the guarantee from lease payments even if it expected to receive a payment from Lessee under the guarantee at lease commencement.

KPMG Observations

The 2010 EDs proposed that residual value guarantees would be included in lease payments based on a probability-weighted expected outcomes approach. The 2013 EDs propose that a lessee estimate the amount expected to be paid under a residual value guarantee, but do not indicate how to make this estimate. In addition to a probability-weighted expected outcomes approach, another approach might be to base the initial measurement of the residual value guarantee payment on the difference between the guaranteed value and forecasted market prices at the commencement date for comparably aged assets (i.e., compared to the age of the underlying asset when the residual value guarantee payment would be determined). Under this approach lessees might need to adjust the forecasted market prices based on the specific facts and circumstances relative to their intended use of the underlying asset over the lease term (e.g., an expectation that the intended use for the leased asset would reduce its market value relative to comparably aged similar assets). However, it is unclear whether this type of approach is what the Boards intend.

Amounts payable under residual value guarantees are included in a lessee's minimum lease payments under current GAAP whether or not payment of the guarantee constitutes a purchase of the underlying asset. However, the amount to be included is the maximum exposure under the guarantee and not the expected amount to be paid as proposed by the 2013 EDs. The result is that the amount recognized on the balance sheet under the 2013 EDs would likely be significantly smaller for leases with residual value guarantees that are classified as capital leases under current U.S. GAAP or finance leases under current IFRS.

Under current GAAP, when the lessor has the right to require the lessee to purchase the property at termination of the lease for a fixed or determinable amount, it is considered a lessee guarantee. This is because the lessor's put option functions economically as a residual value guarantee and the exercise price of the option is an amount the lessee is required to pay. The 2013 EDs do not specify whether these clauses would be considered residual value guarantees or purchase options. If they are treated as residual value guarantees the amount included in lease payments by lessees likely would be smaller than the amount that would be included if the lessee were required to make a balloon payment and accept title to the underlying asset at termination of the lease because of the possibility that the lessor may not exercise the option if the market value of the underlying asset at termination of the lease exceeds the option exercise price.

A lease provision requiring the lessee to fund a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive use is excluded from the calculation of minimum lease payments under current U.S. GAAP, similar to contingent rentals. The 2013 EDs do not specify whether these payments would be considered residual value guarantees or contingent rentals. If these payments were considered residual value guarantees lessees would be required to develop an expectation of the amounts to be paid in determining the lease payments.

The 2013 EDs illustrate that, in leases where the lessor will pay to, or receive from, a counterparty any difference between the selling price of an underlying asset and a specified residual value (i.e., where lease payments are structured as residual value guarantees) the amount to be included in lease payments by the lessor is the guaranteed amount. This effectively would treat the lessee as the owner of the underlying asset. However, the 2013 EDs' definition of lease payments for lessees does not include lease payments structured as residual value guarantees. Therefore, it is not clear whether the lessee also would be required to include the guaranteed amount of the residual asset in lease payments rather than the estimate of the amount the lessee would be required to pay (as it would for other residual value guarantees).

Termination Penalties

The 2013 EDs retain the 2010 EDs' proposal to include penalties for the early termination of the lease in lease payments in some circumstances. However, the 2010 EDs' proposed a probability-weighted expected outcomes approach in determining the estimated termination penalty to be included in lease payments. Under the 2013 EDs' proposals, the determination of the lease term would govern whether a termination penalty is required to be included in lease payments. Termination penalties would only be included in lease payments if the lessee has a significant economic incentive to terminate the lease and incur the penalty.

Purchase Options

The 2013 EDs proposals would require the exercise price of a purchase option to be included in lease payments if the lessee has a significant economic incentive to exercise the purchase option. This is a change from the 2010 EDs' proposal to exclude purchase options from lease payments regardless of the likelihood of exercise.

On further consideration, the Boards decided that purchase options should be treated in the same way as other options to extend the term of the lease because they viewed a purchase option as the ultimate option to extend the lease term. A lessee that has an option to extend a lease for the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, a lessee would assess whether a significant economic incentive exists to exercise a purchase option using the same factors discussed above in evaluating optional lease periods when determining the lease term (i.e., contract-based, asset-based, market-based, and entity-based factors).

Discount Rate. The 2013 EDs propose that lessees would discount the lease payments using the rate the lessor charges the lessee. If that rate cannot be readily determined, the lessee's incremental borrowing rate would be used. Nonpublic lessees applying U.S. GAAP would be permitted to make an accounting policy election for all leases to use a risk-free discount rate determined using a period comparable to that of the lease term.

Lessors would discount the lease payments using the rate the lessor charges the lessee. The 2013 EDs define this rate as a discount rate that takes into account the nature of the transaction as well as the terms of the lease, for example, the rate implicit in the lease, or the property yield. The 2013 EDs further clarify that the rate implicit in the lease is the rate of interest that, at a given date, 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 estimated residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset. Cash flows from variable lease payments (i.e., contingent rents) could be included in this calculation, even though those expected payments would be excluded from lease payments. The lessor would be required to use the rate implicit in the lease as the discount rate if that rate is available.

The 2013 EDs define the lessee's incremental borrowing rate as the rate of interest that the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

Both the lessee's incremental borrowing rate and the rate the lessor charges the lessee would reflect the nature of the transaction and the terms and conditions of the lease (e.g., the lease payments, the lease term, the security attached to the lease, the nature of the underlying asset and the economic environment).

KPMG Observations

The 2013 EDs' proposals would require estimated future lease payments to be discounted by the lessee using the rate the lessor charges the lessee (even if it is higher than the lessee's incremental borrowing rate). In cases where this rate cannot be readily determined, the lessee would use its incremental borrowing rate. Current U.S. GAAP requires the lessee's discount rate to be its incremental borrowing rate unless (1) it is practicable for the lessee to determine the implicit rate used by the lessor, and (2) the implicit rate is lower than the lessee's incremental borrowing rate. If both of these conditions are met, the lessee's discount rate is required to be the implicit rate. The 2013 EDs' proposed requirements would result in more instances where the discount rate is the rate the lessor charges the lessee than current U.S. GAAP. Similarly, the removal of the U.S. GAAP requirement prohibiting the use of an implicit rate that is higher than the lessee's incremental borrowing rate would result in increased use of discount rates that are higher than an entity's incremental borrowing rate. This would result in a smaller present value of lease payments and corresponding reduction in the lessee's lease liability and ROU asset, all other things being equal. It also would increase the likelihood of Type B lease classification.

The proposed definition of the incremental borrowing rate in the 2013 EDs would require that the rate reflect a secured borrowing rate. Current U.S. GAAP allows a lessee to use a secured borrowing rate as its incremental borrowing rate if that rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances. However, it does not require the use of a secured rate. The 2013 EDs do not propose that a lessee's incremental borrowing rate be adjusted to consider the uncertainty related to some lease payments (e.g., associated with optional periods, residual value guarantees, and termination penalties) that would be excluded from lease payments in some cases but affect the economics of the contract between the lessee and lessor.

The 2013 EDs' proposed definition of the incremental borrowing rate differs from the current U.S. GAAP definition in another important respect. The current U.S. GAAP definition of the incremental borrowing rate refers to the rate that the lessee would have incurred to borrow the funds necessary to purchase the *leased asset*. Conversely, the 2013 EDs propose that the incremental borrowing rate would be the rate that the lessee would pay to borrow the funds necessary to obtain an asset of a similar value to the *right-of-use asset*. Because right-of-use assets generally are not financed outside of lease transactions, it is unclear how a lessee would obtain the information needed to comply with the proposed definition of incremental borrowing rate.

The rate charged by the lessor may be the same as the lessee's incremental borrowing rate because both rates would need to reflect the nature of the transaction and the specific terms of the lease. However, in practice, the rates would likely be different as lessees and lessors may have different assumptions about the lease term, expected contingent rentals, and expected payments under early termination penalties and residual value guarantees. Consequently, the rate the lessor charges the lessee may not reflect the lessee's determination of the rate it would have to pay to enter into a similar borrowing arrangement.

Economic Life of the Underlying Asset. The 2013 EDs propose that the *economic life* of the underlying asset would be considered either the period over which the asset is expected to be economically usable or the number of production or similar units expected to be obtained from the asset. The evaluation of economic usefulness would not be based solely on the asset's intended use by its current owner or be limited to an assumption that the asset would only have a single owner. In contrast, the 2013 EDs propose that the *useful life* of the underlying asset would be considered the period over which the asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity. The useful life of a given underlying asset could differ depending on the asset's intended use by its current owner.

KPMG Observations

The current U.S. GAAP definition of estimated economic life for purposes of lease classification is "[t]he estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at lease inception, without limitation by the lease term."[21] Although this differs from the 2013 EDs' proposed definition of economic life, the two definitions would likely result in similar conclusions in most cases. The current IFRS definition of economic life for purposes of lease classification is almost identical to the 2013 EDs' proposed definition.[22] Consistent with current GAAP, the 2013 EDs' proposed definition of economic life would result in a period that is at least as long as, and typically longer than, the 2013 EDs' proposed definition of useful life.

The current U.S. GAAP definition of useful life, which is the period over which depreciation is recognized or over which lease expense is recognized in some leases, is "[t]he period over which an asset is expected to contribute directly or indirectly to future cash flows."[23] Conversely, the current IFRS definition of useful life is "the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity."[24] While both of these definitions differ from the 2013 EDs' proposed definition of useful life, they would likely result in similar conclusions in most cases.

Fair Value of the Underlying Asset. The 2013 EDs do not contain a proposed definition of fair value of the underlying asset. Instead, the fair value measurement guidance in current GAAP would apply for purposes of determining the underlying asset's fair value.[25] Although this would be a change from lease accounting requirements under current U.S. GAAP and IFRS, which both contain their own definitions of fair value that differ from the general guidance on fair value measurements, the resulting fair value measurements would likely be similar in most cases.[26]

Lease Classification Tests

The 2013 EDs propose that the classification of a lease would be performed at lease commencement and would not be reassessed subsequently unless there is a substantive modification of the contractual terms and conditions of the lease that would require it to be accounted for as a new lease. If a lease includes a purchase option that the lessee has a significant economic incentive to exercise, it would be classified as a Type A lease. If not, lessees and lessors would apply the following lease classification tests:

- If the underlying asset is property (defined as land or a building, or part of a building, or both) the lease would be classified as a Type B lease *unless* one or more of the following criteria are met, in which case the lease would be classified as a Type A lease:
  - (a) The lease term is for a major part of the underlying asset's *remaining* economic life;
  - (b) The present value of the lease payments is substantially all of the fair value of the underlying asset.

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[21] FASB ASC Section 840-10-20, available at www.fasb.org.

[22] IAS 17, Leases.

[23] FASB ASC Section 350-30-20, available at www.fasb.org.

[24] IAS 17, Leases.

[25] FASB ASC Topic 820, Fair Value Measurement, available at www.fasb.org, and IFRS 13, Fair Value Measurement.

[26] FASB ASC Section 840-10-20, available at www.fasb.org, and IAS 17, Leases.

- If the underlying asset is not property (e.g., equipment) the lease would be classified as a Type A lease *unless* one or more of the following criteria are met, in which case the lease would be classified as a Type B lease:

  (a) The lease term is insignificant in relation to the *total* economic life of the underlying asset;

  (b) The present value of the lease payments is insignificant in relation to the fair value of the underlying asset.

KPMG Observations

In paragraphs BC44 – BC45 of the 2013 EDs the Boards discuss their rationale for the classification of leases as follows:

> When there is no expected decline in the value or service potential of the asset (that is, when the lessee is not expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset), the lease payments made by the lessee would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, that is, a charge for the use of the asset by the lessee. That return or charge would be expected to be even, or relatively even, over the lease term. In many respects for such a lease, the payments made by the lessee could be viewed as being somewhat similar to an entity paying interest on an interest-only loan. That is because the lessee "borrows" the underlying asset, uses it during the lease term while paying the lessor even (or relatively even) lease payments for that use (providing the lessor with a constant return on its investment in the asset), and returns the underlying asset to the lessor with virtually the same value or service potential as it had at the commencement date. In the case of a lease, however, the asset "loaned" to the lessee is a tangible asset rather than a financial asset.
>
> In contrast, when the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, the lessor would charge the lessee for recovery of that portion of the underlying asset that the lessee is expected to consume during the lease term, as well as obtaining a return on its investment in the asset. The lease payments, and thus the right-of-use asset, would incorporate the acquisition of the portion of the underlying asset that the lessee is expected to consume. When that is the case, the Boards concluded that accounting for the right-of-use asset similar to other nonfinancial assets (such as property, plant, and equipment) would provide the most useful information to users of financial statements about the nature of such leases.

The Boards acknowledge that the 2013 EDs' proposed lease classification tests would not always result in conclusions that are consistent with the principle described above (e.g., leases of property classified as Type B leases for which the lessee expects to consume more than an insignificant portion of the property), but they assert that the classification tests would result in most leases being classified according to that principle.

The lease classification principle described by the Boards is based on consumption of the underlying asset. While it is true that leases are priced in part based on the lessee's consumption of the underlying asset, the 2013 EDs' proposed lease accounting model is based on the right-of-use rather than the underlying asset. The lessee will fully consume the right-of-use in every lease (including leases of land) regardless of the extent of its consumption of the underlying asset.

As the Boards acknowledged, the results of applying the lease classification tests may be inconsistent with the principle they have described. In the case of the classification test that would apply to leases of assets other than property, the inconsistency is created by the use of the underlying asset's *total* economic life rather than its *remaining* economic life along with the fact that the lessee can be deemed to consume an insignificant portion of the economic benefits embedded in the underlying asset even if one of the insignificant thresholds is exceeded. That is, the lease could be classified as a Type B lease if either the lease term is more than insignificant in relation to the total economic life of the underlying asset, or the present value of the lease payments is more than insignificant in relation to the fair value of the underlying asset.

In the case of the classification test that would apply to leases of property, the inconsistency is created by the fact that, on a spectrum, there is a gap between insignificant and both (a) the threshold that would apply to the lease term criterion (major part), and (b) the threshold that would apply to the present value of lease payments criterion (substantially all). The lease term may be more than insignificant in relation to the leased property's remaining economic life but not represent a major part of the property's remaining economic life, and the present value of the lease payments may be more than insignificant in relation to the fair value of the property but not represent substantially all of the property's fair value.

It is unclear why the Boards decided to require a different analysis of economic life for leases of property versus non-property assets. A classification test that compares the lease term with an asset's total (rather than remaining) economic life is inconsistent with a classification test that compares the present value of the noncontingent lease payments with the asset's fair value. A test that purports to be based on consumption seemingly should focus on the extent of consumption of the specific underlying asset in its actual condition at lease commencement.

The dual-model approach for lessee accounting may raise further questions about the Boards' decision to base the accounting for leases on rights of use rather than underlying assets. The distinction between leases based on the characteristics and level of consumption of the underlying asset appears to be more consistent with accounting for the underlying asset than accounting for a right of use.

These issues illustrate the conceptual difficulties in designing a dual-model approach and how the Boards' decision to include lease classification tests within the proposed lease accounting model results in additional complexities that must be addressed.

Example 20: Lease Classification – Non-Property[27]

Lessee enters into a 2-year lease of a rice harvester with a total economic life of 12 years. The present value of the lease payments is $127,000. The fair value of the harvester at the lease commencement date is $500,000.

The lease would be classified as a Type A lease because the underlying asset is not property and the lease term of 2 years is considered more than insignificant in relation to the 12-year total economic life of the harvester (i.e., 16.7%). In addition, the present value of the lease payments is considered more than insignificant in relation to the fair value of the equipment at the lease commencement date (i.e., 25.4%). Note that the lease would be classified as a Type A lease if *either* the lease term were more than insignificant in relation to the total economic life of the underlying asset *or* the present value of the lease payments were more than insignificant in relation to the fair value of the underlying asset.

[27] Based on Example 11 in proposed FASB ASC Subtopic 842-10 of the 2013 FASB ED and Example 12 of the 2013 IASB ED.

KPMG Observations

The 2013 EDs' example that corresponds to the fact pattern in Example 20 for a lease of a non-property asset also reaches a conclusion that the lease would be classified as a Type A lease. In that example the lease term is 16.7% of the underlying asset's total economic life and the present value of the lease payments is 27.8% of the underlying asset's fair value at lease commencement. This provides some indication about how to interpret the meaning of insignificant. However, how much lower the threshold for insignificant would be than the benchmarks illustrated in the Boards' example is likely to be the subject of future interpretive debate.

Example 21: Lease Classification – Property[28]

Lessee enters into a 15-year lease of a storage warehouse, which has a remaining economic life of 40 years at the lease commencement date. The present value of the lease payments is $300,000. The fair value of the property at the lease commencement date is $400,000.

The lease would be classified as a Type B lease because the underlying asset is property and the lease term of 15 years is for less than a major part of the remaining economic life of the property (i.e., 37.5%), and the present value of the lease payments represents less than substantially all of the fair value of the property at the lease commencement date (i.e., 75.0%).

KPMG Observations

The 2013 EDs' example that corresponds to the fact pattern in Example 21 for a lease of property also reaches a conclusion that the lease would be classified as a Type B lease. In that example the lease term is 37.5% of the underlying asset's remaining economic life and the present value of the lease payments is 75.0% of the underlying asset's fair value at lease commencement. This provides some indication about how to interpret the meaning of major part and substantially all. However, how much higher the thresholds for major part and substantially all would be than the benchmarks illustrated in the Boards' example is likely to be the subject of future interpretive debate.

Multiple Underlying Assets in a Single Lease Component. The 2013 EDs propose that if a lease component contains the right to use more than one underlying asset, the nature of the underlying asset (i.e., property or non-property) for purposes of determining the applicable lease classification test would be based on the *primary asset* within the lease component. The primary asset would be the predominant asset for which the lessee entered into the lease contract. The other assets included in the component generally would facilitate the lessee obtaining benefits from the use of the primary asset.

In these cases an entity would use the *total* (if non-property) or *remaining* (if property) economic life of the *primary asset* for purposes of evaluating the applicable classification criterion based on lease term. However, an entity would use the present value of the lease payments for the entire component in relation to the total fair value of all the underlying assets in the component for purposes of evaluating the applicable classification criterion based on lease payments.

[28] Based on Example 12 in proposed FASB ASC Subtopic 842-10 of the 2013 FASB ED and Example 13 of the 2013 IASB ED.

Example 22: Determination of the Primary Asset in a Lease Component with Multiple Underlying Assets

Lessor leases a gas-fired turbine plant to Lessee so that Lessee can produce electricity for its customers. The lease does not include a purchase option. The plant includes the turbine, a building that exists only to house the turbine, and the land on which the building sits. Assume that the lease of the turbine, building, and associated land is considered a single lease component.

The main purpose of the lease is for Lessee to obtain the power-generation capabilities of the gas-fired turbine; the building and land simply enable the lessee to obtain those capabilities from the turbine. Therefore, the turbine would be considered the primary asset in the component.

Because the turbine is an equipment asset (i.e., non-property), the lease would be classified as a Type B lease only if the lease term is insignificant in relation to the turbine's total economic life or the present value of the lease payments is insignificant in relation to the total fair value of all the underlying assets in the component (i.e., the land, building, and turbine).

Leases of Land and Buildings. The 2013 EDs propose that a lease of both land and a building would be accounted for as a single lease component. The remaining economic life of the building would be considered the remaining economic life of the property for purposes of lease classification – i.e., the building would be considered the primary asset. Consequently, a lease of property that includes land and a building would be classified as a Type B lease unless the lease term is for a major part of the remaining economic life of the building or the present value of the lease payments represents substantially all of the total fair value of the combined land and building.

KPMG Observations

While determining the primary asset in a lease component that includes multiple underlying assets would require judgment, the Boards believe this determination would usually be straightforward. The Boards noted that if an entity is unable to determine the primary asset, this may indicate that one or more of the underlying assets in the component should be accounted for as a separate lease component, and that the entity should revisit its identification of separate components.

Based on the 2013 EDs' proposals, lease components that contain integral equipment (i.e., equipment attached to the real estate that cannot be removed and used separately without incurring significant cost) would not be considered property leases if that equipment is determined to be the primary asset and, therefore, would be less likely to qualify for Type B lease classification than property leases. Under current U.S. GAAP, leases of integral equipment are frequently classified as operating leases that result in a straight-line pattern of expense/income. The proposals in the 2013 EDs may have a significant effect on the accounting for leases of integral equipment as well as the real estate that it is attached to (in addition to the fact that these leases would be recognized on the balance sheet, which would itself be a significant change from current GAAP).

The 2013 EDs' proposals represent a change from current GAAP, which generally requires an entity to allocate lease payments between the land and building elements of a lease when applying the lease classification requirements. Lease payments are either allocated based on the relative fair values of the leasehold interests in the land and building elements (IFRS), or by attributing to the land element lease payments equal to the product of the fair value of the land multiplied by the lessee's incremental borrowing rate and attributing the remaining portion of the lease payments to the building element (U.S. GAAP). Under current

GAAP the remaining economic life of the leased asset is used for purposes of lease classification regardless of the nature of the asset.

Compared to current GAAP, the 2013 EDs' proposals could change the pattern of expense or income for leases of land or a building that are part of a property lease component that includes both. However, this potential outcome is mitigated by the relatively high proportion of situations in which the lease classification tests likely would result in Type B classification for property leases. In addition, excluding a requirement to allocate lease payments within a single property lease component is more consistent with the 2013 EDs' other proposals on leases of multiple underlying assets because it treats a single lease component as a single unit of account for lease accounting purposes.

The proposal to preclude Type B lease classification in a property lease with both land and building elements when the lease term is for a major part of the remaining economic life of the building is intended to ensure that the pattern of expense/income does not change for building leases that would be classified as capital/finance leases under current GAAP.

Although not explicitly addressed in the 2013 EDs, we understand that a lease component that contains the right to use more than one underlying asset would be classified as a Type A lease if the lessee has a significant economic incentive to exercise an option to purchase the primary asset in the component.

Lessee Accounting and Financial Statement Presentation

The Right-of-Use Model

Consistent with the 2010 EDs, the 2013 EDs propose that lessees account for all lease contracts within their scope, other than some short-term leases, on-balance sheet under the right-of-use model. The lessee would recognize an asset for its right to use the underlying asset and a liability for its obligation to make lease payments. The right-of-use asset and lease liability would be recognized in essentially the same way that capital (finance) leases are recognized under current GAAP. However, the measurement of the asset and liability would differ from current GAAP. Consistent with current GAAP, lessees would not separately account for renewal options, contingent rentals, or residual value guarantees except as already required by other authoritative literature. They would recognize a single right-of-use asset and a single liability to make estimated future lease payments for each lease component and reflect the various features that pertain to the lease component in the measurement of the asset and liability.

As discussed previously in the section on *Lease Classification*, unlike the 2010 EDs, the 2013 EDs propose that lessees would apply a dual-model approach to account for rights of use in lease contracts. Under the 2013 EDs' proposed dual-model approach for lessees, only the subsequent measurement of the ROU asset and the income statement presentation of total noncontingent lease expense would differ between Type A leases and Type B leases.

	Statement of financial position	Statement of comprehensive income	Profile of total lease expense
Type A leases	ROU asset Lease liability	Amortization of ROU asset (operating expense) Interest expense on lease liability (finance expense)	Front-loaded
Type B leases	ROU asset Lease liability	Lease expense (operating expense)	Straight-line

KPMG Observations

Under current U.S. GAAP, lessees are required to classify and account for their leases as either capital leases or operating leases, using bright-line classification tests. This approach permits leases to be structured as operating leases to obtain the simplified accounting treatment and to keep them off lessees' balance sheets. The 2013 EDs would substantially reduce lessees' off-balance-sheet lease commitments because all leases within their scope, other than some short-term leases, would result in the recognition of a right-of-use asset and a liability to make lease payments. The Boards believe that the 2013 EDs' proposed approach better reflects the assets and liabilities arising from lease contracts. In particular, the Boards believe the current lessee model omits relevant information about rights and obligations that meet the definitions of assets and liabilities in their conceptual frameworks.

When evaluating companies' creditworthiness, many analysts and lenders already consider off-balance-sheet operating lease obligations based on information available in the notes to the financial statements and elsewhere. However, because the liability to make lease payments would be calculated based on factors that are not typically disclosed (e.g., estimated lease term and residual value guarantee payments, etc.), the judgments about the creditworthiness of a lessee may be impacted when the lessee first issues financial statements in which it applies the right-of-use model.

The proposed requirement to recognize additional assets, liabilities, and to accelerate expense recognition for Type A leases is likely to affect key performance ratios commonly used in credit and investment decision making and may impact a lessee's ability to satisfy the financial covenants of its debt arrangements. The magnitude of the effects will depend on lessee-specific facts and circumstances. However, in general the following changes are likely:

- Lower liquidity ratios such as the current ratio (current assets/current liabilities) and quick ratio ((cash + short-term investments + receivables)/current liabilities) due to increased current liabilities;
- Higher leverage ratios such as debt-to-capital ratio (total debt/(total debt + total equity)) and debt-to-equity ratio (total debt/total equity) due to increased debt (i.e., liability to make lease payments) and typically 100% financing of the right-of-use asset;
- Lower profitability ratios such as return on assets ratio (net income/average total assets) due to increased total assets and the acceleration of expense (for Type A leases), and return on equity ratio (net income/average total equity) and net profit margin (net income/revenue) due to the acceleration of expense (for Type A leases);
- Higher working capital turnover (revenue/average working capital) due to

reduced working capital because the lease liability is partially current, and a lower asset turnover (revenue/average total assets) due to increased total assets;

- Lower earnings-per-share in the early periods of the lease due to decreased net income as a result of the acceleration of expense (for Type A leases) and higher trailing price-to-earnings ratio (price per share/earnings per share) due to decreased earnings;
- Reduced weighted average cost of capital (WACC) due to the increase in debt on a lessee's balance sheet, which would increase the weighting of debt in the lessee's WACC calculation; and
- Increased operating cash flow because a portion of the lease payments for Type A leases would be classified as financing cash outflows rather than operating cash outflows.

Companies currently negotiating debt or other arrangements that will contain financial covenants may want to explore whether the covenants can be negotiated in such a way as to minimize the impact of the new leases standard if and when it becomes effective. The recognition of additional assets and liabilities also may affect the results of impairment tests of asset groups, disposal groups, and reporting units that include the leases because the on-balance sheet right-of-use asset would be within the scope of the impairment standards.

The proposed changes to lease accounting likely would drive greater scrutiny by lessees on the economics of leasing transactions compared to other forms of financing. This likely would lead to an increased emphasis on asset management by many lessees. Changes to internal control systems would be necessary to increase the involvement of the accounting and treasury functions in various aspects of leasing transactions. Arrangements that include lease and non-lease components also likely would need to be analyzed in greater detail to determine whether to separately account for the lease and non-lease components as well as how to apply the lease classification tests and otherwise account for components that include both lease and non-lease elements.

If the 2013 EDs' proposals are finalized as GAAP, lessees may expect lessors to provide more information, guidance, and tools to help them satisfy the new accounting and compliance requirements, which may create an expectation gap between lessees and lessors. Accounting simplicity would no longer be a benefit of certain types of leases (e.g., those that would be operating leases under current GAAP), as right-of-use assets would be subject to unique subsequent measurement requirements that are different from those that apply to other tangible and intangible assets, including reassessment requirements for changes in estimates (the lease liability also would be subject to the reassessment requirements). Right-of-use assets would be more likely to create a charge to earnings due to impairment than operating leases under current GAAP. Finally, as discussed later, the new accounting requirements would likely create new deferred tax items in the financial statements, which could change the assessment of the recoverability of deferred tax assets, and may lead to new ways of assessing state and local taxes.

Timing of Initial Recognition and Measurement

Consistent with the 2010 EDs, the 2013 EDs propose that a lessee initially measure and recognize a right-of-use asset and a lease liability at the lease commencement date, that is, the date on which the lessor makes the underlying asset available for use by the lessee. This timing is consistent with the proposed right-of-use model under which a lessee would obtain control over the use of the underlying asset at the lease commencement date.

In response to feedback received from constituents, the 2013 EDs propose to align the timing of initial measurement with the timing of initial recognition (i.e., the lease commencement date) for both the right-of-use asset and the lease liability. This is a change from the 2010 EDs' proposals to initially measure the lease liability and right-of-use asset as of the lease inception date (that is, the earlier of the date of the lease agreement and the date of commitment by the parties to the agreement).

Notwithstanding the 2013 EDs' proposal on timing of initial recognition and measurement of a lease, if an entity enters into an onerous contract, the entity would be required to account for it consistently with GAAP guidance on other onerous contracts, which may require recognition of a liability before the lease commencement date.[29]

The Boards noted that, for some leases, the rights and obligations that arise from signing a lease could be significant. Assuming that the entity did not have an onerous contract liability, financial statement users would have no information about those rights and obligations before the commencement date without adequate disclosure. The 2013 EDs propose that a lessee would be required to disclose information about the terms of a lease that creates significant rights and obligations between the lease inception and commencement dates as discussed in further detail below.

KPMG Observations

In some leases there is a significant delay between the lease inception date and the lease commencement date (e.g., when parties commit to lease an asset that has not yet been constructed). The Boards' proposed alignment of the initial recognition and measurement dates for right-of-use assets and lease liabilities is intended to simplify the proposals in the 2010 EDs and would resolve issues such as accounting for changes in the terms of a lease, changes in indices, and changes in the fair value of the underlying asset between the lease inception and commencement dates as well as accounting for the time value of money between the two dates. The Boards' decision is also more consistent with the measurement date for other transactions, such as business combinations and acquisitions of property, plant, and equipment.

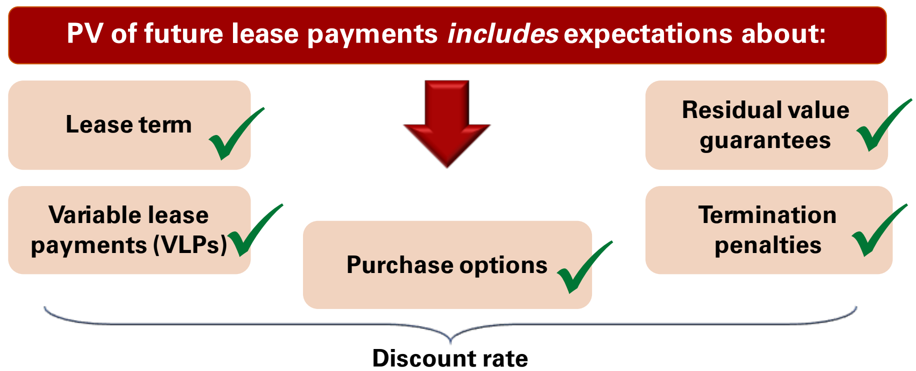
The 2013 EDs effectively propose that a lease contract be recognized only once the lessor has performed by delivering the underlying asset to the lessee. This contrasts with the forthcoming revenue recognition standard, which would require a seller to recognize a net contract asset or net contract liability when either it performs by delivering a good or service or the customer performs by paying consideration.

The 2010 EDs did not address the accounting for any transactions between the lease inception date and the lease commencement date (e.g., up-front cash payments by the lessee or lessor, payment of certain costs such as leasehold improvements, etc.). In practice, there are many arrangements in which substantial payments are made by the lessee to the lessor before the commencement of the lease, particularly when the underlying asset is being constructed specifically for the lessee. The 2013 EDs clarify that a lessee would include the amount of any initial direct costs incurred to enter into a lease and any lease payments made to the lessor at or before the commencement date in the measurement of the right-of-use asset at lease commencement.

[29] FASB ASC Subtopic 450-20, Contingencies – Loss Contingencies, available at www.fasb.org, and IAS 37, Provisions, Contingent Liabilities and Contingent Assets.

Initial Measurement of the Lease Liability

The 2013 EDs propose that at lease commencement, a lessee would measure the lease liability at the present value of the future lease payments over the lease term. The section on *Lease Classification* discusses the proposed definitions of lease term and lease payments as well as the discount rate that would be used by the lessee to measure the present value of the lease payments. The proposed measurement of the lease liability would require the lessee to evaluate whether it has a significant economic incentive to exercise any lease term or purchase options in the lease. Variable lease payments other than residual value guarantees, payments that depend on an index or rate, and payments that are in-substance fixed would be excluded from the measurement of the lease liability.



- Exercise price of options included if significant economic incentive to exercise
- VLPs included only if based on a rate or index, or in-substance fixed
- Residual value guarantees: amount expected to be payable

KPMG Observations

The Boards' view is that the lease liability is a financial liability. However, it would be measured under the 2013 EDs' proposed requirements and not the financial instruments standards. Although the lease liability would exclude the present value of estimated variable lease payments other than any estimated residual value guarantee payments and payments that depend on an index or rate, the proposed method typically would provide a reasonable approximation of fair value while minimizing the costs and complexities involved in fair value measurement.

Initial Measurement of the Right-of-Use Asset

The 2013 EDs propose that lessees initially measure the right-of-use asset using the following equation:

Amount of lease liability + Initial direct costs + Prepaid lease payments − Lease incentives received = ROU asset

Initial direct costs would be defined as costs directly attributable to negotiating and arranging a lease that would not have been incurred without entering into the lease. The 2013 EDs include proposed application guidance that would assist a lessee in determining whether costs are incremental and whether they are directly attributable to negotiating and arranging a lease. These costs would include those related to negotiating a transaction; commissions; legal fees; costs in connection with recording guarantees, collateral, and other security arrangements; and other costs that are incremental and directly attributable to negotiating and arranging the lease. Initial direct costs would not include costs for general overhead, advertising, soliciting potential leases, and servicing existing leases.

Typical initial direct costs	
Include ✓	**Exclude** ✗
• Commissions • Legal fees • Costs of evaluating the prospective lessee's financial condition • Costs of evaluating and recording guarantees, collateral and other security arrangements • Costs of negotiating lease terms and conditions • Costs of preparing and processing lease documents • Payments made to existing tenants to obtain the lease	• General overheads • Advertising costs • Costs of soliciting potential leases • Costs of servicing existing leases • Costs of other ancillary activities

KPMG Observations

At the date of initial recognition, the right-of-use asset and liability to make lease payments would not be equal if any lease payments were made to the lessor at or before the commencement date, the lessor provided lease incentives to the lessee, or initial direct costs were incurred by the lessee. Accordingly, for most leases the right-of-use asset and lease liability would not be equal at lease commencement.

Current U.S. GAAP precludes the lessee in a capital lease from measuring the asset recognized at an amount that is greater than the fair value of the underlying asset at lease inception. However, that requirement was not included in the 2013 EDs' proposals. Consequently, under those proposals the carrying amount of a right-of-use asset at initial recognition could exceed the fair value of the underlying asset.

Subsequent Measurement of the Lease Liability

Similar to the 2010 EDs, the 2013 EDs propose that subsequent to the commencement date, a lessee would measure the lease liability on an amortized cost basis, similar to other financial liabilities. The lease liability carrying amount would be increased to reflect the interest on the unamortized balance of the liability and decreased by lease payments made during the lease period. The lessee would determine the portion of the periodic payments that relates to interest on the lease liability as the amount that results in a constant periodic discount rate on the remaining balance of the liability (taking into account the liability reassessment requirements discussed below).

Subsequent Measurement of the Right-of-Use Asset

Similar to the 2010 EDs, the 2013 EDs propose that subsequent to the commencement date, a lessee would measure the right-of-use asset at cost less accumulated amortization and any impairment losses. However, a lessee applying IFRS would be required to measure right-of-use assets that meet the definition of investment property at fair value if the lessee has an accounting policy to measure investment property at fair value.[30] In addition, a lessee applying IFRS would be permitted to measure right-of-use assets that do not meet the definition of investment property using a revaluation model if the lessee revalues all assets within the same class of property, plant, and equipment as the underlying asset.[31]

Expense Recognition

As highlighted in the section on *Lease Classification*, the lessee would classify each lease other than some short-term leases as a Type A or a Type B lease. For each type of lease a lessee would recognize the following costs in net income or loss, unless the costs are included in the carrying amount of another asset under other applicable GAAP:

- For Type A leases, interest expense on the lease liability and, separately, amortization of the right-of-use asset; and
- For Type B leases, a single lease expense comprised of the sum of interest on the lease liability and amortization of the right-of-use asset.

Amortization of Type A Right-of-Use Assets

The 2013 EDs propose that for Type A leases, a lessee would amortize the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the right-of-use asset. Amortization would be recognized over the period from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, if the lessee has a significant economic incentive to exercise a purchase option to acquire the underlying asset, the lessee would amortize the right-of-use asset over the period to the end of the underlying asset's useful life.

Amortization of Type B Right-of-Use Assets

The Boards concluded that for Type B leases, a lessee would be required to calculate the periodic amortization of the right-of-use asset as an amount equal to the greater of zero or the remaining cost of the lease allocated over the remaining lease term on a straight-line basis minus the periodic interest on the lease liability. (This is necessary to achieve the generally straight-line pattern of total lease expense for Type B leases.)

The remaining cost of a lease for purposes of applying the straight-line basis calculation would consist of:

- Lease payments (determined at the lease commencement 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 made to the lease liability that arise from remeasuring the liability (as discussed below). The adjustment to the remaining cost of a lease would equal the total change in future lease payments less any

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[30] IAS 40, Investment Property.

[31] IAS 16, Property, Plant and Equipment.

amounts recognized in net income or loss at the date of remeasurement of the lease liability.

Impairment of the Right-of-Use Asset

The 2013 EDs propose that a lessee would determine whether the right-of-use asset is impaired and recognize any corresponding impairment loss using existing GAAP.[32]

Example 23: Initial and Subsequent Measurement by a Lessee

Lessee has entered into a lease contract with Lessor to lease an asset for a 10-year term with an option to extend for 5 years. Lease payments are $14,527 in the first year and escalate at 3% per year, all due annually in arrears. Lessee incurs initial direct costs of $5,000.

At the commencement date, Lessee concludes that it does not have a significant economic incentive to exercise the option to extend and therefore determines the lease term to be 10 years.

The rate Lessor charges Lessee is not readily determinable. Lessee's incremental borrowing rate is 10%.

At the commencement date, Lessee had incurred the initial direct costs, and measures the lease liability at the present value of the 10 payments, starting at $14,527 and escalating at 3% per year, discounted at 10%, which is $100,000.

Lessee recognizes the lease assets and liabilities as follows:

	Debit	**Credit**
Right-of-use asset	105,000	
Lease liability		100,000
Cash (initial direct costs)		5,000

During the first year of the lease, Lessee recognizes lease expenses depending on how the lease is classified:

If the Lease Is Classified as a Type A Lease

Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and amortizes the right-of-use asset on a straight-line basis.

Interest expense	10,000	
Lease liability		10,000
Amortization expense	10,500	
Right-of-use asset		10,500

At the end of the first year of the lease, the carrying amount of Lessee's lease liability is $95,473 ($100,000 present value of future lease payments + $10,000 year 1 interest expense – $14,527 year one lease payment).

At the end of the first year of the lease, the carrying amount of the right-of-use asset is $94,500 ($105,000 initial ROU asset – $10,500 year 1 amortization expense).

If the Lease Is Classified as a Type B Lease

Lessee determines the cost of the lease to be the sum of $166,536 (sum of the lease payments for the term of the lease of $14,527 in year one and escalating 3% per year thereafter), plus $5,000 (initial direct costs incurred by Lessee). The

[32] FASB ASC Topic 360, Property, Plant, and Equipment, available at www.fasb.org, and IAS 36, Impairment of Assets.

annual lease expense to be recognized is therefore $17,154 ($171,536 ÷ 10 years).

	Debit	**Credit**
Lease expense	17,154	
Lease liability		10,000
Right-of-use asset		7,154

At the end of the first year of the lease, the carrying amount of Lessee's lease liability is $95,473 ($100,000 present value of future lease payments + $10,000 year 1 interest expense – $14,527 year one lease payment). This is the same as for the Type A lease.

At the end of the first year of the lease, the carrying amount of the right-of-use asset is $97,846 ($105,000 initial ROU asset – $7,154 year 1 amortization).

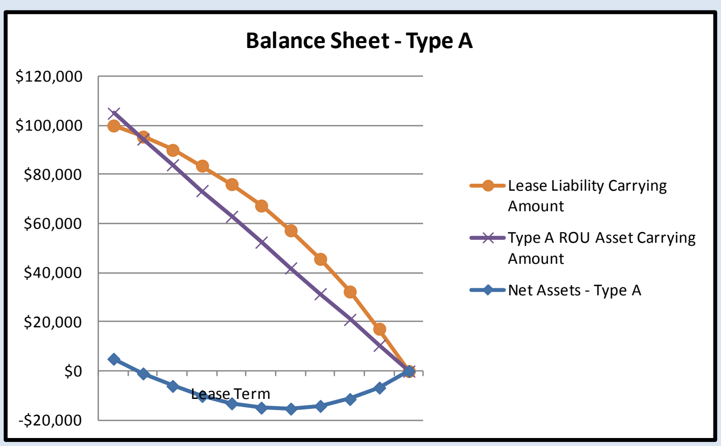
KPMG Observations

The 2013 EDs' subsequent measurement guidance for Type A right-of-use assets and lease liabilities generally would result in a negative net asset position for the lessee (in leases with no prepaid rent) throughout the lease term other than at lease commencement and lease termination (assuming a straight-line basis of amortization for Type A leases). The Type A amortization model would result in a balance sheet impact that is more consistent with that of assets that are acquired with 100% debt financing.

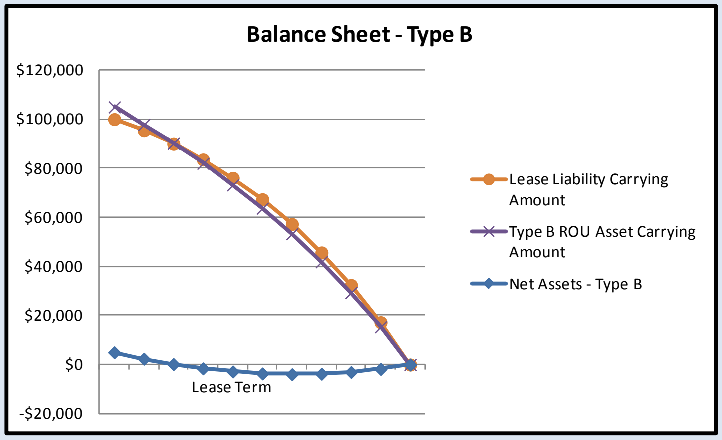
For Type B leases, even though the lease often would result in a negative net asset position for the lessee, it is more likely that the carrying amount of the right-of-use asset would more closely track the carrying amount of the lease liability throughout the entire lease term. In addition to deferring expense recognition related to the amortization of the right-of-use asset, this approach would minimize the balance sheet carrying amount mismatch during the term of the lease. The balance sheet impacts of these two methods may be an important consideration as it relates to the impact over the lease term of debt covenants that involve ratios based on assets and liabilities.

The following charts illustrate these effects for lessees using the facts in Example 23.

Type A – Lease Liability and ROU Asset Carrying Amounts



Type B – Lease Liability and ROU Asset Carrying Amounts

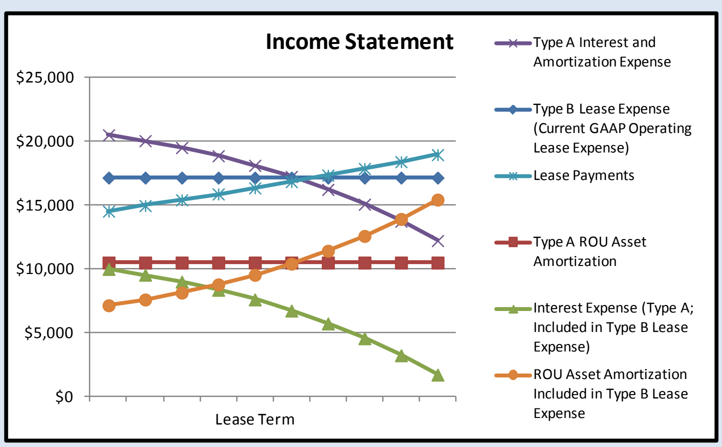


The 2013 EDs' proposed timing of expense recognition for Type A leases would differ significantly from operating leases under current GAAP. Expenses would be accelerated or front-loaded compared to the straight-line expense recognition associated with most operating leases under current GAAP because interest expense on the liability to make lease payments would be recognized by applying the effective interest method.

In addition, the proposed requirement to subject both Type A and Type B right-of-use assets to an impairment analysis could affect the timing of expense recognition. Under current GAAP, impairment analyses for capital (finance) leases are required but lessees generally do not record losses on lease contracts that are classified as operating leases until the lessee permanently stops using the underlying asset or terminates the lease agreement.

The following chart depicts differences that could arise between the expense recognition pattern under the 2013 EDs' proposals compared to current GAAP for a lease with the same facts as the one illustrated in the previous chart. To isolate the 2013 EDs' proposed effects, the chart illustrates a single lease accounted for under both a Type A and Type B lease classification (for Type B leases the interest expense and amortization expense would be recognized as a single straight-line lease expense in the financial statements but are broken out on the graph to demonstrate the pattern of recognition). The differences in expense recognition may be less dramatic for a lessee with a large revolving portfolio of leases that have varying maturities.

Type A and Type B Income Statement Amounts



The right-of-use asset would be tested for impairment (individually or together with other assets of an asset group) whenever there are indicators that the asset or asset group may not be recoverable. The lessee would follow current accounting guidance by comparing the recoverable amount of the right-of-use asset or asset group based on undiscounted cash flows to its carrying amount. If the carrying amount exceeds the recoverable amount, the lessee would measure an impairment loss as the excess of the carrying amount over its fair value. Under current GAAP, financial liabilities generally are excluded from the asset group for purposes of evaluating and measuring impairment. This means that lease liabilities generally would be excluded from the analysis of whether the ROU asset is impaired and from the measurement of impairment, if any.

Amortization of Type B ROU assets would represent a balancing entry or plug to achieve an overall straight-line pattern of total noncontingent lease expense. As depicted in the graph above, the Type B right-of-use asset amortization pattern (broken out on the graph for illustrative purposes only) would defer the amortization of the right-of-use asset as compared with a typical straight-line amortization model for other tangible and intangible assets. This amortization pattern may be inconsistent with how the utility of the underlying asset is ultimately consumed by the lessee and could increase the risk of impairment during the term of the lease if the asset or asset group is not able to generate the future cash flows needed to recover the higher carrying amount of the asset in later periods during the lease term. This risk may be somewhat mitigated given the greater likelihood of Type B lease classification for leases of property (i.e., as opposed to equipment, which may be more prone to an accelerated decline in utility in the early years of its economic life).

For Type B leases, the lessee would be required to recognize total lease expense on a straight-line basis over the lease term unless the periodic straight-line lease expense is less than the periodic interest on the lease liability (e.g., due to an impairment). This pattern of expense recognition would be required for lessees regardless of whether another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the right-of-use asset.

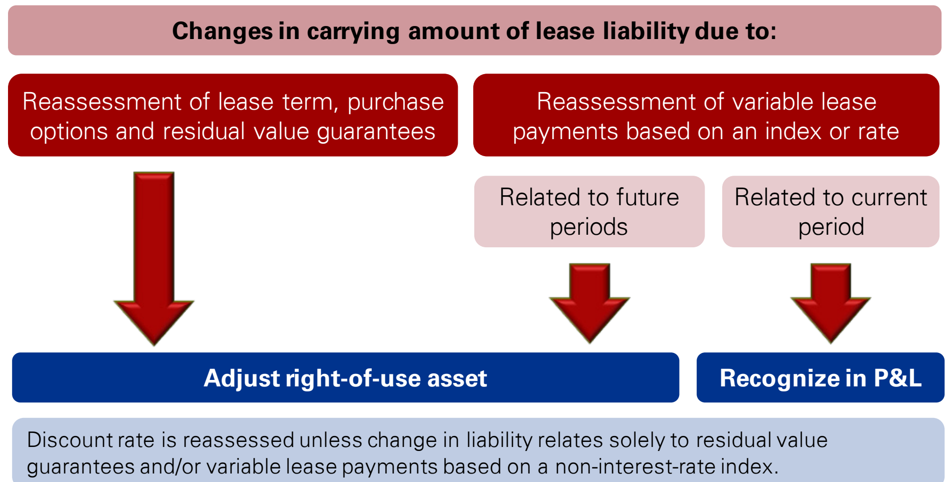
Subsequent Measurement – Variable Payments

Any variable lease payments not included in the lease liability and right-of-use asset would be recognized in the period in which the obligation for those payments is incurred. For example, when lease payments are contingent on the lessee's sales, contingent rentals would be recognized in the period the sales are generated. The exclusion of contingent rentals from the calculation of the lease liability under the 2013 EDs' proposals represents a significant change from the 2010 EDs' proposals. Under the 2010 EDs, contingent rentals were to be included in the initial measurement of the lease liability and right-of-use asset using a probability-weighted assessment.

Reassessment of the Lease Liability

The 2013 EDs propose that the lessee would be required to remeasure the lease liability to reflect any change to the lease payments and discount rate (see discussion below). A change in the lease payments could occur due to a change in the assessment of whether the lessee has a significant economic incentive to exercise a lease term or purchase option, a change in estimated payments to be made under a residual value guarantee, or a change in an index or rate on which variable lease payments are based. Lease classification would *not* be reconsidered upon a reassessment of the lease liability. Any remeasurement of the lease liability would result in a corresponding adjustment to the right-of-use asset, with the following exceptions:

- Any amount of remeasurement attributable to changes in an index or rate that relates to the current period would be recognized in net income or loss; and
- If the carrying amount of the right-of-use asset were reduced to zero, any remaining amount of remeasurement would be recognized in net income or loss.



Remeasuring the lease liability would involve a two-step process. The lessee first would determine at each reporting date whether changes in facts or circumstances indicate that there would be a change to the lease payments and discount rate. If that is the case, the lessee would then recalculate the liability using the revised assumptions as of the reporting date.

The 2010 EDs proposed that if payments required by an arrangement that contains both lease and non-lease components change after the commencement of the lease, the lessee would be required to determine, if possible, which component(s) the change relates to. If unable to determine the amount of the change attributable to each component, the lessee would allocate the change to the lease and non-lease components in the same proportion as determined at the commencement of the arrangement. Conversely, the 2013 EDs do not contain any proposed guidance about how to attribute changes in the measurement of payments required by an arrangement that contains both lease and non-lease components due to a reassessment or a change in the factors on which variable payments are based to the components that qualify for separate accounting.

KPMG Observations

A requirement to potentially revise the lease liability during the lease term would represent a significant change from current GAAP requirements for capital (finance) leases where the liability is not subsequently reassessed and would likely result in greater volatility in the liabilities recognized by lessees. Such volatility could significantly impact a company's financial position and operating results, the accuracy of its financial forecasts, its compliance with debt covenants, and its ability to pay dividends.

The Boards expressed the view that reassessment of the expected lease payments would provide more relevant information to financial statement users because it would reflect current economic conditions rather than using assumptions established at initial measurement throughout the lease arrangement, which the Boards believe could be misleading.

The 2010 EDs proposed requiring a lessee to remeasure the amount of the lease liability if facts or circumstances indicated that there would be a significant change in the liability since the previous reporting period. While the significant threshold was intended to minimize the frequency with which a reassessment would be required, the 2010 EDs' proposed requirement to measure the lease liability using a probability-weighted assessment of all potential outcomes would have created complexities in interpreting and evaluating what would be considered significant. The 2013 EDs' proposals related to initial recognition and reassessment are intended to minimize both the frequency and costs associated with a periodic reassessment, while still providing financial statement users more relevant information as current economic conditions related to the lease arrangement change.

Companies would need to establish processes and controls around those processes to identify changes in facts or circumstances that could significantly impact the lease payments and discount rate. This would involve cross-functional coordination and the development of appropriate controls to ensure timely identification of changes in facts and circumstances.

Also worth noting is the proposal to recognize remeasurements as an adjustment to the right-of-use asset, excluding the two exceptions mentioned above. This model deviates from the general recognition model under GAAP that generally requires a liability remeasurement to be recognized in net income or loss. The Boards determined that changes in the lease term or lease payments related to a purchase option represent a lessee's expectation that it has acquired more or less of the right to use the underlying asset and the adjustment to the right-of-use asset should be made to appropriately measure the total cost of the asset. Changes to the carrying amount of the right-of-use asset as a result of revised estimates of the lease liability also would require the lessee to revise useful life estimates and amortization expense on a prospective basis.

Because the 2013 EDs do not propose how to allocate remeasurements of lease payments to lease components that qualify for separate accounting, it is unclear whether those remeasurements would be allocated on the same basis as at lease commencement or whether they could be allocated to one or more specific components.

Reassessment of Lease Liability Due to Lease Payment Changes

The 2013 EDs propose the following specific guidance to indicate the situations that would require a reassessment of the lease payments.

Lease Term and Purchase Options. A change in the assessment of whether the lessee has a significant economic incentive to exercise a lease term or purchase option would require a remeasurement of the lease payments based on the new assessment.

A reassessment of whether the lessee has a significant economic incentive to exercise a lease term or purchase option would be required upon a change in contract-based, asset-based, or entity-based factors that affected the previous assessment of whether to include in lease payments amounts the lessee would be required to pay if it exercised a lease term or purchase option. Conversely, a change in market-based factors (such as market lease rates for a comparable asset) would not, in isolation, trigger a reassessment of whether the lessee has a significant economic incentive to exercise a lease term or purchase option.

Similarly, the actual election by a lessee to exercise an option, where previously the lessee had determined that a significant economic incentive did not exist to do so, would result in a reassessment. Likewise, not exercising an option where previously the lessee had determined a significant economic incentive existed would trigger a reassessment.

KPMG Observations

The 2010 EDs proposed that the lease term would be determined using a more likely than not threshold when assessing initial and remeasurement requirements related to lease term options. The 2013 EDs' proposed significant economic incentive threshold is intended to require remeasurement on a comparatively less frequent basis.

As indicated above, a change in market-based factors that impacted the previous assessment of whether to include amounts the lessee would be required to pay if it exercised a lease term or purchase option in lease payments would not, in isolation, trigger a reassessment of whether the lessee has a significant economic incentive to exercise a lease term or purchase option. It is unclear whether the Boards expect the impact of a change in market-based factors to be included in a reassessment of whether the lessee has a significant economic incentive to exercise a lease term or purchase option that is triggered by a change in contract-based, asset-based, or entity-based factors. However, as a practical matter it would seem difficult to ignore changes in market-based factors when considering whether there has been, and the impact of, a change in contract-based, asset-based, or entity-based factors.

Under current U.S. GAAP, the exercise of a renewal option that was not included in the original lease term is accounted for as a new lease. This would change under the 2013 EDs' proposals because the asset and liability would be measured differently than they would have been had a new lease with the same terms been executed.

Residual Value Guarantees. Lessees would be required to revise the estimated lease payments to reflect changes in amounts expected to be payable under residual value guarantees. These changes may arise from an increase or a decrease in the expected value of the underlying asset at the end of the lease term.

KPMG Observations

It may appear counter-intuitive to adjust the carrying amount of the right-of-use asset for changes in expectations about the future value of the underlying asset. An increase in the amount payable under a residual value guarantee typically occurs when there is a decrease in the value of the underlying asset; this may be seen as indicating a decrease in the value of the right to use that asset rather than an increase in that value. In addition, a decrease in the residual value of the underlying asset, which results in an increase in the right-of-use asset, may be viewed as creating an immediate impairment of that right-of-use asset.

In the Boards' view, changes in the expected amounts payable under residual value guarantees are changes to the cost of the right-of-use asset, which is consistent with including the expected amounts payable under residual value guarantees as part of the initial measurement of the right-of-use asset. The Boards' proposed requirement for lessees to review right-of-use assets for impairment is designed to ensure that assets arising from leases are not overstated.

Lease Payments Based on an Index or Rate. Lessees would be required to determine the revised lease payments to reflect changes in an index or rate on which variable lease payments are based, using the index or rate at the end of the reporting period. The Boards believe such a reassessment is necessary to provide relevant information to financial statement users about a lessee's lease liabilities at the reporting date.

The 2013 EDs do not include the 2010 EDs' proposed requirements to determine the portion of the change in lease payments that relates to current and prior periods versus future periods for reassessments of whether the lessee has a significant economic incentive to exercise a lease term or purchase option and changes in estimated residual value guarantee payments. However, those proposed requirements were retained for changes in an index or a rate on which variable lease payments are based. A lessee would be required to determine the amount of a remeasurement from a change in an index or rate attributable to the current period and recognize that amount in net income or loss rather than as an adjustment of the right-of-use asset.

KPMG Observations

For Type A leases a lessee would record two separate expenses: amortization expense and interest expense. The 2013 EDs do not provide any proposed guidance on whether changes in current period expense resulting from changes in an index or rate used to determine lease payments should be classified as interest expense, amortization expense, or some other expense. However, it would seem more consistent with the concept underlying the attribution of these changes to reflect them as an adjustment to interest expense.

Example 24: Lease Payments Indexed to CPI

A lessee enters into a lease of a building for a 5-year term. The building has a remaining estimated useful life that exceeds 5 years. The lease stipulates that the lessee's base payment is $100,000 per year (paid in arrears) and that the base payment will be adjusted each year (including the initial year of the lease) by the change in CPI since the lease's commencement. The lessee incurs no initial direct costs to enter into the lease and does not make any prepayments of rent. The lessee's incremental borrowing rate is 6%, and the lessee would initially measure the lease liability as the present value of $100,000 per year over 5 years discounted at 6% based on a beginning CPI index value of 196.800.

If the Lease Is Classified as a Type A Lease

The following table summarizes the balances of the lessee's right-of-use asset and lease liability as well as amortization, interest, and variable lease expense throughout the lease term, inclusive of the effects of reassessment of the estimated lease payments at the end of each period, assuming that the lease is classified as a Type A lease. Note that the actual outcomes during the lease term, which are reflected in the table, would not be known by the lessee at lease commencement.

Year	Base Rent Payments	CPI Index	Actual Payments	Ending ROU Asset	Ending Lease Liability	Amorti-zation Expense	Interest Expense	Variable Lease Expense	Total Expense
0		196.800		$421,236	$421,236				
1	$100,000	201.800	$102,541	345,793	355,314	$84,247	$25,274	$2,541	$112,062
2	100,000	210.036	106,726	270,532	285,279	86,448	21,319	4,185	111,952
3	100,000	210.228	106,823	180,534	195,849	90,177	17,117	97	107,391
4	100,000	215.949	109,730	93,009	103,519	90,267	11,751	2,907	104,925
5	100,000	219.179	111,371	-	-	93,009	6,211	1,641	100,861
	$500,000		**$537,191**			**$444,148**	**$81,672**	**$11,371**	**$537,191**

The lessee would make the following entries each year of the lease.

	Debit	Credit
Lease Commencement		
ROU asset	421,236	
Lease liability		421,236
To initially recognize and measure the lease.		
Year 1		
Lease liability	74,726	
Amortization expense	84,247	
Interest expense	25,274	
Variable lease (interest) expense	2,541	
Cash		102,541
ROU asset		84,247
To recognize scheduled and actual lease payments.		
ROU asset	8,804	
Lease liability		8,804
To recognize the reassessment of the estimated lease payments. (Calculated as present value over 4 years of payment of $102,541 per year based on revised index of 201.800 less present value over 4 years of previously scheduled payment of $100,000 per year based on previous index of 196.800, both discounted at 6%.)		
Year 2		
Lease liability	81,222	
Amortization expense	86,448	
Interest expense	21,319	
Variable lease (interest) expense	4,185	
Cash		106,726
ROU asset		86,448
To recognize scheduled and actual lease payments.		
ROU asset	11,187	
Lease liability		11,187
To recognize the reassessment of the estimated lease payments. (Calculated as present value over 3 years of payment of $106,726 per year based on revised index of 210.036 less present value over 3 years of previously scheduled payment of $102,541 per year based on previous index of 201.800, both discounted at 6%.)		
Year 3		
Lease liability	89,609	
Amortization expense	90,177	
Interest expense	17,117	
Variable lease (interest) expense	97	
Cash		106,823
ROU asset		90,177
To recognize scheduled and actual lease payments.		
ROU asset	179	
Lease liability		179
To recognize the reassessment of the estimated lease payments. (Calculated as present value over 2 years of payment of $106,823 per		

year based on revised index of 210.228 less present value over 2 years of previously scheduled payment of $106,726 per year based on previous index of 210.036, both discounted at 6%.)

	Debit	Credit
Year 4		
Lease liability	95,072	
Amortization expense	90,267	
Interest expense	11,751	
Variable lease (interest) expense	2,907	
Cash		109,730
ROU asset		90,267

To recognize scheduled and actual lease payments.

	Debit	Credit
ROU asset	2,742	
Lease liability		2,742

To recognize the reassessment of the estimated lease payments. (Calculated as present value over 1 year of payment of $109,730 based on revised index of 215.949 less present value over 1 year of previously scheduled payment of $106,823 based on previous index of 210.228, both discounted at 6%.)

	Debit	Credit
Year 5		
Lease liability	103,519	
Amortization expense	93,009	
Interest expense	6,211	
Variable lease (interest) expense	1,641	
Cash		111,371
ROU asset		93,009

To recognize scheduled and actual lease payments.

If the Lease Is Classified as a Type B Lease

The following table summarizes the balances of the lessee's right-of-use asset and lease liability as well as amortization, interest, and variable lease expense throughout the lease term, inclusive of the effects of reassessment of the estimated lease payments at the end of each period, assuming that the lease is classified as a Type B lease. Note that the actual outcomes during the lease term, which are reflected in the table, would not be known by the lessee at lease commencement. Also note that although interest on the lease liability is provided in the table, the lessee would present a single total for lease expense (including amortization of the ROU asset and interest on the lease liability) within operating expense – i.e., no finance expense would be presented.

Year	Base Rent Payments	CPI Index	Actual Payments	Ending ROU Asset	Ending Lease Liability	Amortization of ROU Asset	Interest on Lease Liability	Variable Lease Expense	Total Expense
0		196.800		$421,236	$421,236				
1	$100,000	201.800	$102,541	355,314	355,314	$74,726	$25,274	$2,541	$102,541
2	100,000	210.036	106,726	285,279	285,279	81,222	21,319	4,185	106,726
3	100,000	210.228	106,823	195,849	195,849	89,609	17,117	97	106,823
4	100,000	215.949	109,730	103,519	103,519	95,072	11,751	2,907	109,730
5	100,000	219.179	111,371	-	-	103,519	6,211	1,641	111,371
	$500,000		**$537,191**			**$444,148**	**$81,672**	**$11,371**	**$537,191**

The lessee would make the following entries each year of the lease.

	Debit	Credit
Lease Commencement		
ROU asset	421,236	
Lease liability		421,236
To initially recognize and measure the lease.		
Year 1		
Lease liability	74,726	
Lease expense (straight-line)	100,000	
Lease expense (variable)	2,541	
Cash		102,541
ROU asset		74,726
To recognize scheduled and actual lease payments.		
ROU asset	8,804	
Lease liability		8,804
To recognize the reassessment of the estimated lease payments. (Refer to calculation under entries if the lease is classified as a Type A lease above.)		
Year 2		
Lease liability	81,222	
Lease expense (straight-line)	102,541	
Lease expense (variable)	4,185	
Cash		106,726
ROU asset		81,222
To recognize scheduled and actual lease payments.		
ROU asset	11,187	
Lease liability		11,187
To recognize the reassessment of the estimated lease payments. *(Refer to calculation under entries if the lease is classified as a Type A lease above.)*		
Year 3		
Lease liability	89,609	
Lease expense (straight-line)	106,726	
Lease expense (variable)	97	
Cash		106,823
ROU asset		89,609
To recognize scheduled and actual lease payments.		
ROU asset	179	
Lease liability		179
To recognize the reassessment of the estimated lease payments. *(Refer to calculation under entries if the lease is classified as a Type A lease above.)*		

	Debit	Credit
Year 4		
Lease liability	95,072	
Lease expense (straight-line)	106,823	
Lease expense (variable)	2,907	
Cash		109,730
ROU asset		95,072
To recognize scheduled and actual lease payments.		
ROU asset	2,742	
Lease liability		2,742
To recognize the reassessment of the estimated lease payments. *(Refer to calculation under entries if the lease is classified as a Type A lease above.)*		
Year 5		
Lease liability	103,519	
Lease expense (straight-line)	109,730	
Lease expense (variable)	1,641	
Cash		111,371
ROU asset		103,519
To recognize scheduled and actual lease payments.		

KPMG Observations

The reassessment of variable lease payments based on an index or rate potentially could require a significant level of time and effort even though the impact of these reassessments is likely to be minimal. The following table provides a summary of the total Type A lease expense that would be recognized by the lessee for Example 24 if there were no periodic reassessment of the lease liability and a comparison of that expense to the total expense recognized under the reassessment approach.

	Total Expense		Difference	
Year	**With Reassessment**	**Without Reassessment**	**Amount**	**Percentage**
1	$112,062	$112,062	$ -	0.00%
2	111,952	111,764	188	0.17%
3	107,391	107,109	282	0.26%
4	104,925	104,977	(52)	-0.05%
5	100,861	101,279	(418)	-0.41%
	$537,191	**$537,191**	**$ -**	**0.00%**

Because the amount included in lease payments used to measure the lease liability and right-of-use asset when there are variable payments based on an index assumes no change in the index at the measurement date, there would be no difference in the total Type B lease expense that would be recognized by the lessee for Example 24 if there were no periodic reassessment of the lease liability. That is, remeasurement of a Type B lease liability solely due to a change in an index on which variable lease payments are based would not affect the periodic total lease expense to be recognized. In Example 24, if the lease were classified as a Type B lease, the total lease expense with or without a reassessment would be equal to the actual lease payments.

This illustrates why the Boards' constituents may question whether the benefits of some reassessments outweigh their cost.

Discount Rate Changes

Unlike the 2010 EDs, the 2013 EDs' proposals would require a reassessment of the discount rate for changes to any of the following, unless the possibility of change was reflected in determining the discount rate at the lease commencement date:

- The lease term;
- Relevant factors that result in the lessee having or ceasing to have a significant economic incentive to exercise an option to purchase the underlying asset; or
- A reference interest rate on which variable lease payments are based.

Under the 2013 EDs' proposals the revised discount rate would be determined at the date of reassessment in the same manner as at the lease commencement date.

KPMG Observations

During redeliberations of the 2010 EDs' proposals, the Boards decided that, in most cases, an entity should not reassess the discount rate during the lease term, which is generally consistent with amortized cost accounting. However, the Boards believe there are some circumstances in which an entity should reassess the discount rate. In the Boards' view, these situations, which were included in the 2013 EDs' proposals, represent a significant change in the economics of the lease and should be reflected in the discount rate.

This would represent a shift from current U.S. GAAP for capital leases where a lessee, subject to certain requirements, would use the discount rate determined at lease inception to calculate the change in the lease liability as a result of a change in the amount of remaining minimum lease payments due to a lease modification that is not accounted for as a new lease.

Example 25: Reassessment of the Lease Liability and Right-of-Use Asset – Accounting for a Change in the Lease Term

Assume the same fact pattern as in Example 23 except that in the sixth year of the lease, a change in Lessee's business related to the use of the underlying asset occurs such that Lessee now has a significant economic incentive to exercise the option to extend the lease term. Lessee's incremental borrowing rate at the end of year 6 is reassessed, taking into consideration the extended remaining lease term, and determined to be 12% (Lessee is not able to determine the rate Lessor is charging). Although the lease term changes, Lessee does not reassess the lease classification.

At the end of the sixth year, before accounting for the change in the lease term, the unamortized lease liability is $57,307 (present value of 4 remaining payments from the initial $14,527 annual payment increasing by 3% per year, discounted at the rate of 10%). Lessee's unamortized right-of-use asset is $42,000 if the lease is classified as a Type A lease or $53,352 if the lease is classified as a Type B lease.

Lessee remeasures the lease liability at an amount now equal to the present value of the four remaining lease payments for years 7-10, followed by 5 additional payments, with each continuing to increase at 3% per year, all discounted at the rate of 12%, which is $102,050. Lessee increases the lease liability by $44,743 representing the difference between the remeasured liability of $102,050 and its current carrying amount of $57,307. A corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional rights, as follows:

	Debit	Credit
Right-of-use asset	44,743	
Lease liability		44,743

Following the adjustment, the carrying amount of Lessee's right-of-use asset is $86,743 ($42,000 + $44,743) if the lease is a Type A lease or $98,095 ($53,352 + $44,743) if the lease is a Type B lease.

Lessee recognizes the year 7 payment of $17,346 (initial payment of $14,527 increasing at 3% per year) and expense as follows, depending on how the lease was classified at the commencement date:

If the lease was classified as a Type A lease at the commencement date

Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, therefore, amortizes the right-of-use asset on a straight-line basis over the remaining 9-year lease term.

Interest expense	12,246	
Amortization expense	9,638	
Lease liability	5,100	
Cash		17,346
Right-of-use asset		9,638

At the end of the seventh year of the lease, the carrying amount of Lessee's lease liability is $96,950 ($102,050 present value of future lease payments after reassessment + $12,246 year 7 interest expense – $17,346 year 7 lease payment).

At the end of the seventh year of the lease, the carrying amount of the right-of-use asset is $77,105 ($86,743 remeasured ROU asset – $9,638 year 7 amortization expense).

If the lease was classified as a Type B lease at the commencement date

Lessee determines the remaining cost of the lease as:

- The sum of $166,536 (sum of the lease payments for the original term of the lease of $14,527 in year 1 and escalating 3% per year thereafter for 10 years), plus $103,651 (sum of the lease payments for the optional period – years 11 through 15 – escalating at 3% per year), plus $5,000 (initial direct costs incurred by Lessee), that is $275,187; less
- The cost of the lease already recognized as an expense of $102,924 (annual lease expense of $17,154 recognized during the first 6 years of the lease).

The amount of the remaining cost of the lease is therefore $172,263 ($275,187 – $102,924). Consequently, the lessee determines that the annual expense to be recognized is $19,140 ($172,263 ÷ 9 years). Below are the journal entries for the recognition of lease expense and the rental payment due at the end of year 7:

Lease expense	19,140	
Lease liability	5,100	
Right-of-use asset		6,894
Cash		17,346

At the end of the seventh year of the lease, the carrying amount of Lessee's lease liability is $96,950 ($102,050 present value of future lease payments after reassessment + $12,246 year 7 interest expense – $17,346 year 7 lease payment). Note this is the same amount as for the Type A lease.

At the end of the seventh year of the lease, the carrying amount of the right-of-use asset is $91,201 ($98,095 remeasured ROU asset – $6,894 year 7 amortization expense).

Lessee Financial Statement Presentation

The 2013 EDs propose that a lessee would present the items arising from lease contracts as follows:

Statement of Financial Position

- Present in the statement of financial position or disclose in the notes to the financial statements:
  - Right-of-use assets separately from other assets;
  - Lease liabilities separately from other liabilities;
  - Right-of-use assets arising from Type A leases separately from those arising from Type B leases; and
  - Lease liabilities arising from Type A leases separately from those arising from Type B leases.
- If a lessee does not present right-of-use assets and lease liabilities separately in the statement of financial position, the lessee would:
  - Present right-of-use assets within the same line item as the corresponding underlying assets would be presented if they were owned; and
  - Disclose the line items in the statement of financial position that include right-of-use assets and lease liabilities.

KPMG Observations

The Boards concluded that presenting leased assets in the statement of financial position in a similar way as owned assets would provide useful information to financial statement users about the function of the underlying asset. The Boards proposed that right-of-use assets be presented or disclosed separately from owned assets because of differences in the financial flexibility and exposure to risk.

Similarly, the 2013 EDs propose that a lessee would present the carrying amount of the lease liability separately from other financial liabilities in either the statement of financial position or in the notes to the financial statements. The Boards view a lease liability as a unique class of liability that is linked to a corresponding asset and may have features, such as options and variable lease payments, which differ from those in other liabilities. Separate presentation or disclosure would allow financial statement users to understand the extent to which a company uses leases.

Statement of Comprehensive Income

- For Type A leases, a lessee would present the interest on the lease liability separately from the amortization of the right-of-use asset; and
- For Type B leases, a lessee would present the interest on the lease liability together with the amortization of the right-of-use asset as part of a single lease expense amount.

KPMG Observations

For Type A leases, the proposed standard does not indicate in which financial statement caption contingent rentals would be recorded. As a result, it is unclear whether they could be included with amortization expense, interest expense, or presented as some other expense.

The Boards determined that for Type B leases, a lessee would recognize a single lease expense that combines the amortization of the right-of-use asset and the interest on the lease liability. The Boards' view is that when a lessee is not expected to consume more than an insignificant portion of the underlying asset, presenting a single lease expense provides more useful information than presenting amortization and interest expense separately. This is because, for such leases, the Boards believe the lessee is paying to use the underlying asset without acquiring a significant portion of it.

Statement of Cash Flows

The 2013 EDs propose that a lessee would present cash flows from leasing transactions in the statement of cash flows as follows:

- Repayments of the principal portion of the lease liability arising from Type A leases would be classified as financing cash flows;
- Interest on the lease liability arising from Type A leases would be classified using IAS 7, *Statement of Cash Flows*, by entities applying IFRS, and as operating cash flows by entities applying U.S. GAAP;
- Variable lease payments and short-term lease payments not included in the lease liability would be classified as operating cash flows; and
- Payments arising from Type B leases would be classified as operating cash flows.

KPMG Observations

The 2013 EDs' proposals related to the presentation in the statement of cash flows are generally linked to the presentation of expenses arising from a lease in the statement of comprehensive income. Consequently, a lessee would classify cash paid on the principal portion of the lease liability for Type A leases as financing activities. Cash paid for Type B leases would be classified as operating activities because lease expense relating to Type B leases would be presented in line items above financing costs in the statement of comprehensive income. Lessees would be required to disclose the amount of the lease liability and corresponding portion of the right-of-use asset recognized upon entering into a lease as a non-cash investing and financing activity.

The 2013 EDs' proposed presentation requirements would result in treating Type A leases as financing transactions in the statement of financial position, statement of comprehensive income, and statement of cash flows. Conversely, Type B leases would be treated as financings in the statement of financial position, but not in the statement of comprehensive income or statement of cash flows.

Lessor Accounting and Financial Statement Presentation

The 2013 EDs would require lessors to apply the same lease classification tests as lessees. For Type A leases lessors would apply a receivable and residual (R&R) model. The R&R model is based on the derecognition approach proposed in the 2010 EDs. Under the R&R model, at lease commencement, a lessor would derecognize the underlying asset and recognize a lease receivable for its right to receive lease payments from the lessee and a residual asset for its right to the return of the underlying asset at the end of the lease term. Profit or loss would be recognized at lease commencement for any difference between (1) the previous carrying amount of the underlying asset, and (2) the sum of the lease receivable and the residual asset recognized. No profit or loss would be recognized at lease commencement in circumstances in which the fair value and carrying amount of the underlying asset are the same at that date. Profit or loss recognized at lease commencement would relate only to the right-of-use transferred to the lessee and not to the residual asset retained by the lessor. If the lessor uses lease arrangements to provide financing, it would present commencement date profit or loss on a net basis in a single line item in the statement of comprehensive income (e.g., as a gain or loss within other income). If the lessor uses leases as an alternative to selling (e.g., many manufacturers and dealers), then it would present commencement date profit or loss on a gross basis as separate line items in the statement of comprehensive income (e.g., as revenue and cost of goods sold).

For short-term leases to which the lessor elects not to apply the R&R model and Type B leases, the lessor would apply an operating lease model similar to operating lease accounting under current GAAP in which the lessor would continue to recognize the underlying asset and would recognize lease payments as income over the lease term generally on a straight-line basis. No lease receivable or residual asset would be recorded under the operating lease model because the lessor would not derecognize the underlying asset.

	Statement of financial position	Statement of comprehensive income	Profile of total lease income
Type A leases	Lease receivable Residual asset	Profit/loss on lease commencement Interest income on lease receivable Interest income on accretion of residual asset	Front-loaded
Type B leases	Underlying asset	Lease income	Straight-line

KPMG Observations

While the Basis for Conclusions to the 2013 EDs outlines the Boards' view that the right to receive lease payments in a Type A lease meets the definition of an asset in their respective conceptual frameworks, it does not explain why only lease receivables in Type A leases accounted for under the R&R model meet this definition. The Basis for Conclusions discusses the Boards' view that when the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee and therefore the lessor has an unconditional lease receivable. The lessor controls that right (e.g., it can decide to sell or securitize that right). The right arises from a past event (the signing of the lease and the underlying asset being made available for use by the lessee) and future economic benefits are expected to flow to the lessor (typically cash from the lessee). It is unclear how the lessor's rights and performance in a Type B lease differ from its rights and performance in a Type A lease or why a Type B lease does not also give rise to a lease receivable that meets the definition of an asset. The Boards' lessor accounting model for Type B leases appears to follow the rationale that for some leases the lessor should account for the underlying asset rather than the conveyance of a right to use the underlying asset. However, that approach appears to be inconsistent with their overarching premise that lease accounting should be about rights-of-use rather than the underlying assets.

Applying the Receivable and Residual Model (Type A Leases)

The R&R model is based on the perspective that the lessor has sold a portion of the underlying asset to the lessee in exchange for a right to receive lease payments. It is a partial sale model because profit or loss would be recognized by the lessor at lease commencement only on the portion of the underlying asset that is considered to be sold to the lessee. No profit or loss would be recognized at lease commencement when the fair value and carrying amount of the underlying asset are the same at that date. The Boards rejected an approach under which the lessor would recognize profit or loss at lease commencement equal to the difference between the carrying amount of the underlying asset and its fair value when the lessor retains a residual interest in the underlying asset. The following equation depicts total profit or loss (including the unearned portion) at lease commencement:

$$\text{Fair value of underlying asset} - \text{Carrying amount of underlying asset} = \text{Total profit (loss)}$$

The R&R model would require the lessor to derecognize the underlying asset and recognize a lease receivable (i.e., right to receive lease payments) and a residual asset. Profit or loss that would be recognized by the lessor at lease commencement is depicted by the following equation:

$$\text{Total profit (loss)} \times \frac{\text{Present value of lease payments}}{\text{Fair value of underlying asset}} = \text{Profit (loss) recognized at lease commencement}$$

This can also be calculated as the lease commencement date amounts recorded for prepaid rent, the lease receivable, and the residual asset minus the carrying amount of the derecognized underlying asset. Unearned profit or loss (i.e., profit or loss that would not be recognized at lease commencement) is depicted by the following equation:

$$\text{Total profit (loss)} - \text{Profit (loss) recognized at lease commencement} = \text{Unearned profit (loss)}$$

Unearned profit (loss) would not be recognized as income (expense) until a reassessment occurs that affects the measurement of the residual asset, the underlying asset is either sold or re-leased, or an impairment of the residual asset is recognized.

Timing of Initial Recognition and Measurement. Consistent with the 2013 EDs' lessee accounting proposals, a lessor would initially measure and recognize a lease receivable and residual asset and derecognize the underlying asset at the lease commencement date, that is, the date on which the lessor makes the underlying asset available for use by the lessee. This timing is consistent with the proposed right-of-use model under which a lessee would obtain control over the use of the underlying asset at the lease commencement date and would align the timing of initial measurement with the timing of initial recognition. This is a change from the 2010 EDs' proposals to initially measure the lease receivable and residual asset as of the lease inception date (the earlier of the date of the lease agreement and the date of commitment by the parties to the agreement).

Lease Receivable. The 2013 EDs propose that at lease commencement, a lessor would measure the lease receivable at the present value of the lease payments over the lease term. The section on *Lease Classification* discusses the proposed definitions of lease term and lease payments as well as the discount rate that would be used by the lessor to measure the present value of the lease payments. The proposed measurement of the lease receivable would require the lessor to evaluate whether the lessee has a significant economic incentive to exercise any lease term or purchase options in the lease. Residual value guarantees and variable lease payments other than payments that are based on an index or rate would be excluded from the measurement of the lease receivable.

The lessor's lease receivable would be measured at the lease commencement date in a manner substantially similar to how the lessee would measure its lease liability. The lessor's lease receivable would include all of the following payments to be received during the lease term that have not yet been received by the lessor at the lease commencement date:

- Fixed lease payments (less any lease incentives payable to the lessee);
- Variable lease payments that either: (a) are based on an index or rate (initially measured using the index or rate at lease commencement), or (b) are in-substance fixed payments;
- The exercise price of a purchase option that the lessee has a significant economic incentive to exercise;
- Penalty payments for terminating the lease if the lease term reflects that the lessee will exercise a termination option; and
- Lease payments structured as residual value guarantees.

Each of the first four items above would be measured in the same manner by both the lessee and the lessor. Estimated payments as a result of residual value guarantees, which would be included in the lessee's lease liability, would be excluded from the lessor's lease receivable unless the guarantee requires the lessor to pay to, or receive from, the counterparty (which may or may not be the lessee) any difference between the selling price of the underlying asset and a specified residual value. The Boards determined that such a provision in a lease contract effectively represents a fixed payment in the form of a residual value guarantee, which is similar to a fixed lease payment receivable at the end of the lease term (see Example 26).

KPMG Observations

Lessor accounting for Type A leases can be seen – in broad terms – as a development of current sales-type (finance) lessor accounting. It is also – in broad terms – complementary to the right-of-use approach to lessee accounting. In effect the lessor in a Type A lease accounts for a partial disposal of the underlying asset on deferred payment terms, in the same way that the lessee accounts for acquisition of the right-of-use asset.

However, lessor accounting for Type A leases is notably complex. Much of the complexity arises from the accounting issues associated with the residual asset. In a sales-type (finance) lease the lessor recognizes the unguaranteed residual value but its balance is relatively small in relation to the lessor's net investment in the lease (including the lease receivable). In contrast, the lessor's residual asset in a Type A lease may be much larger. For example, if a lessor leases out a new aircraft for the first 5 years of its 21-year life, then the residual asset will probably be much larger than the lease receivable. The Boards decided to develop a new approach to account for the residual asset because it will often be a significant component of the lessor's investment.

The 2013 EDs' proposal for lessors generally to exclude residual value guarantees from the measurement of the lease receivable is different than the proposals on lessee accounting, which would require lessees to include amounts expected to be paid under residual value guarantees in measuring the lease liability. Consequently, lessors' initial and subsequent measurement of lease receivables for leases in which the lessee provides a residual value guarantee could differ from lessees' measurement of lease liabilities.

In deciding that estimated payments from the lessee under residual value guarantees would not be included in the lessor's lease receivable, the Boards took the view that to do so would double count the asset. The estimated future residual value and corresponding residual asset would include the guaranteed residual value; therefore, to include any estimated payment from the lessee to realize that value in the lease receivable would effectively record that value twice. Although not discussed in the 2013 EDs, in leases where the lessor will pay to, or receive from, a counterparty any difference between the selling price of an underlying asset and a specified residual value the lessor presumably would be expected to recognize no residual asset. Otherwise the double-counting issue that led the Boards to propose excluding residual value guarantees from measurement of the lease receivable would arise.

Excluding residual value guarantees from the lease receivable also would reduce the amount of lease transactions that would be within the scope of the accounting requirements for transfers of financial assets because the guaranteed portion of the residual asset would not be considered a financial asset.[33] Consequently, it could be more difficult for lessors to derecognize the guaranteed portion of the residual asset than it is under current GAAP. This may affect the pricing for some lease transactions or cause lessors to be less willing to enter into certain leases. Many lessors may find the proposed accounting for residual value guarantees counterintuitive, especially given the fact that the guaranteed portion of the residual asset is considered a financial asset and is included in the measurement of the lessor's lease receivable under current GAAP.

Subsequent to initial recognition, the lessor would measure the lease receivable at amortized cost using the effective interest method. In addition, the carrying amount of the lease receivable would be revised to reflect the result of applying the proposed reassessment requirements discussed below. The lessor would recognize impairment losses on lease receivables using the impairment guidance for financial instruments. On December 20, 2012, the FASB issued a proposed ASU on credit losses that would change the way an entity recognizes credit impairment losses on financial assets.[34]

[33] FASB ASC Topic 860, Transfers and Servicing, available at www.fasb.org, and IAS 39, Financial Instruments: Recognition and Measurement.

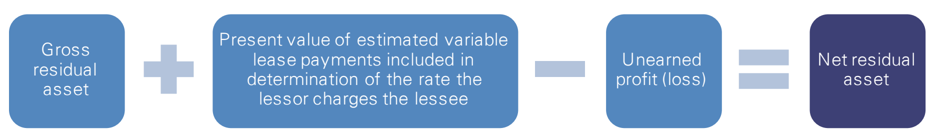
[34] FASB Proposed Accounting Standards Update, Financial Instruments – Credit Losses, available at www.fasb.org. For additional information, see KPMG's Defining Issues No. 13-2, FASB Proposes Model for Recognizing Credit Losses on Financial Instruments, and Issues In-Depth No. 13-1, Applying the FASB Proposed Model on Financial Asset Credit Losses, both available at www.kpmginstitutes.com/financial-reporting-network.

The FASB's proposed impairment model would reflect a vendor's current estimate of contractual cash flows that are not expected to be collected over the life of the receivable in the determination of the credit loss. Receivables that result from lease transactions (i.e., lease receivables) would be included within the scope of the proposed ASU. Current U.S. GAAP for impairment of receivables requires recognition of a loss when it is probable that an asset has been impaired at the balance sheet date and the amount of the loss can be reasonably estimated. The proposed ASU would supersede that guidance and eliminate the probable recognition threshold in favor of a broader expected loss model. In addition, to determine the impairment amount, an entity would consider not only past events and current conditions, but also reasonable and supportable forecasts. As a result, credit losses generally would be recognized earlier under the FASB's proposed impairment model than under current U.S. GAAP.

In determining the amount of impairment to recognize under the financial instruments guidance, the lessor also would consider the expected value of the residual asset in relation to the carrying amount of the gross residual asset (see discussion below). For example, assume a projected impairment of the lease receivable based on the financial instruments guidance of $5,000 and that no allowance for credit losses previously had been recorded. However, also assume that if the lessee were to default the residual value of the underlying asset that would be recoverable by the lessor would be $8,000 (e.g., in resale) as compared to a current carrying amount of the gross residual asset of $6,000. Therefore, projected impairment would be reduced by $2,000 because the lessor could recover that portion of the projected impairment through its interest in the residual asset. As a result, the lessor would only record a $3,000 impairment allowance on the lease receivable ($5,000 projected impairment – $2,000) in its current period net income or loss.

Residual Asset. For each lease it enters into, the 2013 EDs propose that the lessor would be required to calculate both a *gross* residual asset and a *net* residual asset. The gross residual asset would be the present value of the expected residual value of the underlying asset at the end of the lease term, discounted at the rate the lessor charges the lessee. The gross residual asset would not be reported in the lessor's statement of financial position.

The net residual asset would be reported in the lessor's statement of financial position and would be determined using the following equation:



A lessor would not be required to reflect an expectation of variable lease payments (i.e., payments that are not in-substance fixed payments and are not based on an index or rate) in determining the rate the lessor charges the lessee. However, if a lessor reflects an expectation of variable lease payments in determining the rate the lessor charges the lessee, the lessor would include in the initial measurement of the net residual asset the present value of the variable lease payments used in determining the rate the lessor charges the lessee. Those variable lease payments would be excluded from the lease receivable.

Subsequent to lease commencement, and excluding the impact of reassessments of the lease receivable (discussed below), each period the net residual asset would be:

- Increased based on accretion of the gross residual asset, which would be calculated based on the previous balance of the gross residual asset multiplied by the rate the lessor charges the lessee; and

- Decreased based on derecognition of the portion of the net residual asset recognized at lease commencement that was attributable to estimated variable lease payments (if applicable). The periodic amount derecognized would be calculated as:

$$\frac{\text{ORIGINAL estimate of variable lease payments during the period}}{\text{ORIGINAL estimate of variable lease payments during the lease term}} \times \text{Present value of ORIGINAL estimate of variable lease payments during the lease term discounted at the rate the lessor charges the lessee} \times \frac{\text{Carrying amount of underlying asset at lease commencement}}{\text{Fair value of underlying asset at lease commencement}}$$

  For example, assume the lessor originally estimated that it would receive $10,000 in total variable lease payments in calculating the rate it charges the lessee (e.g., the interest rate implicit in the lease). Assume further that the present value of those variable payments was $8,000 at lease commencement, and the lessor originally estimated $2,000 would be earned in the current period. Finally, assume that the fair value and carrying amount of the underlying asset were equal at lease commencement (e.g., $50,000). In that case, the amount of the net residual asset the lessor would derecognize during the current period would be $1,600 (calculated as [{$2,000 ÷ $10,000} × $8,000 × {$50,000 ÷ $50,000}]). The lessor would charge net income or loss for a corresponding amount. This charge would be recognized in the same period in which the actual variable lease payments are recognized as income and may be more or less than those payments (see Example 27).

The residual asset would be subject to impairment testing under the accounting guidance for intangible or fixed assets using the carrying amount of the net residual asset.[35] The residual asset (both the gross and the net residual asset) also might be adjusted if the lease term is reassessed (see below), but otherwise would not be remeasured during the lease term.

KPMG Observations

The 2010 EDs' proposals would have precluded the lessor from accreting the residual asset. Many of the Boards' constituents expressed concerns about that proposed requirement because they did not believe it would properly reflect the manner in which the lessor prices the lease. The 2013 EDs' proposal to require accretion of the gross residual asset is a response to those concerns. Mathematically, accretion of the residual asset spreads income over the lease term and reduces the profit that would otherwise arise on sale of the residual asset or commencement of the next lease. However, from a conceptual perspective, there may be concerns with this approach because it represents the recognition of interest income on a nonfinancial asset.

The 2010 EDs would have required the lessor to include a probability-weighted expectation of variable lease payments that would be received during the lease term in measuring the lease receivable. Financial statement preparers commented that estimating lease payments for contingent rentals and other variable lease payments would be challenging because it may require companies to forecast activities in periods beyond their normal planning or budgeting cycles or use a methodology that differs from their normal planning or budgeting methodology,

[35] FASB ASC Topic 350, Intangibles—Goodwill and Other, and FASB ASC Topic 360, Property, Plant, and Equipment, both available at www.fasb.org, and IAS 36, Impairment of Assets.

especially for long-term leases such as 10- or 20-year leases of retail space with contingent rentals based on a percentage of sales. In addition, lessors might experience particular difficulty in estimating contingent rentals that depend on the actions of lessees. Consequently, these respondents, as well as some financial statement users, suggested that the 2010 EDs' proposals may not produce useful, reliable information, and the costs of producing that information would likely exceed its benefits.

In response to these concerns, the Boards proposed in the 2013 EDs to exclude variable lease payments from the measurement of the lease receivable, except when those payments are in-substance fixed payments or are based on an index or rate. However, the Boards noted that the interest rate implicit in the lease (i.e., the rate that causes the sum of the present value of payments by the lessee for the right to use the underlying asset and the present value of the underlying asset's estimated residual value at the end of the lease to be equal to the fair value of the underlying asset at lease commencement), could be artificially low if the lease was expected to have significant contingent rent payments as compared with a similar lease where the payments were fixed rather than contingent. For example, if an underlying asset with a lease commencement date fair value of $60,000 were leased for a term of five years for total fixed lease payments of $25,000 with an estimated residual value of $30,000 the interest rate implicit in the lease would be a negative rate. However, assuming that the estimated residual value is not expected to be affected by the factors on which contingent rentals are based, if estimated contingent rentals of $20,000 were considered in determining the interest rate implicit in the lease it would be a positive rate that would more reasonably reflect the economic return expected by the lessor. As a result, the 2013 EDs contemplate that the lessor may estimate variable lease payments that it expects to receive in determining the rate that it charges the lessee.

The 2013 EDs do not provide guidance on whether a lessor that includes an estimate of variable lease payments in its calculation of the discount rate would measure those variable lease payments on a probability-weighted basis as proposed in the 2010 EDs, or using another method, such as a most likely outcome approach. The forthcoming revenue recognition standard is expected to allow a seller to estimate variable consideration using either a probability-weighted method or a most likely outcome approach. It does not prescribe when a seller must use either method; however, where there are a large number of possible outcomes, a probability-weighted approach may be the better method. The forthcoming revenue recognition standard is also expected to limit the estimated variable consideration to be included in the contract's transaction price to those amounts that the seller has a relatively high level of confidence it will be entitled to receive. The 2013 EDs do not contain similar proposed guidance; however, lessors would need to consider the reasonableness of the discount rate in a lease in relation to the lessor's expected return.

In some leases, variable lease payments are designed to compensate the lessor if a decline in the underlying asset's future residual value as compared with the residual value estimated by the lessor in pricing the lease occurs because the lessee uses the asset during the lease term to a greater extent than the assumed level of usage in the lessor's residual value estimate. For example, in many vehicle leases the lessee is required to make additional lease payments if the vehicle is driven more than a specified distance during the lease term. In these situations, including an estimate of variable lease payments in the determination of the rate the lessor charges the lessee may not significantly affect that rate because the estimated residual value may be lower if those estimated variable payments are expected to be received by the lessor. However, where the estimated residual value is not expected to be affected by the factors on which variable lease payments are based, the determination of the rate that the lessor charges the lessee could be significantly affected by those payments and, therefore, estimating those payments may be important in determining the appropriate discount rate.

The Boards expect that companies that negotiate leases with contingent rental arrangements have some level of understanding about the likely payment amount. Nevertheless, estimating variable lease payments for financial reporting purposes may be a difficult exercise that would become more complex if the lessor were required to reassess its original estimates (see discussion on reassessments below).

Income Statement Effects. Under the 2013 EDs' proposals, profit or loss recognized at lease commencement would be presented on a gross or net basis depending on which presentation best reflects the lessor's business model. A lessor that uses leases as a means to provide financing would present the net profit or loss on the lease on a net basis in a single line item (e.g., as a gain within other income). A lessor that is a manufacturer or dealer would present revenue and cost of revenue on a gross basis. The 2013 EDs do not propose guidance on how the lessor would determine the amount of revenue and cost of revenue to record if the profit or loss from the transaction recognized at lease commencement is presented on a gross basis. However, under current GAAP, revenue for sales-type (finance) leases generally is equal to the present value of the lease payments while cost of revenue generally is equal to the carrying amount of the underlying asset minus the present value of the estimated unguaranteed residual value. If a consistent approach to current GAAP were used in the R&R model, the revenue recognized would equal the present value of the lease payments at lease commencement, while the cost of revenue would equal the carrying amount of the underlying asset minus the amount of the net residual asset at lease commencement.

Interest income on the lease receivable and residual asset (i.e., accretion) would be recognized over the lease term. Where a lessor includes variable lease payments in its determination of the appropriate discount rate, additional periodic profit or loss would be recorded for actual variable lease payments earned less the amount of the residual asset attributable to variable lease payments derecognized during the period (see formula above and Example 27). If the lessor presents lease revenue and expense on a gross basis, additional revenue would be recorded each period equal to the variable lease payments earned during the period and periodic lease expense recognized during the period would be equal to the amount of the residual asset attributable to variable lease payments that is derecognized during the period.

KPMG Observations

The pattern of income recognition under the R&R model would be similar to, but not the same as, sales-type (finance) leases under current GAAP. Profit or loss would be recognized at lease commencement and interest income would be recognized over the lease term. However, unlike sales-type (finance) lease accounting, a portion of the difference between the fair value and carrying amount of the underlying asset (i.e., the total profit or loss on the lease) would be deferred until the underlying asset is returned by the lessee and sold or re-leased by the lessor. Therefore, in general, income recognition under the R&R model would be accelerated as compared to operating lease accounting under current GAAP, but deferred by an amount equal to unearned profit or loss (see below) compared with sales-type (finance) lease accounting under current GAAP.

For agreements that contain both lease and non-lease components, the importance of separating the lease and non-lease components would increase under the R&R model compared with current operating lease accounting because failure to separate those components could result in an inappropriate acceleration of revenue and profit.

Unearned Profit or Loss. Unearned profit or loss under the 2013 EDs' proposals would be calculated as the difference between the fair value and the carrying amount of the underlying asset immediately prior to lease commencement less any profit or loss recognized at lease commencement. The unearned profit or loss would reflect the portion of total profit or loss (i.e., the difference between the fair value and carrying amount of the underlying asset) that relates to the residual asset. Unearned profit or loss would not be recognized until a reassessment occurs that affects the measurement of the residual asset (as discussed below), the lessor either sells or re-leases the residual asset, or an impairment of the residual asset is recognized.

KPMG Observations

The Boards' conceptual basis for unearned profit or loss is similar to the rationale for the accounting by a joint venture investor for transactions with the joint venture. Sales of assets or services (e.g., inventory) by the investor to the joint venture (or vice versa) often result in the recognition of intercompany profits or losses by the seller. The accounting issue raised in these situations is the extent to which profit or loss on the sales should be eliminated in the investor's financial statements. U.S. GAAP stipulates that it would be inappropriate to reflect 100% of profits in financial statements that purport to present the results of operations of the affiliated group unless the profits are realized by an ultimate sale to unrelated third parties. Similarly, the 2013 EDs propose to preclude profit or loss recognition for the portion of the underlying asset retained by the lessor through its residual interest generally until a reassessment that affects the measurement of the residual asset occurs or it is realized through a sale or re-lease (i.e., transfer of control) to an unrelated third party. In the case of a re-lease, the unearned profit or loss would not be fully realized if the lessor continues to retain a residual interest in the underlying asset at the end of the (re-)lease term. This frequently may be the case for underlying assets that the lessor intends to lease a number of times (e.g., a railcar).

Unearned profit or loss generally would equal the difference between the profit or loss that would be recognized at lease commencement under current sales-type (finance) lease accounting and the profit or loss that would be recognized at lease commencement under the 2013 EDs' proposed R&R model for Type A leases.

Reassessments. A lessor would be required to reassess the lease term if:

- There is a change in relevant factors that affect the assessment of whether the lessee has a significant economic incentive to exercise one or more renewal options in the lease contract or not to exercise an option to terminate the lease (refer to the *Lease Classification* section; factors such as changes in market rental rates would not, in isolation, trigger a reassessment of the lease term); or
- The lessee either (a) elects to exercise a renewal or termination option that the lessor had previously determined it did not have a significant economic incentive to exercise, or (b) elects *not* to exercise a renewal or termination option that the lessor had previously determined the lessee had a significant economic incentive to exercise.

A lessor would remeasure the lease receivable at the present value of the remaining lease payments as of the reassessment date using a reassessed discount rate (see discussion below) if any of the following occur:

- There is a change in the lease term as discussed above;
- There is a change in relevant factors that affect the assessment of whether the lessee has a significant economic incentive to exercise an option to purchase the underlying asset (refer to the *Lease Classification* section); or
- There is a change in an index or rate on which variable lease payments are based (the lessor would determine the revised lease payments using the index or rate as of the end of the reporting period).

Lease classification would not be reconsidered upon a reassessment.

Upon remeasurement of the lease receivable as a result of a reassessment of whether the lessee has a significant economic incentive to exercise a lease term or purchase option, the lessor would:

- Adjust the carrying amount of the residual asset to reflect its revised expectation about the estimated residual value of the underlying asset at the end of the revised lease term; and
- Recognize any difference between the carrying amounts of the lease receivable and the residual asset before the remeasurement and their carrying amounts after the remeasurement in net income or loss.

Changes to the lease receivable resulting from changes in variable lease payments based on an index or rate would not impact the residual asset and, therefore, would be fully recorded in net income or loss. The 2013 EDs do not contain any proposed guidance about how to attribute changes in the measurement of payments required by an arrangement that contains both lease and non-lease components due to a reassessment or a change in the factors on which variable payments are based to the components that qualify for separate accounting.

A lessor would reassess the discount rate if there is a change in one or more of the following, unless the possibility of change was reflected in determining the discount rate at lease commencement:

- The lease term;
- Relevant factors that result in the lessee having or ceasing to have a significant economic incentive to exercise an option to purchase the underlying asset; or
- A reference interest rate on which variable lease payments are based.

The revised discount rate would be determined at the date of reassessment in the same manner as at the lease commencement date.

KPMG Observations

The Boards expressed the view that reassessment of the expected lease payments would provide more relevant information to financial statement users because it would reflect current economic conditions rather than using assumptions established at initial measurement throughout the lease arrangement, which the Boards believe could be misleading.

The 2013 EDs propose that entities only reassess lease term and purchase options when there is a change in the evaluation of whether the lessee has a significant economic incentive to exercise the option. The Boards believe that limiting the reassessment requirement to these circumstances would alleviate many of the concerns constituents expressed with respect to the 2010 EDs' proposed reassessment provisions, which would have required reassessments if there were a change in the evaluation of whether it was more likely than not that the lessee would exercise a lease term option.

Regardless of whether the proposed reassessment requirements in the 2013 EDs are less burdensome than those proposed in the 2010 EDs, entities would still need to establish processes and controls to identify changes in facts or circumstances that could affect whether or not the lessee has a significant economic incentive to exercise a lease term or purchase option. This would necessitate cross-functional coordination and the development of appropriate controls to ensure timely identification of changes in facts and circumstances. The changes also would need to be considered on a cumulative basis because small changes each reporting period could accumulate to a significant change over time (e.g., a steady increase in the lessee's sales above initial estimates).

Example 26: Application of the Receivable and Residual Model to a Type A Lease

Lessor leases a machine with a total economic life of 8 years to Lessee for 4 years for annual payments of $16,000, paid in arrears. The lease contains one two-year renewal option during which Lessee would continue to pay $16,000 per year. Lessor concludes that Lessee does not have a significant economic incentive to exercise the renewal option at lease commencement. The machine has a commencement date fair value of $72,000 and a carrying amount of $65,000. Lessee provides a guarantee that the residual value of the machine will be at least $30,000 at the end of the non-cancelable lease term – this is also Lessor's estimated residual value. The amount of the guaranteed residual value is excluded from Lessor's lease receivable and, therefore, Lessor's lease receivable is the present value of the total lease payments of $64,000 due over the 4-year lease term. There are no prepaid lease payments and, for simplicity, assume there are no initial direct costs incurred by Lessor.

The rate Lessor charges Lessee is the rate implicit in the lease, which is 9.57% (i.e., the rate that causes the present value of the lease payments and the estimated residual value to equal the fair value of the machine at lease commencement). Therefore, the present value of the estimated lease payments is $51,189 (the present value of 4 annual payments of $16,000 discounted at 9.57%). Based on the present value of the estimated lease payments and the lease term, the lease would be classified as a Type A lease.

At the lease commencement date, Lessor records the following entries to establish its lease assets, derecognize the leased machine, and record profit:

	Debit	Credit
Lease receivable	51,189	
Gross residual asset*	20,811	
Gain**		4,977
Unearned profit***		2,023
Equipment		65,000

* Present value of $30,000 estimated residual value discounted at 9.57%

** Calculated as (total profit [$72,000 fair value of machine – $65,000 carrying amount of machine = $7,000] × present value of lease payments [$51,189] ÷ fair value of machine [$72,000])

*** Calculated as (total profit [$7,000] – profit recognized at lease commencement [$4,977])

Alternatively, if Lessor is a manufacturer or dealer whose business model is to effectively sell its equipment inventory through leasing transactions, Lessor would record profit on the lease on a gross basis as:

	Debit	Credit
Lease receivable	51,189	
Gross residual asset	20,811	
Cost of goods sold****	46,212	
Unearned profit		2,023
Inventory		65,000
Revenue		51,189

**** Calculated as (revenue [$51,189] – upfront profit [$4,977]) or as (carrying amount of machine [$65,000] × present value of lease payments [$51,189] ÷ fair value of machine [$72,000])

The lease assets as of the lease commencement date are included in the table below (Year 0). In each year of the lease, Lessor receives its fixed annual lease payment of $16,000 from Lessee and recognizes: (1) receipt of the lease payment, (2) interest on the lease receivable determined using the effective interest method, and (3) accretion of (interest on) the gross residual asset determined using the effective interest method. Lessor records the following entry under this lease at the end of Year 1:

Cash	16,000	
Gross residual asset+	1,992	
Lease receivable++		11,099
Interest income+++		6,893

+ Day 1 gross residual asset of $20,811 × 9.57%

++ $16,000 cash payment – interest on lease receivable calculated as (carrying amount of lease receivable [$51,189] × rate Lessor charges Lessee [9.57%] = $4,901)

+++ Calculated as ($1,992 accretion of gross residual asset + $4,901 interest on lease receivable)

The following table shows the changes in the balances of the lease assets and the lease's impact on Lessor's statement of comprehensive income over the lease term.

	Statement of financial position				Statement of comprehensive income		
End of Yr	Lease receivable	Gross residual asset	Unearned profit on residual asset	Carrying amount of net residual asset	Interest on lease receivable	Accretion of gross residual asset	Net income
0	$51,189	$20,811	$2,023	$18,788	$ -	$ -	$ 4,977
1	40,090	22,803	2,023	20,780	4,901	1,992	6,893
2	27,928	24,987	2,023	22,964	3,838	2,184	6,022
3	14,602	27,379	2,023	25,356	2,674	2,392	5,066
4	-	30,000	2,023	27,977	1,398	2,621	4,019
Totals					**$12,811**	**$9,189**	**$26,977**

At the end of the lease, Lessor reclassifies the residual asset to property, plant, and equipment (PP&E) (or inventory, if appropriate, depending on the circumstances):

PP&E (inventory)	27,977	
Unearned profit	2,023	
Gross residual asset		30,000

Reassessment

Alternatively, assume that at the end of Year 2 Lessor determines that Lessee now has a significant economic incentive to exercise the two-year renewal option. Assume further that at the end of Year 2 the machine has a fair value of $62,600. The carrying amounts of Lessor's lease receivable and net residual asset are

$27,928, and $22,964, respectively, at the end of Year 2. The contract states that if Lessee elects the two-year renewal option, the guaranteed residual value decreases from $30,000 to $15,000. Upon reassessment, Lessor estimates that the residual value of the machine will be $15,000 at the end of the revised lease term. The revised interest rate implicit in the lease is 8.91%.

Upon reassessment, Lessor would record the following entry:

	Debit	Credit
Lease receivable†	24,010	
Unearned profit††	29	
Gross residual asset†††		14,325
Gain††††		9,714

† Calculated as (post-reassessment lease receivable [4 fixed payments of $16,000 discounted at 8.91% = $51,938] – lease receivable carrying amount immediately before reassessment [$27,928])

†† Calculated as (unearned profit prior to reassessment [$2,023] – unearned profit upon reassessment [total profit of $11,708 calculated as ($62,600 fair value of machine at reassessment – $27,928 carrying amount of lease receivable immediately before reassessment – $22,964 carrying amount of net residual asset immediately before reassessment) – profit recognized upon reassessment of $9,714 calculated as (total profit [$11,708] × present value of lease payments upon reassessment [$51,938] ÷ fair value of machine upon reassessment [$62,600]) = $1,994])

††† Calculated as (carrying amount of gross residual asset prior to reassessment [$24,987] – present value of gross residual asset upon reassessment [$15,000 estimated residual value discounted at 8.91% = $10,662])

†††† Calculated as (total profit [$11,708] × post-reassessment present value of lease payments [$51,938] ÷ fair value of machine upon reassessment [$62,600]). This would be presented on a gross basis as revenue ($24,010) and cost of goods sold ($14,296 calculated as [$24,010 – $9,714 profit recognized upon reassessment]) if the lessor utilized a gross presentation at lease commencement.

Subsequent to recording the above adjustments, Lessor's accounting for the remainder of the lease would follow the same process as outlined above. The following table shows the changes in the balances of the lease assets and the lease's impact on Lessor's statement of comprehensive income over the reassessed lease term.

	Statement of financial position				Statement of comprehensive income		
End of Yr	Lease receivable	Gross residual asset	Unearned profit on residual asset	Carrying amount of net residual asset	Interest on lease receivable	Accretion of gross residual asset	Net income
0	$51,189	$20,811	$2,023	$18,788	$ -	$ -	$ 4,977
1	40,090	22,803	2,023	20,780	4,901	1,992	6,893
2	27,928	24,987	2,023	22,964	3,838	2,184	6,022
2R[a]	51,938	10,662	1,994	8,668	-	-	9,714
3	40,566	11,612	1,994	9,618	4,628	950	5,578
4	28,180	12,646	1,994	10,652	3,614	1,034	4,648
5	14,691	13,773	1,994	11,779	2,511	1,127	3,638
6	-	15,000	1,994	13,006	1,309	1,227	2,536
Totals					**$20,801**	**$8,514**	**$44,006**

[a] Revised balances upon reassessment at the end of Year 2.

At the end of the lease, Lessor reclassifies the residual asset to PP&E (or inventory, if appropriate, depending on the circumstances):

	Debit	Credit
PP&E (inventory)	13,006	
Unearned profit	1,994	
Gross residual asset		15,000

Impairment

As a final variation on this example, assume that at the end of Year 5 Lessee defaults on the lease because it does not make the required lease payment. Lessor measures the allowance for expected losses on the lease receivable using applicable financial instruments guidance. Because Lessee did not make its required lease payment, Lessor has the right to repossess the machine. By taking possession of the machine at the end of Year 5, Lessor expects that it could sell the machine for $25,000. Lessor's estimate of the value it will be able to derive from the machine at the end of the lease term (i.e., the residual value) is still $15,000.

In measuring the impairment allowance, Lessor calculates the portion of the collateral allocable to the lease receivable as the difference between the cash flows that would result from sale of the machine if repossessed (i.e., $25,000) and those that Lessor allocates to the residual asset (i.e., the gross residual asset of $13,773 at the end of Year 5), which equals $11,227. The difference between the lease receivable at the end of Year 5 ($14,691) and the portion of the collateral allocated to the lease receivable ($11,227) of $3,464 is recorded to expense (assuming no prior impairment allowance had been recognized) as:

	Debit	Credit
Bad debt expense	3,464	
Lease receivable		3,464

Assume Lessee does not remediate the default and Lessor repossesses the machine. Lessor records the machine as PP&E (or inventory if appropriate, depending on the circumstances) at the sum of the remaining lease receivable ($11,227) plus the net residual asset at the end of Year 5 ($11,779), which effectively equals the estimated price for which Lessor could sell the machine ($25,000) less the existing unearned profit ($1,994):

	Debit	Credit
PP&E (inventory)	23,006	
Unearned profit	1,994	
Lease receivable		11,227
Gross residual asset		13,773

Upon sale of the machine to a third-party at the estimated amount of $25,000, Lessor records the following entry:

	Debit	Credit
Cash	25,000	
PP&E (inventory)		23,006
Gain		1,994

If the sale proceeds were different from the amount estimated by Lessor upon recognizing the impairment charge, the gain or loss would not be the same as the unearned profit prior to reclassifying the lease receivable and residual asset to PP&E (or inventory if appropriate, depending on the circumstances). For example, if the machine were sold for $24,500, the gain would be $1,494 rather than $1,994.

KPMG Observations

The Boards will need to clarify the language in the 2013 EDs on how to determine the profit or loss from a reassessment that affects the measurement of the residual asset. It is likely that the Boards intend for a revised amount of unearned profit or loss to be determined in the same manner as it would be determined at lease commencement. However, the language could be read to suggest that any unearned profit or loss would be eliminated. In Example 26, this would result in profit of $11,708 upon the reassessment rather than profit of $9,714. Elimination of unearned profit or loss on the residual asset when it will have a carrying amount greater than zero would be inconsistent with the partial sale concept underlying the R&R model. The approach illustrated in Example 26 is consistent with the methodology used to determine profit or loss at lease commencement and with the partial sale concept underlying the R&R model.

Example 27: Type A Lease with Variable Lease Payments

Lessor leases a machine that it has manufactured to Lessee. The machine has a carrying amount of $50,000 and a fair value of $57,000 at lease commencement. The lease term is 5 years with no renewal options, and the machine has an estimated total economic life of 15 years. The lease payments are $5,000 annually paid in arrears and $500 per hour for every machine hour of operation in excess of 2,500 hours per year. Lessor estimates that Lessee will operate the machine for the following number of hours during the lease: Year 1 – 2,510; Year 2 – 2,520; Year 3 – 2,506; Year 4 – 2,505; and Year 5 – 2,490, which means that Lessee would pay Lessor $20,500 in variable lease payments during the lease term. Lessor's estimated residual value for the machine at the end of the lease is $30,000 and is not expected to be significantly affected by the number of hours Lessee operates the machine.

The rate Lessor charges Lessee is the rate implicit in the lease (i.e., the rate that causes the present value of the lease payments and the estimated residual value to equal the fair value of the machine at lease commencement), which is 8.45%. The calculation of the rate implicit in the lease includes Lessor's estimate of the variable lease payments it expects to collect from Lessee based on expected usage of the leased machine.

Lessor's lease receivable at the lease commencement date is $19,729 (the fixed lease payments of $25,000 discounted at the rate Lessor charges Lessee), and its net residual asset is $32,694 (the present value of the $30,000 estimated residual value [$19,998] + the present value of the estimated $20,500 in variable lease payments included in the calculation of the discount rate [$17,273] – the unearned profit of $4,577 in this lease). Unearned profit is determined as total profit (fair value of the machine [$57,000] – carrying amount of the machine [$50,000]) less profit recognized at lease commencement (total profit [$7,000] × present value of lease payments [$19,729] ÷ fair value of the machine [$57,000]). The variable lease payments, while considered in the determination of the rate Lessor charges Lessee and, therefore, included in Lessor's net residual asset, are excluded from the estimated lease payments included in Lessor's lease receivable because they are not based on an index or rate and are not in-substance fixed payments. Therefore, Lessor's initial accounting for this lease at lease commencement is:

	Debit	Credit
Lease receivable	19,729	
Residual asset (net)	32,694	
Cost of goods sold*	17,306	
Inventory		50,000
Revenue*		19,729

* Because Lessor is a manufacturer of the leased equipment, it recognizes the profit at lease commencement on a gross basis. Cost of goods sold is determined as (revenue – profit

recognized at lease commencement). It can also be determined as (present value of lease payments [$19,729] ÷ fair value of the machine [$57,000] × carrying amount of the machine [$50,000]).

The initial lease assets as of the lease commencement date are included in the table below (Year 0). At the end of each year of the lease Lessor receives its fixed annual lease payment of $5,000 from Lessee plus any variable consideration due from Lessee based on usage overages, at which point Lessor will recognize: (1) receipt of the lease payment, (2) interest income on the lease receivable, (3) accretion of the gross residual asset, and (4) the variable lease payments earned as current period income. At the end of each year of the lease Lessor also will *derecognize* the applicable portion of the net residual asset based on Lessor's estimate of variable lease payments for the period and in total at lease commencement. Assume Lessee's actual variable lease payments equal those estimated by Lessor at lease commencement. The following entry is what Lessor records at the end of Year 1 when it receives its first annual lease payment of $5,000 plus the variable lease payment of $5,000 for usage overages:

	Debit	Credit
Cash	10,000	
Cost of goods sold**	3,696	
Residual asset (net)***		2,006
Lease receivable		3,333
Interest income****		3,357
Revenue		5,000

** Portion of residual asset attributable to estimated variable lease payments derecognized, calculated as (estimated variable lease payments in current period [$5,000] ÷ estimated variable lease payments for lease term [$20,500]) × present value at lease commencement of total estimated variable lease payments [$17,273] × carrying amount of machine at lease commencement [$50,000] ÷ fair value of machine at lease commencement [$57,000])

*** Calculated as (portion of residual asset attributable to estimated variable lease payments derecognized [$3,696] – accretion of gross residual asset [Day 1 gross residual asset of $19,998 × 8.45% = $1,690])

**** Calculated as (accretion of gross residual asset [$1,690] + interest on lease receivable [$1,667])

The following table shows the changes in the balances of the lease assets and the lease's impact on Lessor's statement of comprehensive income over the lease term.

	Statement of financial position		Statement of comprehensive income				
Yr	Lease receivable	Carrying amount of net residual asset[a]	Lease (sales) revenue	Cost of goods sold	Interest on lease receivable	Accretion of gross residual asset	Net income
0	$19,729	$32,694	$19,729	$17,306	$ -	$ -	$ 2,423
1	16,396	30,688	5,000	3,696	1,667	1,690	4,661
2	12,781	25,129	10,000	7,391	1,385	1,832	5,826
3	8,861	24,900	3,000	2,217	1,080	1,988	3,851
4	4,610	25,207	2,500	1,848	749	2,155	3,556
5	-	27,544	-	-	390	2,337	2,727
	Totals		**$40,229**	**$32,458**	**$5,271**	**$10,002**	**$23,044**

[a] The change in the net residual asset each period = prior balance + accretion of gross residual asset – portion of the residual asset attributable to variable lease payments derecognized in the period. The amount at the end of each period is net of unearned profit of $4,577.

At the end of the lease, Lessor reclassifies the residual asset to PP&E (or inventory if appropriate, depending on the circumstances):

	Debit	Credit
PP&E (inventory)	27,544	
Residual asset (net)		27,544

In this type of lease scenario, based on the 2013 EDs' proposals, at the end of the lease the net residual asset of $27,544 plus the unearned profit of $4,577 will not equal the estimated residual value of the underlying asset estimated at lease commencement of $30,000. This is because the amount of the reduction to the residual asset over the lease term that relates to estimated variable lease payments is based on an allocation of the underlying asset's carrying amount at lease commencement whereas the amount included in the carrying amount of the residual asset at lease commencement that relates to estimated variable lease payments is determined as the present value of the estimated variable lease payments discounted at the rate Lessor charges Lessee (which is a function of the underlying asset's fair value). Consequently, the portion of total profit on the lease that relates to estimated variable lease payments is included in both the gross residual asset and the unearned profit throughout the lease term. At the end of the lease, the components of the $27,544 net residual asset would be (gross residual asset [$30,000] + remaining balance related to estimated variable lease payments [$17,273 original present value of estimated variable lease payments included in calculating the discount rate – $15,152 portion of net residual asset derecognized during the lease term related to estimated variable lease payments included in calculating the discount rate = $2,121] – unearned profit [$4,577]).

Operating Lease Model (Type B and Short-Term Leases)

Type B lessors, as well as those that elect not to apply the 2013 EDs' recognition and measurement requirements to short-term leases, would apply a lessor model substantially similar to operating lease accounting under current GAAP. For such leases, the lessor would continue to recognize the underlying asset, and continue to depreciate it over its estimated useful life. Lease payments under the contract would be recorded as receivables only when they are due and payable, and lease income would be recognized on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which income is earned from the underlying asset, in which case that basis would be used.

KPMG Observations

The proposed lessor accounting for Type B leases is – in broad terms – similar to current operating lease accounting. It is likely to be particularly welcomed by lessors of real estate.

However, the proposed lessor accounting for Type B leases is not consistent with the Boards' initial objective of recognizing the assets and liabilities that arise from lease contracts. For example, in a Type B lease a lessee would recognize a financial liability for its obligation to make lease payments; however, the lessor would not recognize a corresponding financial asset for its right to receive those lease payments.

Unlike the lessee accounting proposals for Type B leases, the 2013 EDs' lessor accounting proposals for Type B leases do not include any proposed reassessment requirements. Although the factors that affect the determination of the lease term and lease payments could change after lease commencement and the Boards have decided that the accounting for all other leases should reflect changes in those factors as they occur, the Boards did not address reassessments of Type B leases for lessors.

Lessor Financial Statement Presentation

The 2013 EDs propose that a lessor would present the items arising from lease contracts as follows:

Statement of Financial Position – Type A Leases

- Present lease assets (i.e., the total of lease receivables and residual assets) separately from other assets; and
- If not presented separately on the balance sheet, disclose the carrying amounts of lease receivables and residual assets in the notes to the financial statements.

Statement of Comprehensive Income – Type A Leases

- Either (a) present total lease income in the statement of comprehensive income, or (b) disclose total lease income in the notes to the financial statements, including disclosure of the line item(s) that includes lease income;
- Present profit or loss at lease commencement in a manner that best reflects the lessor's business model:
  - If the lessor uses lease arrangements for the purpose of financing, then the lessor would present profit or loss at lease commencement on a net basis in a single line item (e.g., as a gain within other comprehensive income);
  - If the lessor uses leases as an alternative to selling (e.g., many manufacturers and dealers), then the lessor would present profit or loss at lease commencement on a gross basis as separate line items (e.g., as revenue and cost of goods sold).

    The 2013 EDs do not propose guidance on how the lessor would determine the amount of revenue and cost of goods sold to record if the profit or loss from the transaction recognized at lease commencement is presented on a gross basis. However, under current GAAP, revenue for sales-type (finance) leases generally is equal to the present value of the lease payments while cost of goods sold generally is equal to the carrying amount of the underlying asset minus the present value of the estimated unguaranteed residual value. Using that approach in the R&R model, the revenue recognized would equal the present value of the lease payments at lease commencement, while the cost of goods sold would equal the carrying amount of the underlying asset minus the carrying amount of the residual asset at lease commencement.

Statement of Cash Flows – Type A Leases

Classify all lease payments received as operating cash flows. Lessors applying the indirect method would present changes in the lease receivable separately from changes in other operating receivables. Lessors applying the direct method would present the cash flows from lease payments separately from other cash flows from operating activities.

Type B Leases

A lessor would present items arising from Type B leases in the same manner as under current operating lease accounting. The underlying asset and related depreciation expense would continue to be presented using other GAAP.[36] Lease income and expense would similarly be presented in the statement of comprehensive income in the same manner as they are under current GAAP, and all cash receipts from leases would be classified as operating activities in the statement of cash flows.

Leveraged Leases

Leveraged leases are a unique class of leases under current U.S. GAAP that are financed by lessors using non-recourse debt and meet certain other criteria. The FASB considered the possibility of retaining the current lessor accounting model for leveraged leases because many leases are partially financed by recourse debt and others are partially financed by non-recourse debt. However, the FASB ultimately decided to propose eliminating this accounting model. As a result, the 2013 EDs' proposed lessor accounting requirements would be applied to existing leveraged leases retrospectively as of the effective date of the final standard.

KPMG Observations

The FASB decided to propose eliminating the current accounting model for leveraged leases because it believes that the cash inflows from the tax attributes of an underlying asset are the same for the lessor regardless of whether it finances the asset with recourse or non-recourse debt. The FASB does not believe that differences in the method of financing or differences in tax impacts should affect the pattern of income recognition or presentation in the statement of financial position as leveraged lease classification currently does. Also, eliminating this model would promote convergence with IFRS.

Leveraged leases likely would be accounted for as Type A leases under the R&R model based on the similarities associated with the current direct finance lease criteria that apply to a leveraged lease. However, gross asset and liability presentation under the R&R model of an existing leveraged lease currently presented net of the non-recourse debt on the lessor's statement of financial position may have a significant impact on financial covenant ratios requiring an assessment of ongoing financial covenant compliance, ratings agency communications, analysts' evaluations and forecasts, and a potential consideration of regulatory capital requirements. In addition, the timing of income and expense recognition from the lease and related income tax effects are likely to be significantly different under the proposals than under current leveraged lease accounting.

Leveraged lease transactions have historically been highly tax-motivated transactions and the tax benefits received by the lessor have been an integral part of the accounting for the transaction. Under the 2013 EDs, the accounting for all leases would be on a pre-tax basis. As a result, transactions that would be classified as leveraged leases under current U.S. GAAP may become less desirable to lessors. Also, some lessors may seek to dispose of highly tax-advantaged leases in preparation for the new standard to avoid significant charges to retained earnings in some cases on adoption and ongoing pre-tax U.S. GAAP losses after adoption.

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[36] FASB ASC Topic 360, Property, Plant, and Equipment, available at www.fasb.org; IAS 16, Property, Plant and Equipment; and IAS 40, Investment Property.

Subleases

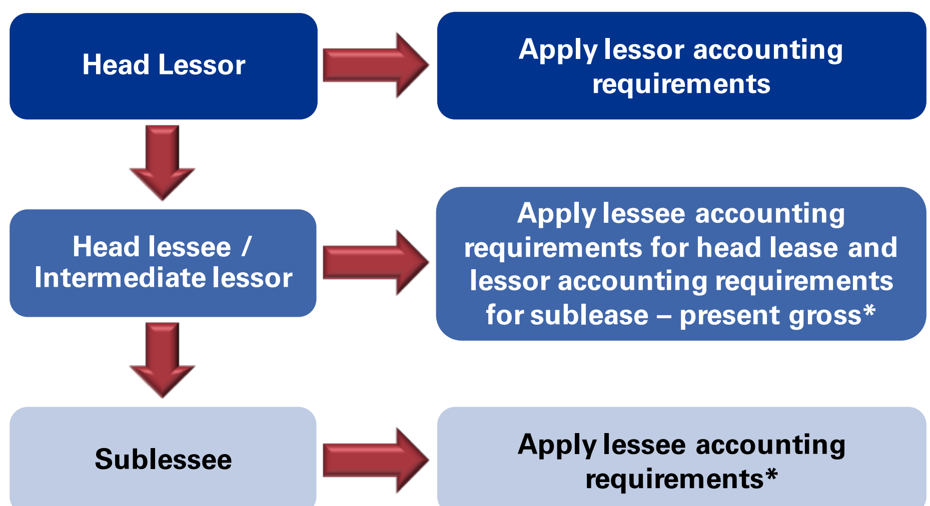
The 2013 EDs define a sublease as a transaction in which an underlying asset is re-leased by the original lessee (or intermediate lessor) to a third party, and the lease (or head lease) between the original lessor and lessee remains in effect.

The 2013 EDs propose that an intermediate lessor (as the lessee in a head lease) would classify and account for the head lease in accordance with the lessee accounting proposals. Similarly, it would classify and account for the sublease in accordance with the lessor accounting proposals. To determine the classification of the sublease, the sublessee and intermediate lessor would consider the underlying asset in the head lease, not the ROU asset arising under the head lease.

In a sublease that is classified as a Type A lease by the intermediate lessor, a portion of the right-of-use asset recognized under the head lease would be derecognized and the remainder would be classified as a residual asset.

The 2013 EDs' proposals would require the intermediate lessor to present or disclose the liability to make lease payments and the right-of-use asset under the head lease. When applying the receivable and residual model to a sublease classified as a Type A lease, the intermediate lessor would present or disclose its right to receive lease payments and residual right-of-use assets separately from other financial assets and residual assets that arise from lease contracts (i.e., leases in which the entity is the head lessor).

An intermediate lessor would present the head lease and the sublease on a gross basis in the statement of comprehensive income and statement of cash flows in accordance with the lessee (for the head lease) and lessor (for the sublease) presentation requirements.



* Sublease classification based on underlying asset, not ROU asset.

KPMG Observations

In practice, subleases are very common and there are some arrangements that intermediate lessors treat as a pass-through. Applying the right-of-use model would result in significantly different accounting for subleases than under current GAAP. For example, consider an intermediate lessor that currently accounts for both the head lease and the sublease as operating leases. Under the 2013 EDs' proposals, the intermediate lessor would recognize a right-of-use asset and lease liability on the head lease and, depending on the lease classification, may record a lease receivable and a residual right-of-use asset on the sublease. Conversely, under current GAAP, the intermediate lessor would recognize only prepaid or accrued rentals or an accrued loss to the extent one was expected.

The 2013 EDs do not propose any recognition or measurement exceptions for subleases. In practice, this could lead to frequent asymmetry between the way in which an intermediate lessor accounts for a head lease and a sublease relating to the same underlying asset. Intermediate lessors would be required to account for many such arrangements on a gross basis even if the terms of the head lease and sublease are similar. The asymmetry would be particularly pronounced for a head lease and sublease that are classified as Type B leases. In this case, the intermediate lessor would recognize a financial liability for its obligation to pay rentals to the head lessor, but would not recognize a financial asset for its right to receive rentals from the sublessee.

Depending on the facts and circumstances, an intermediate lessor may be required to measure the lease liability relating to a head lease differently from its lease receivable relating to a Type A sublease of the same underlying asset. Differences may arise that relate to the inclusion of certain lease payments when measuring the respective assets and liabilities and determining the appropriate discount rate.

Many lessees and sublessors will find the 2013 EDs' proposal to consider the underlying asset leased under the head lease to be the underlying asset for purposes of sublease classification to be more intuitive than considering the head lease right-of-use asset to be the underlying asset for purposes of sublease classification. However, depending on the timing of the sublease and the specific facts and circumstances surrounding the underlying asset, the lease classification of the sublease and head lease may be different. For example, a lessee of real estate might classify the lease as a Type B lease because it concluded there was not a significant economic incentive to exercise a renewal option that, if included in the lease term, would cover a major part of the underlying asset's economic life or result in a present value of estimated lease payments that is substantially all of the fair value of the underlying asset. If the lessee subsequently exercised that renewal option without modifying the lease and then subleased the asset for the remaining term of the head lease, the sublease likely would be accounted for under the receivable and residual model (i.e., as a Type A lease) rather than as an operating lease (i.e., a Type B lease).

Example 28: Sublease with Different Lease Classification than Head Lease

Company X leases an office building with a fair value of $15 million at lease commencement from Lessor Y for a non-cancelable term of five years, with fixed lease payments of $900,000 per year (which is a fair market rate) made in arrears. The lease contains six, five-year renewal options at the same annual lease rate. There are no penalties for failing to renew the lease. Company X determines that it does not have a significant economic incentive to exercise any of the renewal options. It is planning to construct its own headquarters building prior to the end of the non-cancelable lease term. Company X concludes that its building lease is a Type B lease based on the present value of the estimated lease payments and the expected lease term. Company X uses its incremental borrowing rate of 6% to discount its lease payments under the contract.

Two years after commencement of the non-cancelable lease term, Company X completes construction of its own office building and enters into a sublease with Company Z for the remaining term of its lease with Lessor Y. The fair value of the leased office building is now $15.5 million. Company Z has just built expensive new manufacturing facilities in the vicinity, so agrees to a sublease rental rate of $1,100,000 per year, also paid in arrears (Company X grants Company Z a sublease with the same renewal options, albeit at higher rental rates, as it has in the head lease with Lessor Y). Company X determines, based on Company Z's planned leasehold improvements and location, that Company Z has a significant economic incentive to renew the lease four times, resulting in a lease term of 23 years. Company Z's incremental borrowing rate and the rate Company X charges Company Z is 5%. Company X's incremental borrowing rate is now also 5%. Company X classifies the sublease as a Type A lease because the present value of the estimated lease payments is substantially all of the fair value of the building at sublease commencement ($14.8 million ÷ $15.5 million = 95%).

Company X's accounting at head lease commencement would be:

	Debit	**Credit**
Right-of-use asset	3,791,127	
Lease liability		3,791,127

To record the lease of the property from Lessor Y at market rates at lease commencement.

Upon entering into the sublease agreement with Company Z, Company X would adjust its accounting for the head lease as follows:

Right-of-use asset	9,734,005	
Lease liability		9,734,005

Calculated as (present value of $900,000 per year for 23 years discounted at 5% [$12,139,716] less remaining lease liability balance at end of Year 2 of the initial non-cancelable five-year lease term [$2,405,711])

To update the head lease accounting to an estimated remaining lease term of 23 years.

Company X would record the sublease with Company Z at the sublease commencement date as follows:

Lease receivable	14,837,431	
Right-of-use asset		12,139,716
Gain		2,697,715

The right-of-use asset amount is determined as the remaining unamortized balance of the right-of-use asset after the $9,734,005 adjustment for reassessment of the lease liability.

To record the Type A sublease at sublease commencement under the receivable and residual model.

Company X expects to return the building to Lessor Y upon the conclusion of the sublease to Company Z and, therefore, has no residual interest in its right-of-use asset. After recording the above entries, Company X's balance sheet would reflect a lease receivable under the sublease and a liability to make lease payments under the head lease, which would not be netted against one another. Its head lease right-of-use asset would be derecognized and no residual asset would be recognized for the reasons outlined.

Sale-Leaseback Transactions

A sale-leaseback transaction involves the sale (or transfer) of an asset and its subsequent leaseback by the seller. Under current GAAP, sale-leaseback transactions result in off-balance-sheet accounting for the seller-lessee when a sale is recognized and the lease is classified as an operating lease. Sale-leaseback transactions would no longer be fully off-balance sheet under the 2013 EDs' proposals because all leases other than some short-term leases would be required to be recognized in the lessee's balance sheet. However, it would be possible for a seller-lessee to reduce its total assets by entering into a sale-leaseback transaction in cases where the amount of the right-of-use asset recognized at the date of the sale-leaseback transaction is less than the carrying amount of the underlying asset immediately before the sale-leaseback occurs.

The 2013 EDs propose that a sale and leaseback of the underlying asset would be recognized if the requirements for sale recognition in the forthcoming revenue recognition standard are met; otherwise, the transaction would be accounted for as a financing. The existence of the leaseback would not, on its own, result in a conclusion that the buyer-lessor did not obtain control of the underlying asset under the forthcoming revenue recognition standard's provisions. Although a seller-lessee may direct the use of, and obtain significant benefits from using, the underlying asset over the leaseback term, the buyer-lessor's right to receive lease payments and obtain possession of the underlying asset at the end of the lease term would be considered when evaluating whether the buyer-lessor obtained substantially all of the underlying asset's benefits upon entering into the sale-leaseback transaction.

However, even if there were no other factors preventing sale accounting under the forthcoming revenue recognition standard's provisions (e.g., the sale agreement contains an option for the seller-lessee to repurchase the underlying asset or includes a put option that the buyer-lessor has a significant economic incentive to exercise), the 2013 EDs propose that a sale-leaseback transaction would be accounted for as a financing by the seller-lessee and buyer-lessor rather than a separate sale and leaseback if:

- The lease term is for a major part of the remaining economic life of the underlying asset; or
- The present value of the lease payments amounts to substantially all of the fair value of the underlying asset.

For example, if a seller-lessee sells equipment with a 5-year remaining economic life to a buyer-lessor, while concurrently entering into a lease for which the lease term is for a major part of the remaining economic life (e.g., 4 years) of the equipment and/or in which the present value of the lease payments amounts to substantially all (e.g., 95%) of the equipment's fair value, the transfer of control criteria would not be met and the transaction would be accounted for as a financing rather than a sale-leaseback.

Conversely, an entity that sells a building with a 40-year remaining economic life to a buyer, while concurrently entering into a lease for which the lease term is for less than a major part of the remaining economic life (e.g., 15 years) of the building and in which the present value of the lease payments to be made over the lease term is less than substantially all (e.g., 60%) of the fair value of the building would recognize a sale and leaseback if the other conditions for sale accounting in the forthcoming revenue recognition standard are met.

The seller-lessee would recognize a gain or loss on sale transactions not accounted for as financings based on the sale price if the sale price and leaseback payments are at market rates. If the sale price or the leaseback payments are not at market rates, the seller-lessee would measure its lease liability and right-of-use asset to reflect current market lease payments for use of the asset rather than the contractual payments. The seller lessee would adjust the gain or loss recognized on the sale for the difference between the present value of the contractual payments and the present value of the market payments and recognize an offsetting financial asset or liability. The buyer-lessor would similarly adjust the acquisition date carrying amount it assigns to the purchased asset (if the leaseback is classified as a Type B lease) or to the measurement of the receivable and residual asset (if the leaseback is classified as a Type A lease) to reflect current market rates, with an offsetting financial asset or liability (i.e., the converse to what the seller-lessee would record).

The 2013 EDs propose that seller-lessees disclose information on their sale-leaseback transactions including the principal terms of the arrangements, as well as any gains or losses recognized.

KPMG Observations

Recognition of a Sale. Feedback provided to the Boards in response to their 2011 revenue EDs indicated that it was unclear to constituents how the Boards intended the proposed revenue recognition guidance to apply to sale-leaseback transactions.[37] Principally, it was unclear whether a sale would meet the proposed transfer of control criteria when an entity sells an asset and immediately leases it back. A vendor would recognize revenue on the sale of a good when it satisfies a performance obligation by transferring control of that good (i.e., an asset) to a customer. Satisfaction would occur when the customer has the ability to direct the use of, and receive substantially all the remaining benefits from, the transferred good. Control also includes the customer's ability to prevent other entities from directing the use of, and obtaining the benefit from, the good. The forthcoming revenue recognition standard includes the following indicators, none of which are necessarily determinative, that control of an asset has been transferred to a buyer:

- The seller has a present right to payment for the asset;
- The buyer has legal title to the asset;
- The seller has transferred physical possession of the asset;
- The buyer has the significant risks and rewards of ownership of the asset;
- The customer has accepted the asset.

The 2013 EDs effectively propose overriding the revenue recognition guidance. Under the revenue recognition model, the seller would recognize revenue only when the buyer obtains control of the asset being sold. The proposals in the 2013 EDs would provide for the seller-lessee to recognize a sale if it *relinquishes* control of the underlying asset (i.e., the leaseback does not provide the seller-lessee with the ability to direct the use of and obtain substantially all of the remaining benefits from the asset) but would not require the buyer-lessor to *obtain* control as outlined in the revenue recognition guidance for sale recognition to occur. Consider the following example:

> Seller A sells machines with a five-year remaining economic life to Buyer B. Seller A and Buyer B agree that Seller A will not deliver the machines for two years. Until delivery of the machines, Seller A is free to use them if it wants to, and Buyer B will receive a refund of part of the purchase price from Seller A during the two-year period. The present value of the refund is equal to half the sales price.

Under the guidance in the forthcoming revenue recognition standard, Buyer B must obtain control of the machines (including the ability to receive substantially all of their remaining benefits) for Seller A to recognize a sale. In this example, Buyer B does not meet that requirement at the date of the sale because (among

[37] FASB Proposed Accounting Standards Update, Revenue from Contracts with Customers, November 14, 2011, available at www.fasb.org, and IASB ED/2011/6, Revenue from Contracts with Customers, November 2011, available at www.ifrs.org.

other reasons) Buyer B does not obtain substantially all of the remaining benefits from the machines. However, if the arrangement was structured as a sale-leaseback rather than a bill-and-hold transaction, Seller A would be *required* to recognize a sale and a leaseback upon entering into the transaction because Seller A does not retain substantially all of the remaining benefits from the machines.

Separate Contracts for the Sale and Leaseback. The 2010 EDs contained proposed guidance that transfer and lease contracts resulting in a sale-leaseback must be (a) entered into at or near the same time, (b) negotiated as a package with a single commercial objective, or (c) performed either concurrently or consecutively, and the transfer must meet the conditions for a purchase and sale. The 2013 EDs do not contain similar proposed guidance specific to sale-leaseback transactions, or on whether (or when) a company would combine multiple lease contracts. Therefore, it is unclear whether the parties to the transaction would be required to combine two separate contracts for the sale or purchase of an asset and its subsequent leaseback to the seller. This may call into question whether the parties would have to account for any off-market leaseback terms when recording the sale transaction. If the sale and the leaseback were treated as separate arrangements, the sale presumably would be evaluated and accounted for based on the forthcoming revenue recognition standard for the seller-lessee and at the cost of the asset for the buyer-lessor, while the leaseback would be accounted for using the leases standard without consideration of the sale.

A seller-lessee would need to consider whether the contract combination guidance in the forthcoming revenue recognition standard would apply. The forthcoming revenue recognition standard requires that entities combine two or more contracts entered into at or near the same time with the same *customer* (or related parties) and account for the contracts as a single contract if one or more of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective;
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract;
- The goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation.

Therefore, a seller-lessee would be required to combine separate sale and leaseback contracts only if the buyer-lessor meets the definition of a customer and the separate contracts meet the criteria above.[38] A buyer of an asset in a sale-leaseback transaction may not be a customer; therefore, it is unclear whether separately written contracts for the sale and leaseback would be combined or be evaluated for combination using the criteria above. Sales of nonfinancial assets that are not part of an entity's ordinary activities are subject to the control, measurement, and contract identification requirements of the revenue model; however, the contract combination requirements do not apply to those sales. If the two agreements are not considered a single contract, the seller-lessee may:

- Conclude that it has not completed a sale under the proposed revenue guidance based on a standalone evaluation thereof;
- Conclude that a sale has occurred (i.e., rather than a financing), irrespective of whether the lease term is for a major part of the remaining economic life of the underlying asset or the present value of the minimum lease payments amounts to substantially all of the fair value of the underlying asset; or

[38] The 2011 Revenue EDs define a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities."

- Conclude that it can ignore off-market leaseback terms in its accounting for the sale transaction.

It is unlikely that the Boards intend for the sale transaction to be considered separate from the lease solely as a result of entering into separate contracts as the Boards note in the Basis for Conclusions to the 2013 EDs that the sale and leaseback transactions are often interdependent and that the control principle in the forthcoming revenue recognition standard should be applied to the sale-leaseback transaction as a whole, rather than solely to the sale. However, the absence of proposed guidance in the 2013 EDs results in the potential for confusion in this area.

Comparison to Existing GAAP. Although the 2013 EDs' proposals on when an arrangement qualifies for sale-leaseback accounting are similar in some respects to current requirements under IFRS, they would be significantly different from current U.S. GAAP. Under IAS 17 the seller-lessee effectively bypasses the sale of goods criteria in IAS 18 and accounts for the transaction as a sale and a leaseback in which the lease is accounted for under IAS 17 unless the arrangement does not have the substance of a lease based on the guidance in SIC 27.[39] If the leaseback is classified as a finance lease under IAS 17, then any gain on the sale is deferred and amortized over the lease term. If the leaseback is classified as an operating lease under IAS 17 and the sale price is at fair value, any gain or loss on the sale is recognized immediately. If the leaseback is classified as an operating lease and the sale price is not at fair value, IAS 17 generally requires the difference between the sale price and the fair value of the asset to be deferred and amortized in proportion to the lease payments over the leaseback term. Under current U.S. GAAP, equipment sale-leasebacks automatically qualify for sale and leaseback accounting but real estate sale-leasebacks do not. However, under current U.S. GAAP, a gain on a sale-leaseback transaction accounted for as a sale in which the fair value of the asset is not less than its carrying amount generally is deferred and amortized over the lease term regardless of whether the leaseback is classified as an operating or capital lease.[40]

The Boards proposed that a purchase option at *any* exercise price held by the seller-lessee in a sale-leaseback transaction would result in the transaction being accounted for as a financing. Sale-leasebacks of equipment in the U.S. often contain an option for the seller-lessee to purchase the equipment, which does not preclude accounting for the transaction as a sale under current U.S. GAAP. However, current U.S. GAAP prohibits sale accounting for real estate sale-leasebacks if the seller-lessee has any continuing involvement (including purchase options at any exercise price) with the property other than a normal leaseback. Consequently, sale-leasebacks of real estate usually do not include an option for the seller-lessee to purchase the property. The proposals in the 2013 EDs would make it more difficult for equipment sale-leaseback transactions to qualify for sale and leaseback accounting and easier for real estate sale-leaseback transactions to qualify for sale and leaseback accounting as compared to current U.S. GAAP.

Example 29: Sale-Leaseback Transaction[41]

Company X enters into a transaction with Company Y to sell and leaseback a building and underlying land owned by Company X. The following information is

[39] IAS 17, Leases, IAS 18, Revenue, and SIC 27, Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

[40] FASB ASC Topic 840, Leases, available at www.fasb.org.

[41] Based on Example 1 in proposed FASB ASC Subtopic 842-40 of the 2013 FASB ED and Example 23 of the 2013 IASB ED.

relevant to the accounting:

- Carrying amount of property – $700,000
- Fair value of property – $1,200,000
- Remaining economic life of building – 20 years
- Sale price – $1,000,000
- Leaseback term – 2 years (with no renewal or termination options)
- Annual lease payments (in arrears) – $85,000
- Market lease payments (in arrears) – $150,000
- Company X's incremental borrowing rate – 10%
- Rate that Company Y is charging in the leaseback transaction – 10%

At the commencement of the leaseback, the present value of the estimated lease payments discounted at Company X's incremental borrowing rate is $147,521. The present value of the market lease payments is $260,331. Therefore, the difference is $112,810. Based on this information, if the transaction qualifies for sale-leaseback accounting, the leaseback would be classified as a Type B lease.

If the transaction qualifies for sale-leaseback accounting, the following entries would be recorded by Company X (the seller-lessee):

	Debit	Credit
Cash	1,000,000	
Financial asset	112,810	
PP&E		700,000
Gain on sale		412,810

To record the sale of the property to Company Y on the transaction date.

Right-of-use asset	260,331	
Lease liability		260,331

To record the lease of the property from Company Y at market rates at lease commencement.

The following entry would be recorded by Company Y (the buyer-lessor):

PP&E	1,112,810	
Financial liability		112,810
Cash		1,000,000

To record the purchase of the property from Company X.

Because the leaseback is classified as a Type B lease, no entries would be recorded by Company Y on commencement of the leaseback.

After the commencement date, both Company X and Company Y would treat the market annual lease rate of $150,000 as lease payments each year for the two-year term. The difference between the annual payments and the market annual lease rate (i.e., $65,000) would be accounted for as settlement of the financial asset of Company X and the financial liability of Company Y.

If, alternatively, the transaction does not qualify for sale-leaseback accounting (e.g., if the leaseback term were for 16 years rather than 2 years), the following entries would be recorded by Company X (the seller-lessee) on the transaction date:

	Debit	Credit
Cash	1,000,000	
Debt obligation		1,000,000

To record the legal sale (debt issuance for accounting purposes) of the property to Company Y.

The following entries would be recorded by Company Y (the buyer-lessor) on the transaction date:

	Debit	Credit
Loan receivable	1,000,000	
Cash		1,000,000

To record the legal purchase of the property from Company X (accounting loan to Company X).

KPMG Observations

For the seller-lessee, the Boards did not address whether the financial asset or financial liability recognized to reflect the difference between the contractual terms of the sale-leaseback and market terms could be combined with the lease liability or right-of-use asset on the balance sheet or whether the income statement impact from the interest on the asset or liability could be combined with interest expense (if the leaseback is classified as a Type A lease) or lease expense (if the leaseback is classified as a Type B lease). Similarly, the Boards did not address whether the corresponding financial asset or liability of the buyer-lessor could be combined with the lease receivable or residual asset (if the lease is classified as a Type A lease) or the underlying asset (if the lease is classified as a Type B lease) or whether the income statement impact from the interest on the asset or liability could be combined with interest income (if the lease is classified as a Type A lease) or lease income (if the lease is classified as a Type B lease).

Rather than recognizing a financial asset or financial liability to reflect adjustments to the contractual terms, the Boards could have proposed other approaches to adjust for off-market terms in a sale-leaseback.

- For the seller-lessee, the Boards could have proposed that the lease liability be measured based on the contractual terms and the right-of-use asset be adjusted for any difference between the fair value and sale price of the underlying asset. This approach would preserve the linkage between the reported amount of the lease liability and the seller-lessee's contractual commitments while adjusting the gain or loss on the transaction (and the seller-lessee's future expense) to reflect market terms. Effectively, the seller-lessee would reflect a deficiency between the sale price and the market price of the asset as a prepayment of rent. It would reflect an excess of the sale price over the market price of the asset as additional financing obtained from the buyer-lessor. Although the language in the proposed standard could be read to support this approach, it is not the approach that was illustrated in the 2013 EDs' examples. The entries under this approach would be:

	Debit	Credit
Sale price less than market price		
Right-of-use asset	XXX	
Gain (loss) on sale		XXX

	Debit	Credit
Sale price greater than market price		
Gain (loss) on sale	XXX	
Right-of-use asset		XXX

- For the buyer-lessor, the Boards could have proposed that the fair value of the underlying asset be considered its acquisition cost with any difference between that amount and the price paid treated as an adjustment of the lease payments. Effectively, the buyer-lessor would reflect a deficiency between the purchase price and the market price of the asset as a prepayment of rent received from the seller-lessee. It would reflect an excess of the purchase price over the market price of the asset as other financing provided to the seller-lessee. The entries under this approach would be:

	Debit	Credit
Purchase price less than market price		
Underlying asset	XXX	
Lease receivable (deferred income)*		XXX
Purchase price greater than market price		
Finance receivable	XXX	
Underlying asset		XXX

* The entry would be to lease receivable if the lease was classified as a Type A lease and to deferred income if it was classified as a Type B lease.

The 2013 EDs propose that an adjustment to reflect market rates for the leaseback be made by the seller-lessee and the buyer-lessor if *either* the sales price for the underlying asset is different than its fair value *or* the lease payments are not at market rates. The adjustment in both cases would be to measure the lease based on market rates. This proposal would appear to require the seller-lessee and buyer-lessor to determine *both* the fair value of the underlying asset *and* the market lease payments for the underlying asset over the lease term in assessing whether an adjustment to the stated terms is necessary. However, as a practical matter, given that the adjustment is only to measure the lease based on market rates, it is likely that the seller-lessee and buyer-lessor would only need to determine the market lease payments. Although the market lease payments may be determinable in many cases, it is likely that the fair value of the underlying asset would be more readily determinable.

Income Tax Considerations

Deferred Tax Considerations

The changes proposed by the 2013 EDs would generally result in new temporary differences under U.S. GAAP for many companies involved in leasing transactions. Basis differences would result from recognizing assets and liabilities for financial reporting purposes that would not be recognized for tax purposes. Some of the examples that may result in changes to book-tax temporary differences include:

- Recognition of a right-of-use asset and liability to make estimated future lease payments by lessees;
- Recognition of a lease receivable by lessors;
- Partial derecognition of leased assets (i.e., when applying the receivable and residual lessor accounting model) that would be considered wholly-owned assets of the lessor for tax purposes;

- Changes in sale-leaseback accounting resulting in fewer financing transactions for book purposes;
- Accrual of rental income and expense for tax purposes that differs from amounts recorded for financial reporting purposes (including variable lease payments that are included in the lease liability and lease receivable – e.g., those based on an index or rate – and including an interest component on lease liabilities, lease receivables, and residual assets for financial reporting purposes may result in significant differences); and
- Elimination of leveraged lease accounting, which may change existing book-tax differences for some lessors.

Under the lessee right-of-use model, a lessee would recognize a right-of-use asset and a liability to make lease payments at lease commencement that would be measured at the same amount (except for the impact of initial direct costs capitalized as part of the right-of-use asset, any prepaid rentals, and any lease incentives received). However, separate deferred tax assets and liabilities related to the right-of-use asset and lease liability would be identified on a gross basis. Although those deferred tax assets and liabilities may qualify for net presentation on the balance sheet, the gross deferred tax assets and liabilities may be needed for disclosures about the components of deferred tax assets and liabilities and the assessment of recoverability of deferred tax assets.

State and Local Tax Implications

For U.S. state and local income tax purposes, taxable income is normally apportioned on the basis of a formula (apportionment formula). In many jurisdictions, the apportionment formula is partially based on a company's property (property factor) and often includes a calculated amount for underlying assets. The 2013 EDs' proposals could affect the apportionment formula and therefore impact a company's state or local income tax liability in jurisdictions where the property factor is based on financial statement amounts. This may also impact a company's state or local effective tax rates.

Change in Tax Accounting Method

A change in financial reporting method (e.g., in accounting for leases) will not generally be deemed to constitute a change in underlying facts for U.S. tax procedural purposes. In general, when a new tax accounting method is required or desirable because the financial reporting method changes an entity must obtain permission from the Internal Revenue Service (IRS) National Office by filing Form 3115, *Application for Change in Accounting Method*. The filing procedures and timing vary based on whether the change is automatic or subject to advance consent from the IRS.

If an entity is changing to a tax accounting method that is identified in published IRS guidance, the IRS is deemed to automatically approve the change when Form 3115 is received and, at the same time, forgive interest and penalties, if any, if the entity is moving from an impermissible method to a permissible method. The timing of recognition for financial reporting purposes of the effects of a change in tax accounting methods, including the potential forgiveness of interest and penalties, may depend on when the entity determines to make the change, when Form 3115 is filed, and whether the entity is changing from an impermissible method to a permissible method.

If an entity is changing its tax accounting method outside the automatic procedures, IRS approval of the change (and forgiveness of interest and penalties, if any) is not automatic. The entity may need to consider the U.S. GAAP requirements on accounting for tax uncertainties to determine whether it is appropriate to account for the change before it receives approval (i.e., the ruling letter).

Transfer Pricing

The transfer pricing strategy of a multinational entity can have significant tax implications, and can require extensive documentation to demonstrate how its strategy meets the local requirements for intercompany transactions. If finalized, changes to the amount and timing of lease revenue and lease expense from the proposed standard could have a significant effect on transfer pricing specifically as it relates to using revenue or profit-based methods for establishing the transfer pricing. An entity would need to consider whether its transfer pricing strategies and supporting documentation should be revised or updated.

Leases Acquired in a Business Combination

Under current U.S. GAAP, the acquirer's accounting for acquired leases is based on the acquiree's lease classification.[42] If an acquired company is a lessee under an operating lease, an asset or liability is recognized by the acquirer and measured at fair value on acquisition to the extent that the operating lease is favorable or unfavorable compared to market rates at the acquisition date. If an acquired company is a lessor under an operating lease, the acquirer recognizes and measures the underlying asset at fair value along with an asset or liability for any off-market provisions of the lease. With respect to an acquisition of a company that is a lessee under a capital lease, generally both the capital lease asset and obligation are measured at fair value. The net investment of an acquired lessor in sales-type, direct financing, or leveraged leases is measured at fair value by the acquirer at the acquisition date.

Under the 2013 EDs' proposed guidance, the acquirer would retain the acquiree's classification of a lease acquired in a business combination. If the acquiree is the lessee, the acquirer would record a lease liability at the acquisition date as if the lease were a new lease at that date. The acquirer would record a right-of-use asset equal to the lease liability, adjusted for any off-market terms in the lease contract. If the acquiree is the lessor in a Type A lease, the acquirer would record a lease receivable determined as if the lease were a new lease at the acquisition date and a residual asset equal to the difference between the fair value of the underlying asset at the acquisition date and the amount of the lease receivable. Although not specifically discussed in the 2013 EDs, based on their transition provisions it appears the Boards intend that when the acquiree is the lessor in a Type B lease contract, the acquirer would record an asset or liability at the acquisition date to the extent that the lease is favorable or unfavorable compared to market rates at that date. Subsequent to initial recognition at the acquisition date, an acquirer would account for an acquired lease in the same manner as any lease it originated. For leases that have a remaining maximum possible term of 12 months or less at the acquisition date, the acquirer would not recognize any lease assets or liabilities even if the lease terms are not at market at that date.

KPMG Observations

Business combinations guidance generally requires all assets acquired and liabilities assumed to be measured at fair value as of the acquisition date. The Boards concluded that requiring acquirers to measure lease assets and lease liabilities at fair value was not justifiable from a cost-benefit perspective given the likely difficulties and cost of obtaining reliable fair value measurements for those items, particularly the right-of-use asset. In addition, the Boards observed that for

[42] FASB ASC Topic 805, Business Combinations, available at www.fasb.org.

lessors the acquisition date lease receivable and residual asset together would equal the acquisition date fair value of the underlying asset, which the Boards believe complies with the principle of the business combinations guidance.

The 2013 EDs do not contain proposed guidance on the accounting for leases acquired in an asset acquisition (i.e., acquisition of assets that do not constitute a business). Current practice under U.S. GAAP is to account for these acquired leases in the same manner as they would be accounted for if they were acquired in a business combination.

Example 30: Accounting for an Acquired Lease (Lessee)

Company X acquires Target C. Target C is a logistics company that leases its main transportation hub (a large building and surrounding land near a major airport that serves as a storage and processing facility) from Lessor Z. Target C is currently in Year 6 of a 25-year lease of the transportation hub in which it agreed to pay Lessor Z fixed payments of $1 million per year in arrears, with a 3% increase each year after Year 1, which are considered to be fair market terms at the acquisition date. Target C properly classified the lease as a Type B lease because the lease term was for less than a major part of the building's remaining economic life and the present value of the lease payments was less than substantially all of the fair value of the property. At the acquisition date, the rate Lessor Z is charging Target C cannot be readily determined. Company X's incremental borrowing rate at that date is 8%. At the acquisition date, the building has a remaining economic life of 40 years and the building and land together have a fair value of $28 million. Assume Company X does not have a significant economic incentive to renew the lease.

At the acquisition date, Company X records a lease liability of $16,579,916 (the present value of the future lease payments due under the lease contract for the land and building) and a corresponding (i.e., equal) right-of-use asset. No adjustment is required to the right-of-use asset because the lease is at market rates on the acquisition date. (If the lease had a positive fair value at acquisition, the measurement of the right-of-use asset would be increased by that amount. Conversely, if the lease had a negative fair value at acquisition, the measurement of the right-of-use asset would be decreased by that amount.) Company X will retain Target C's classification of the lease and account for the remainder of the lease as if it is a new Type B lease for the same facility.

Example 31: Accounting for an Acquired Lease (Lessor)

Company Y acquires Target D. Target D leases specialized manufacturing equipment to its customers. At the acquisition date, Target D has just entered the second year of a contract with Customer S in which it is leasing Customer S one of its specialized machines. Target D properly classified the lease as Type A because the lease term was not insignificant compared to the total economic life of the machine, and the present value of the lease payments was not insignificant in relation to the fair value of the machine at lease commencement. The following information about Target D's lease with Customer S is relevant to Company Y's accounting:

- Remaining lease term – 4 years
- Annual lease payments (in arrears) – $100,000
- Fair value of machine at the acquisition date – $600,000

- Expected residual value of machine at the end of the lease term – $375,000
- Interest rate implicit in the lease at the acquisition date – 8.39%

Note that the interest rate implicit in the lease is the rate that causes the present value of the remaining lease payments of $400,000 plus the expected future residual value to equal the acquisition date fair value of the specialized machine.

Therefore, at the acquisition date, Company Y retains Target D's classification of the lease and records a lease receivable of $328,337 (the present value of the future lease payments due under the lease contract) and a residual asset of $271,663 (the present value of the expected residual value of the machine at the end of the lease term). The underlying asset is not reflected in Company Y's post-acquisition balance sheet. No profit or loss is recognized upon acquisition of the lease (which is considered the lease commencement date for Company Y) because if the machine had been recognized in Company Y's purchase accounting immediately before recognition of the lease its carrying amount would have been equal to its fair value. Company Y's accounting subsequent to the initial opening balance sheet recognition will be the same as it would have been had Company Y originated the lease at the acquisition date.

Disclosures

Both lessees and lessors would be required to disclose more information about their leasing arrangements than required under current GAAP. The objective of the 2013 EDs' proposed guidance is to enable users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective lessees and lessors would be required to disclose qualitative and quantitative information about all of the following:

- Their leases;
- The significant judgments made in applying the lease accounting guidance to those leases; and
- The amounts recognized in the financial statements relating to those leases.

Lessees and lessors would be required to consider the level of detail necessary to satisfy the disclosure objectives and the level of emphasis to place on each of the various requirements. Lessees and lessors would be required to aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

Unless otherwise noted, lessees and lessors would be required to disclose the following:

- Information about the nature of their leases, including:
  - A general description of those leases;
  - The basis, and terms and conditions, of options to extend or terminate the lease;
  - The basis, and terms and conditions, on which variable lease payments are determined;
  - For lessees only, narrative disclosure about the options that are recognized as part of the right-of-use asset and lease liability and those that are not, residual value guarantees provided by the lessee, and restrictions or covenants imposed by leases; and

  - For lessors only, options for a lessee to purchase the underlying asset.

  Additionally, lessees would be required to identify the information relating to subleases included in the disclosures above.

- Information about significant assumptions and judgments made in applying the proposed requirements, which may include:
  - The determination of whether a contract contains a lease;
  - The allocation of the consideration in a contract between lease and non-lease components;
  - The determination of the discount rate (lessees only); and
  - The measurement of the residual asset (lessors only).

Both lessees and lessors would also be required to disclose any lease transactions between related parties.

Lessee–only Disclosures. Under the proposed requirements, lessees also would disclose a reconciliation of opening and closing balances of the aggregate lease liability separately for Type A and Type B leases. Those reconciliations would be required to include the periodic interest on the lease liability and other items that are useful in understanding the change in the total carrying amount of the lease liability. The reconciliations would be optional for nonpublic entities. Examples of the types of items included in the reconciliations would include:

- Liabilities created due to leases commencing or being extended;
- Liabilities extinguished due to leases being terminated;
- Remeasurements relating to a change in an index or a rate used to determine lease payments;
- Cash paid;
- Foreign currency transaction gains and losses; and
- Effects of business combinations.

The proposed guidance also would require the following items to be disclosed:

- Information about leases that have not yet commenced but that create significant rights and obligations for the lessee;
- Costs that are recognized in the period relating to variable lease payments not included in the lease liability;
- Information about the acquisition of right-of-use assets in exchange for lease liabilities for both Type A and Type B leases, as a supplemental disclosure of noncash transactions;
- A maturity analysis of the total lease liability, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years (a lessee would be required to reconcile the undiscounted cash flows to the lease liability recognized in the statement of financial position);
- For lessees applying U.S. GAAP, a maturity analysis of commitments for non-lease components related to a lease, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years; and

- For lessees applying IFRS, separate reconciliations of opening and closing balances of right-of-use assets (other than those that are measured at fair value as investment property) by class of underlying asset for (a) Type A leases, (b) Type B leases, and (c) right-of-use assets measured at revalued amounts, including items that are useful in understanding the change in the total carrying amount of those assets (e.g., new assets created, reductions due to lease terminations, remeasurements from reassessments, amortization, impairment, etc.).

Example – Lessee reconciliation rollforward

	ROU assets (lessees applying IFRS)		Lease liability	
	Type A	**Type B**	**Type A**	**Type B**
Balance at January 1, 201X	XXX	XXX	XXX	XXX
Changes in estimate from:				
Options	XX	XX	XX	XX
Variable lease payments	XX	XX	XX	XX
Residual value guarantees	XX	XX	XX	XX
Revaluations	XX	XX	-	-
New rights of use / obligations	XX	XX	XX	XX
Subtotal	**XXXX**	**XXXX**	**XXXX**	**XXXX**
Impairments	(X)	(X)	-	-
Amortization during the year	(XX)	(XX)	-	-
Disposals of rights of use / obligations	(XX)	(XX)	(XX)	(XX)
Repayments of obligations	-	-	(XX)	(XX)
Balance at December 31, 201X	**XXXX**	**XXXX**	**XXXX**	**XXXX**

Lessor–only Disclosures. Under the proposed requirements, lessors also would be required to disclose the following for lease income recognized in the reporting period in a tabular format:

- For Type A leases:
  - Profit or loss recognized at the commencement date (gross or net);
  - Interest on the lease receivable recognized as interest income; and
  - Accretion of the discount on the gross residual asset recognized as interest income.
- For Type B leases, lease income from lease payments;
- Lease income from variable lease payments not included in the measurement of the lease receivable; and
- Short-term lease income.

Example – Lessor reconciliation of lease income	
Lease income – Type A leases	
Profit at lease commencement	XXX
Interest income on lease receivables	XX
Interest income from accretion of residual assets	XX
Subtotal	**XXXX**
Lease income – Type B leases	XXX
Lease income from short-term leases	X
Lease income from variable lease payments	X
Total lease income	**XXXX**

Lessor Type A Disclosures

The proposed guidance also would require a lessor to disclose a reconciliation of the opening and closing balances of the aggregate lease receivable for Type A leases. The reconciliation would include items that are useful in understanding the change in the total carrying amount of the lease receivable such as:

- Additions due to leases commencing or being extended;
- Receivables derecognized due to leases being terminated;
- Cash received;
- Interest on the lease receivable;
- Foreign currency transaction gains and losses;
- Effects of business combinations;
- Changes to the loss allowance.

Similarly, a lessor would be required to disclose a reconciliation of the opening and closing balances of the aggregate residual asset. The reconciliation would include items that are useful in understanding the change in the total carrying amount of the residual asset, for example:

- Additions due to lease commencing;
- Reductions due to leases being extended;
- Reclassifications at expiration or termination of a lease;
- Accretion of the discount on the gross residual asset;
- Effects of business combinations;
- Impairment.

Lessors would be required to disclose a maturity analysis of the total lease receivable showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. The undiscounted cash flows would be required to be reconciled to the lease receivable recognized in the statement of financial position.

Finally, lessors would be required to disclose information about how they manage their risk associated with residual assets, including all of the following:

- Their risk management strategy for residual assets;

- The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor); and
- Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

Lessor Type B Disclosures

The proposed guidance also would require a lessor to disclose a maturity analysis of lease payments for Type B leases, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor would be required to present that maturity analysis separately from the maturity analysis for Type A leases.

Sale and Leaseback Transactions. If a transferor or a transferee enters into a sale and leaseback transaction that results in accounting for the transfer of the asset as a sale, all applicable disclosures listed above would be required for either the lessor or the lessee in the transaction.

Additionally, the seller-lessee would be required to:

- Disclose the main terms and conditions of the transaction; and
- Identify any gains or losses arising from the transaction separately from gains or losses on disposals of other assets.

Short-Term Leases. A lessee would be required to disclose whether it chooses, as a policy election, to recognize the lease payments for short-term leases in net income or loss on a straight-line basis over the lease term. Similarly, a lessor would be required to disclose whether it recognizes the lease payments for such leases in net income or loss over the lease term on a straight-line basis or on another systematic basis that is more representative of the pattern in which income is earned from the underlying asset.

KPMG Observations

The 2013 EDs propose that a company assess the level of detail or aggregation that would best satisfy the overall disclosure objective. This approach would allow companies some flexibility in meeting the detailed disclosure requirements, but also would require them to use judgment to assess whether the detailed disclosures are sufficient to meet the overall objective.

The required disclosures would increase significantly compared to current GAAP. Certain requirements (e.g., balance sheet roll-forward information) would require the tracking and compilation of information that is not currently required to be disclosed. In considering whether and how to comment on the 2013 EDs' proposals, companies will want to assess the proposed disclosure requirements and the potential impact on information technology systems necessary to capture the required information at the appropriate level of disaggregation.

It is interesting that the Boards have proposed to implement a fundamental change to lessee accounting *and* increase the disclosure burden for lessees. If the new accounting model is providing the information that financial statement users need, one might expect to see a *decrease* in required disclosures. The failure to reduce lessee disclosure requirements may indicate that the Boards do not have complete confidence that financial statement users will be fully satisfied with their recognition and measurement proposals.

The proposed additional disclosure requirements for lessors are partly a consequence of the lessor accounting proposals, which include alternative approaches to lessor accounting with different assets and liabilities, and different types of income recognized under each approach. However, the increased disclosure burden for lessors arguably also is a symptom of the complexity of the recognition and measurement proposals.

Effective Date and Transition

Effective Date

The 2013 EDs do not propose an effective date. The Boards are working on various projects, including this one, under their Memorandum of Understanding. They will consider what the effective date should be when they consider constituent feedback on the 2013 EDs. However, the effective date is expected to be no earlier than the effective date of the forthcoming revenue recognition standard (i.e., January 1, 2017, for calendar-year-end companies).

Transition

The 2013 EDs propose that upon the effective date of the standard, an entity would be permitted to recognize and measure all leases within its scope that exist at the beginning of the earliest comparative period presented using a modified retrospective approach. An entity applying the modified retrospective approach would adjust equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented, as if the standard had always been applied, subject to the proposed requirements discussed below. For example, if the leases standard were effective for fiscal years beginning after December 15, 2016, then the date of initial application for a calendar-year-end company that prepares a three-year comparative income statement would be January 1, 2015. Lessees and lessors would not be required to adjust the carrying amounts of assets and liabilities associated with existing finance, capital, sales-type, and direct financing leases at transition.

KPMG Observations

The 2013 EDs do not address how an entity applying the modified retrospective transition approach would determine the classification of a preexisting lease upon adoption of the proposed requirements. However, we understand that lease classification would be determined based on lease commencement date information as adjusted for application of any specified reliefs (see below) the entity elects to apply.

As an alternative to the modified retrospective approach, an entity would be permitted to apply all of the requirements of the standard retrospectively in accordance with current GAAP, taking into consideration the lessor requirements discussed below for any previously securitized receivables arising from leases that were classified as operating leases.[43]

Additionally, if a lessee elects not to apply the recognition and measurement requirements in the standard to short-term leases, the lessee would not be required to apply the approach described below to short-term leases. If a lessor elects not to apply the recognition and measurement requirements in the standard to short-term leases, the carrying amount of the underlying asset and any lease assets or liabilities at the beginning of the earliest comparative period would be the same as the amounts recognized by the lessor immediately before that date.

[43] FASB ASC Topic 250, Accounting Changes and Error Corrections, available at www.fasb.org, and IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

KPMG Observations

SEC regulations require registrants to present selected financial data for the five most recent fiscal years.[44] SEC registrants adopting a standard on a retrospective basis (including the use of one or more practical expedients) would be required to update the other areas of their filings, including MD&A, to reflect the retrospective application of the new accounting standard. Additionally the SEC Staff Financial Reporting Manual states that, if a registrant adopts a new accounting standard retrospectively, the staff will expect all five years to be presented on the same basis.[45] Unless the SEC staff provides different guidance, registrants using either the full or modified retrospective application method likely would be required to apply the adjustments to all of the five years in the selected financial data table.

Specified Reliefs. The following specific transition reliefs would be available under the modified retrospective approach for leases that commenced before the standard's effective date. It is unclear whether these transition reliefs would be available to an entity that elects not to apply the modified retrospective approach. An entity that uses one or both of the specified reliefs below would be required to disclose that fact.

- An entity would not be required to include initial direct costs in the measurement of the right-of-use asset (if the entity is a lessee) or the lease receivable (if the entity is a lessor).
- An entity would be permitted to use hindsight, for example, in determining whether a contract contains a lease, in classifying a lease, or in determining the lease term if the contract contains options to extend or terminate the lease, etc.

Lessees

Leases Previously Classified as Operating Leases

For leases previously classified as operating leases, a lessee applying the modified retrospective transition approach would be required to recognize the following at the beginning of the earliest comparative period presented:

- A lease liability, measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the effective date;
- For each Type A lease, a right-of-use asset measured as a proportion of the lease liability that reflects the remaining duration of the lease relative to the lease term as depicted by the following equation:

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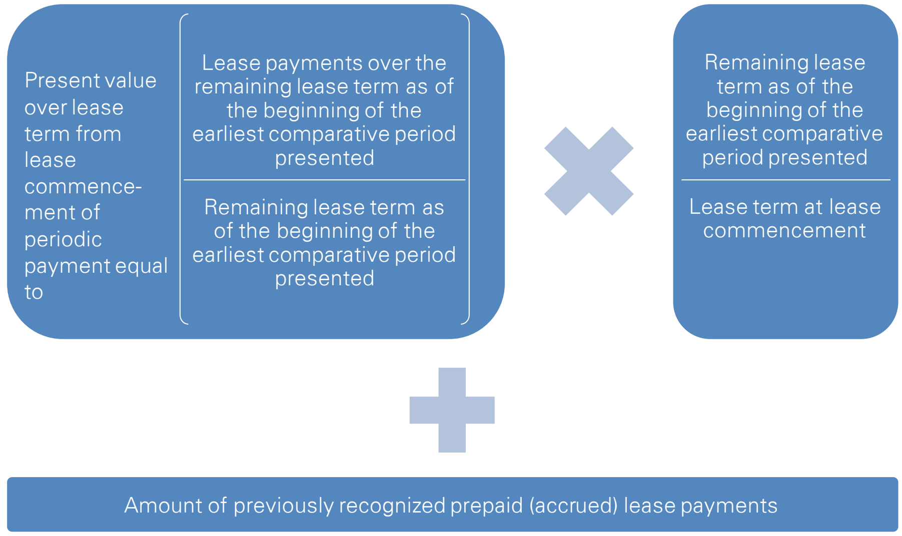
[44] SEC Regulation S-K, Item 301, Selected Financial Data, (see Subpart 229.301).

[45] SEC Division of Corporation Finance, Financial Reporting Manual, Section 1610, Accounting Basis, available at www.sec.gov.



- For each Type B lease, a right-of-use asset measured at an amount that equals the lease liability plus the amount of any previously recognized prepaid lease payments minus the amount of any previously accrued lease payments.

Under the modified retrospective transition approach, a lessee would be permitted to apply a single discount rate to a portfolio of leases with reasonably similar characteristics (for example, a similar remaining lease term for a similar class of underlying asset in a similar economic environment). The lessee would consider its total financial liabilities when calculating the discount rate for each portfolio of leases.

Example 32: Lessee Transition for Operating Lease Classified as a Type A Lease

Assume the effective date of the leases standard for Lessee is January 1, 20X7 and the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies it is January 1, 20X5.

Lessee entered into a 6-year lease of a machine that commenced on January 1, 20X3 and was accounted for as an operating lease. Payments for the lease are made annually in arrears. On January 1, 20X5 (before any transition adjustments), Lessee has a straight-line accrued rent liability of $4,000 related to the lease. There are four remaining lease payments: one payment of $51,000 followed by three payments of $55,000. At the effective date, Lessee's incremental borrowing rate is 6%. The lease is classified as a Type A lease under the provisions of the leases standard.

On January 1, 20X5, Lessee measures the lease liability at $186,807, the present value of one payment of $51,000, and three payments of $55,000, discounted at 6%. Lessee determines the carrying amount of the right-of-use asset at January 1, 20X5 using the formula described above as follows:

Step 1: Determine the lease payments over the remaining lease term as of the beginning of the earliest comparative period presented ($51,000 + [$55,000 × 3] = $216,000)

Step 2: Determine the lease term at lease commencement (6 years)

Step 3: Determine the remaining lease term as of the beginning of the earliest comparative period presented (6 years lease term at lease commencement – 2 years of lease term expired as of beginning of earliest comparative period presented = 4 years remaining lease term)

Step 4: Divide the amount determined in Step 1 by the amount determined in Step 3 ($216,000 ÷ 4 years = $54,000 per year)

Step 5: Determine the present value of the periodic payment calculated in Step 4 over the lease term identified in Step 2 using the lessee's incremental borrowing rate at the effective date as the discount rate ($54,000 per year in arrears discounted at 6% = $265,536)

Step 6: Multiply the amount in Step 5 by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2 ($265,536 × 4 ÷ 6 = $177,024)

Step 7: Add to the amount calculated in Step 6 the amount of any previously recognized prepaid lease payments and subtract from that amount any accrued lease payments ($177,024 – $4,000 = $173,024).

Lessee elects not to include initial direct costs in determining the right-of-use asset as permitted by the transition guidance.

The difference between the right-of-use asset and the lease liability on January 1, 20X5 is an adjustment to opening retained earnings at that date. At January 1, 20X5, Lessee recognizes the following entry to reflect the transition of the operating lease to a Type A lease:

	Debit	Credit
Right-of-use asset	173,024	
Accrued rent	4,000	
Retained earnings	9,783	
Lease liability		186,807

Example 33: Lessee Transition for Operating Lease Classified as a Type B Lease

Assume the same facts as those in Example 32 except that the lease is classified as a Type B lease under the provisions of the leases standard. On January 1, 20X5, Lessee measures the lease liability at $186,807, the present value of one payment of $51,000, and three payments of $55,000, discounted at 6%. Lessee measures the right-of-use asset at an amount equal to the lease liability minus accrued rent. Lessee does not include initial direct costs in determining the right-of-use asset as permitted by the transition guidance.

At January 1, 20X5, Lessee recognizes the following entry to reflect the transition of the operating lease to a Type B lease:

	Debit	Credit
Right-of-use asset	182,807	
Accrued rent	4,000	
Lease liability		186,807

Leases Previously Classified as Capital (Finance) Leases

For leases previously classified as capital (finance) leases under GAAP, the carrying amount of the right-of-use asset and the lease liability at the beginning of the earliest comparative period presented would be the carrying amount of the lease asset and lease liability immediately before that date. For these leases, a lessee would be required to:

- Subsequently measure the right-of-use asset and the lease liability by applying the standard's subsequent measurement provisions for lessees other than the reassessment provisions; and
- Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from Type A leases for purposes of presentation and disclosure.

Additionally, after the effective date if a modification to the contractual terms and conditions of any of the leases previously classified as capital (finance) leases results in a substantive change to the lease, a lessee would be required to account for the lease as a new lease under the requirements of the standard.

KPMG Observations

If the 2013 EDs required full retrospective application, then lessees would be required to compute the balances that would have been recognized on commencement of the lease and prepare lease amortization schedules to determine the changes in those balances between commencement of the lease and the date of initial application (i.e., the beginning of the earliest comparative period presented in the year of adoption). In comparison, the proposed modified retrospective requirements are slightly less onerous. Also, the relief for short-term leases would facilitate transition for lessees with short-term leasing arrangements.

Applying the new requirements for the first time would be a time consuming and costly process for many lessees. They would be required to gather additional data for nearly all leases and especially for those classified currently as operating leases. They also would have to perform new calculations to compute the amounts to be included in the financial statements.

Lessees that would see a significant change in their financial position when applying the new requirements may want to ensure that their shareholders and other financial statement users understand those changes to avoid significant surprises.

In some cases, lessees would need to assess the effect of applying the 2013 EDs on their key financial ratios and covenants and any potential effect on their compliance with key loan agreements and other regulations. Those currently renegotiating loan agreements may want to ensure that financial covenants entered into while current GAAP lease standards remain in effect can be adjusted to reflect application of the proposed requirements.

Between the issuance date and effective date of the new standard, there is likely to be an increase in lessee demand for restructuring of existing leases as lessees evaluate the impact on their financial statements. Lessees may want to enter into early terminations of leases or convert leases to loans or in-substance purchases with limited features subject to reassessment and/or requiring judgment in measuring the lease payments (i.e., purchase options, residual value guarantees, variable lease payments based on an index or rate). Similarly, where the economics may be favorable, lessees may consider moving from fixed lease payments to contingent rental payments because these amounts would not be included in the measurement of the lease liability and right-of-use asset, effectively reducing the balance sheet impact of adoption.

Lessors

Leases Previously Classified as Operating Leases

For leases previously classified as operating leases under GAAP, a lessor would do the following at the beginning of the earliest comparative period presented for each Type A lease:

- Derecognize the underlying asset and any previously recognized prepaid or accrued lease payments;
- Recognize a lease receivable measured at the present value of the remaining lease payments, discounted using the rate the lessor charges the lessee determined at the commencement date, subject to any adjustments required to reflect impairment; and
- Recognize a residual asset according to the standard's initial measurement requirements, using information available at the beginning of the earliest comparative period presented.

For Type B leases, the carrying amount of the underlying asset and any lease assets or liabilities at the beginning of the earliest comparative period presented would be the same as the amounts recognized by the lessor immediately before that date in accordance with current GAAP.

If a lessor had previously securitized receivables arising from leases that were classified as operating leases in accordance with current GAAP, the lessor would account for those transactions as secured borrowings under current GAAP, regardless of whether the lessor elected to apply the retrospective transition alternative.

Example 34: Lessor Transition for Operating Lease Classified as a Type A Lease

Assume the effective date of the leases standard for Lessor is January 1, 20X7 and the beginning of the earliest comparative period presented in the financial statements in which Lessor first applies it is January 1, 20X5.

Lessor entered into a 6-year lease of a machine that commenced on January 1, 20X3 and was accounted for as an operating lease. Payments for the lease are due annually in arrears. On January 1, 20X5 (before any transition adjustments), Lessor has a straight-line accrued rent receivable of $4,000 related to the lease. The machine is recognized in Lessor's financial statements at that date at $240,000 (historical cost of $300,000 – depreciation of $60,000). There are four remaining lease payments: one payment of $51,000 followed by three payments of $55,000. The lease is classified as a Type A lease under the provisions of the leases standard.

The rate implicit in the lease at January 1, 20X3 was 6.25%. The fair value of the machine on January 1, 20X5 is $301,000, and the expected value of the machine at the end of the lease term based on information available on January 1, 20X5 is $150,000. The present value of one payment of $51,000 plus three payments of $55,000, discounted at 6.25% is $185,743. The present value of the expected value of the machine at the end of the lease term, discounted at 6.25%, is $117,713.

Total profit on the machine at January 1, 20X5 is $57,000 ($301,000 fair value – $244,000 carrying amount of machine and accrued rent receivable). Lessor determines that profit of $35,174 relates to the lease ($57,000 total profit × $185,743 lease receivable at January 1, 20X5 ÷ $301,000 fair value of the machine at January 1, 20X5). Lessor calculates the unearned profit relating to the residual asset as $21,826 at January 1, 20X5 ($57,000 total profit – $35,174 profit relating to the lease). The net residual asset at January 1, 20X5 of $95,887 comprises the gross residual asset of $117,713 minus the unearned profit on the residual asset of $21,826.

The difference between the assets previously recognized (machine of $240,000 and accrued rent receivable of $4,000) and the assets recognized at January 1, 20X5 (lease receivable of $185,743 and net residual asset of $95,887) is recognized as a transition adjustment to opening retained earnings of $37,630 at January 1, 20X5.

At January 1, 20X5, Lessor records the following entry to reflect the transition of the operating lease to a Type A lease:

	Debit	Credit
Lease receivable	185,743	
Gross residual asset*	117,713	
Accumulated depreciation	60,000	
PP&E		300,000
Unearned profit*		21,826
Accrued rent		4,000
Retained earnings		37,630

* Not presented or disclosed as two amounts – presented and disclosed on a net basis.

KPMG Observations

As illustrated in Example 34, application of the modified retrospective transition approach to existing operating leases that are classified as Type A leases under the 2013 EDs' proposals may result in recognition of a lease receivable and gross residual asset measured at a total amount that does not equal the fair value of the underlying asset at the beginning of the earliest comparative period presented. This is because of the proposed requirement to use the rate the lessor charges the lessee determined at lease commencement as the discount rate but to determine the underlying asset's estimated future residual value using information at the beginning of the earliest comparative period presented. For many leases, the underlying asset's estimated future residual value will not be the same at lease commencement as it is at the beginning of the earliest comparative period presented.

Leases Previously Classified as Finance, Direct Financing, or Sales-Type Leases

For leases that were classified as finance, direct financing, or sales-type leases under current GAAP, the carrying amount of the lease receivable at the beginning of the earliest comparative period presented would be the GAAP carrying amount of the net investment in the lease immediately before that date. For these leases, a lessor would be required to:

- Apply the guidance related to subsequent measurement of the lease receivable other than the reassessment provisions, including the provisions related to impairment and termination prior to the end of the lease term;
- Not apply the guidance related to subsequent measurement of the residual asset, including the provisions related to accretion of the discount on the gross residual asset, impairment, and termination prior to the end of the lease term; and

- Classify the net investment arising from direct financing or sales-type leases as lease receivables arising from Type A leases for purposes of presentation and disclosure.

After the effective date, if a modification to the contractual terms and conditions of any of these leases results in a substantive change to the lease, a lessor would be required to account for the lease as a new lease under the proposed standard.

Leveraged Leases

For leases that were classified as leveraged leases in accordance with current U.S. GAAP, a lessor would be required to apply the standard retrospectively.

KPMG Observations

Similar to the transition proposals for lessees, those for lessors are slightly less onerous than a full retrospective approach. However, they remain complex and may require more estimates and judgment than what would be required for lessees.

It may be difficult for lessors to determine the rate charged to the lessee at lease commencement because that rate would not necessarily be the same as the implicit rate, which lessors previously would have been required to determine under current U.S. GAAP. Lessors with long-term leases (e.g., real estate leases) may find it particularly difficult to determine the rate charged to the lessee as of the commencement of the lease.

Sale and Leaseback Transactions before the Beginning of the Earliest Comparative Period Presented

If a previous sale and leaseback transaction was accounted for as a sale and a capital (finance), direct financing, or sales-type lease in accordance with current GAAP, an entity would be required to:

- Not reassess the transaction to determine whether it is a sale and leaseback transaction;
- Not remeasure lease assets and lease liabilities at the beginning of the earliest comparative period presented; and
- Continue to amortize any deferred gain or loss from the transaction.

An entity would be required to reassess the transaction to determine whether the buyer-lessor obtains control of the underlying asset by applying the requirements for determining when a performance obligation is satisfied in the forthcoming revenue recognition standard if either:

- A previous sale and leaseback transaction was accounted for as a sale and an operating lease in accordance with current GAAP; or
- A previous transaction was assessed to determine whether it was a sale and leaseback transaction in accordance with current GAAP, but did not qualify for sale and leaseback accounting.

If a buyer-lessor obtains control of the underlying asset in accordance with the standard's sale-leaseback requirements, the seller-lessee would use the lessee transition requirements for leases previously classified as operating leases to measure lease assets and lease liabilities and would derecognize any deferred gain or loss at the beginning of the earliest comparative period presented.

KPMG Observations

The transition provisions with respect to sale-leaseback transactions could prove challenging to apply. For leases of non-integral equipment entered into at, or shortly after, the date the asset is acquired and placed in service (e.g., within 90 days), the lessee's accounting records likely would not identify whether the transaction involved a sale-leaseback because these transactions receive the same treatment under current U.S. GAAP, income tax, and commercial law regardless of whether the lessee temporarily acquired asset ownership.

Lessees would need to obtain that information from the underlying transaction documents (which may not be available). The level of effort needed to initially apply the proposed new sale-leaseback requirements would depend in part on when accounting ownership by the lessee is deemed to occur. If ownership by the lessee is defined as occurring only when title transfers, then the determination could be made more easily than if it is deemed to occur when the lessee has executed a purchase order or assigned a purchase order to another party in an agreement that contains provisions exposing the lessee to constructive risks of asset ownership (e.g., an indemnification of the assignee).

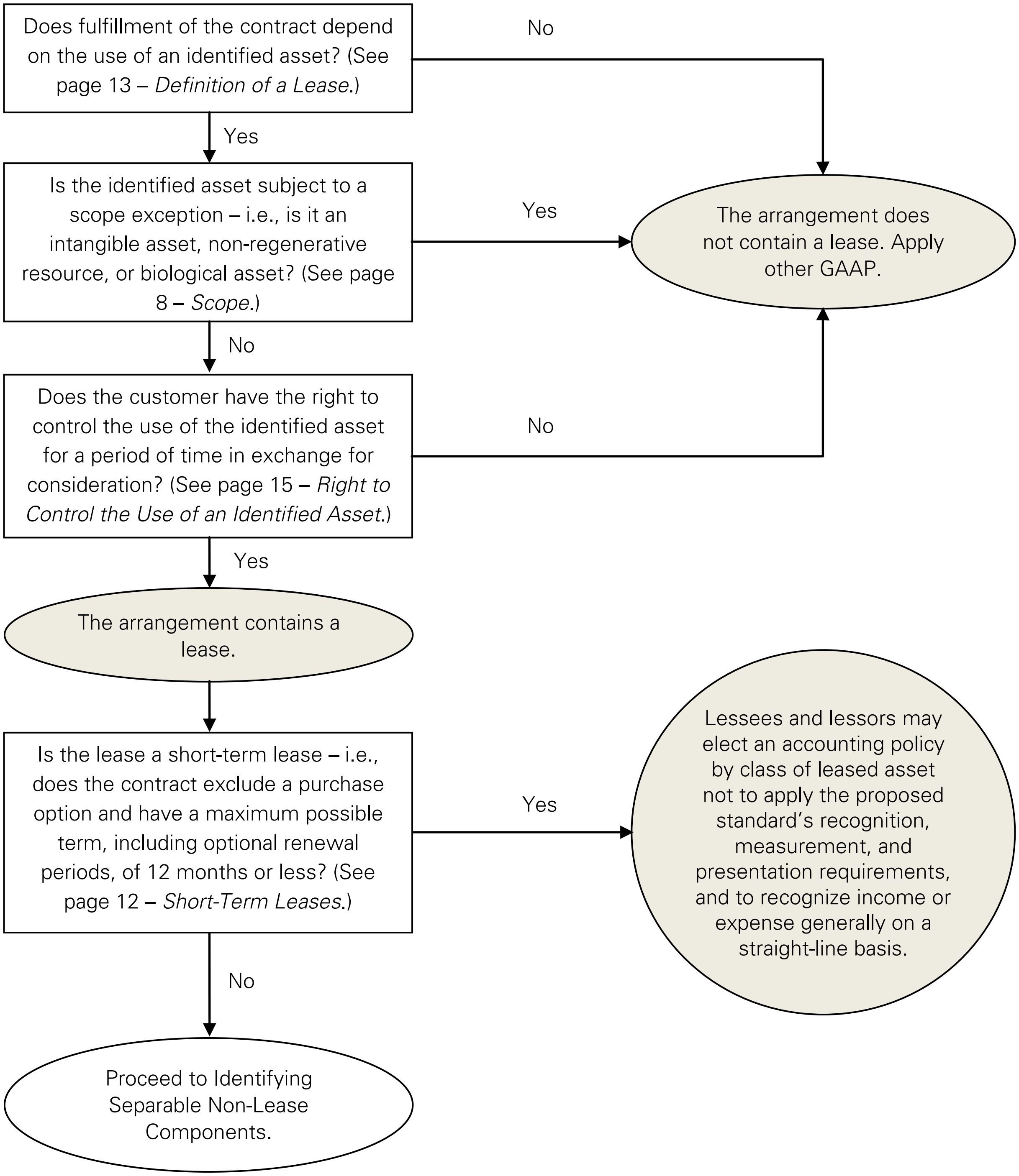
Amounts Previously Recognized in Business Combinations

If an entity has previously recognized an asset or liability relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity would:

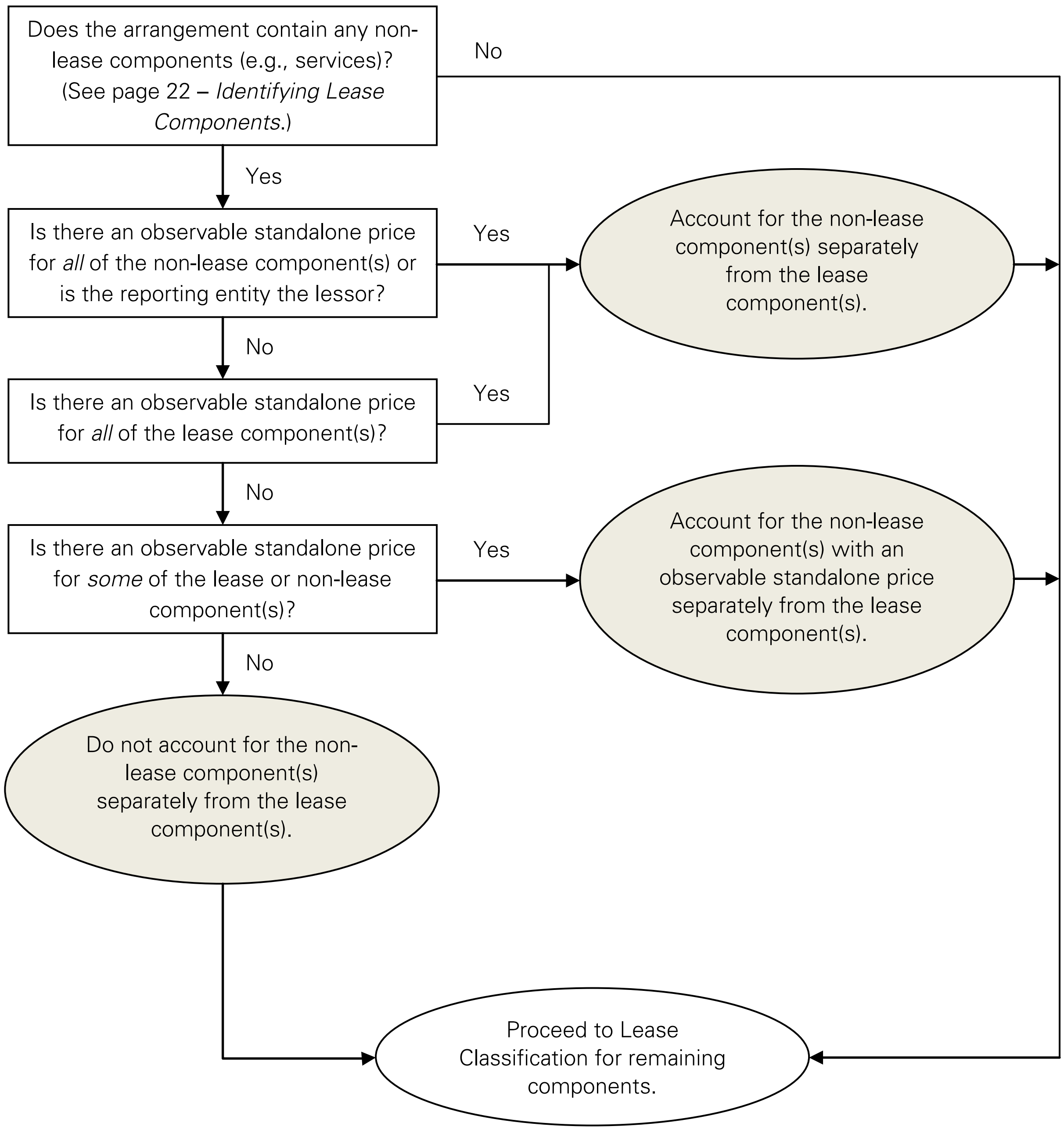
- Derecognize those assets and liabilities (except for those relating to Type B leases for which the entity is a lessor);
- Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee; and
- Make a corresponding adjustment to equity at the beginning of the earliest comparative period presented if the assets or liabilities relate to Type A leases for which the entity is a lessor.

Appendix – Application of the Lease Accounting Proposals

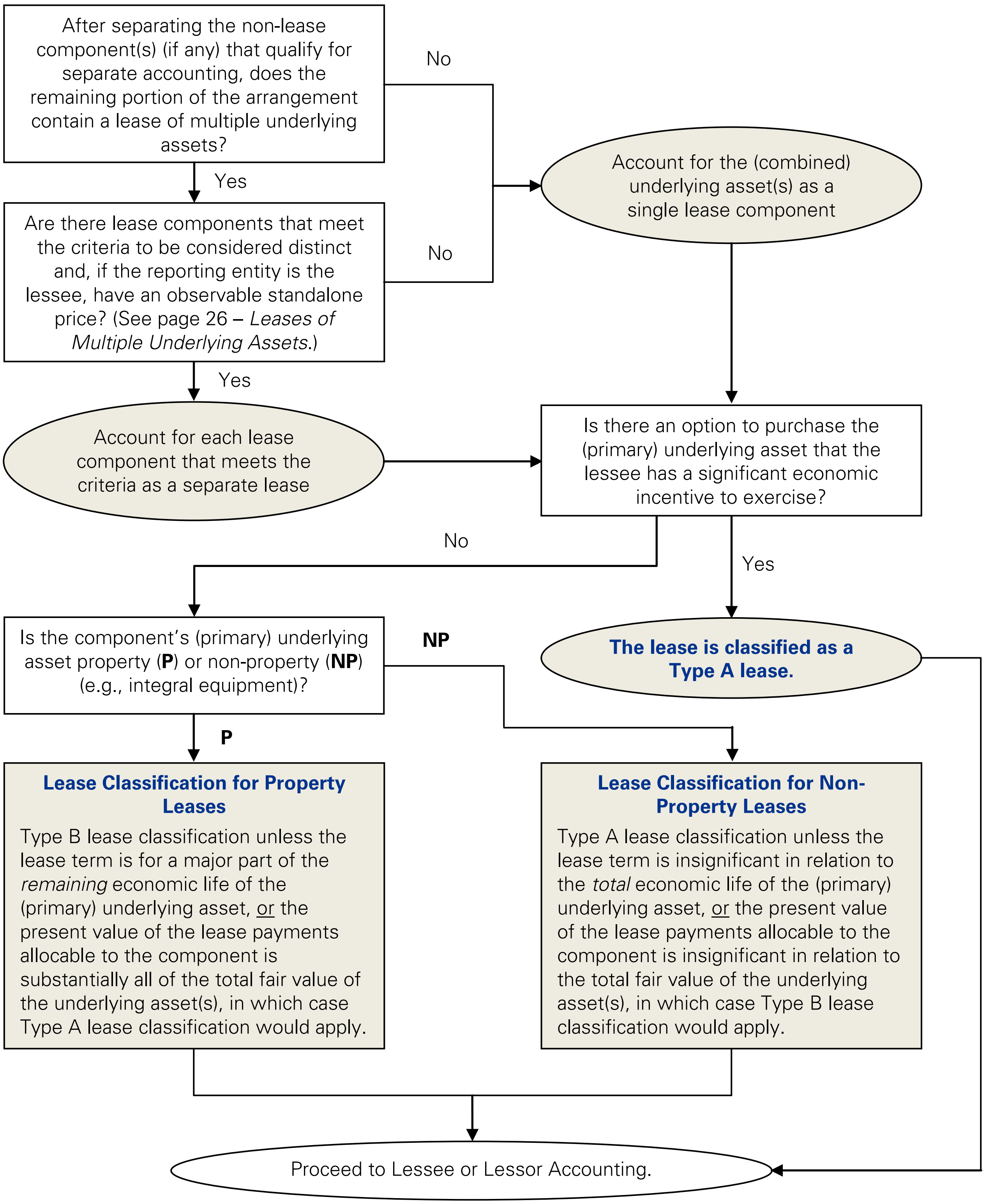
Scope and Definition of a Lease



Identifying Separable Non-Lease Components



Lease Classification



Lessee Accounting

Initial Recognition and Measurement – Type A and B Leases

Initially measure and recognize the lessee's lease liability and right-of-use (ROU) asset at lease commencement date.

Lease Liability – Initially measure at the PV of lease payments over the lease term. (See page 31 for definitions of lease payments and lease term, and the discount rate to be used.)

ROU Asset – Initially measure as:

- Initial measurement of lease liability; plus
- Initial direct costs incurred by lessee; plus
- Any lease payments made to the lessor at or before the commencement date; less
- Any lease incentives provided by the lessor.

(See page 50 – *Initial Measurement of the Right-of-Use Asset*.)

Subsequent Measurement of Lease Liability – Type A and B Leases

Subsequently measure the lease liability on an amortized cost basis using the effective interest method.

Expense Recognition and Subsequent Measurement of ROU Asset

Type A Leases

Expense Recognition – Recognize in profit or loss: interest expense on the lease liability, and separately, amortization of the ROU asset. Recognize variable lease payments not included in the lease liability and ROU asset as additional expense as incurred.

Amortization of ROU Asset – Amortize ROU asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which lessee consumes the economic benefits, in which case that basis would be used. Assess for impairment in accordance with existing GAAP.

Type B Leases

Expense Recognition – Recognize in profit or loss: a single, generally straight-line, lease expense comprised of the sum of interest on the lease liability and amortization of the ROU asset. Recognize variable lease payments not included in the lease liability and ROU asset as additional expense as incurred.

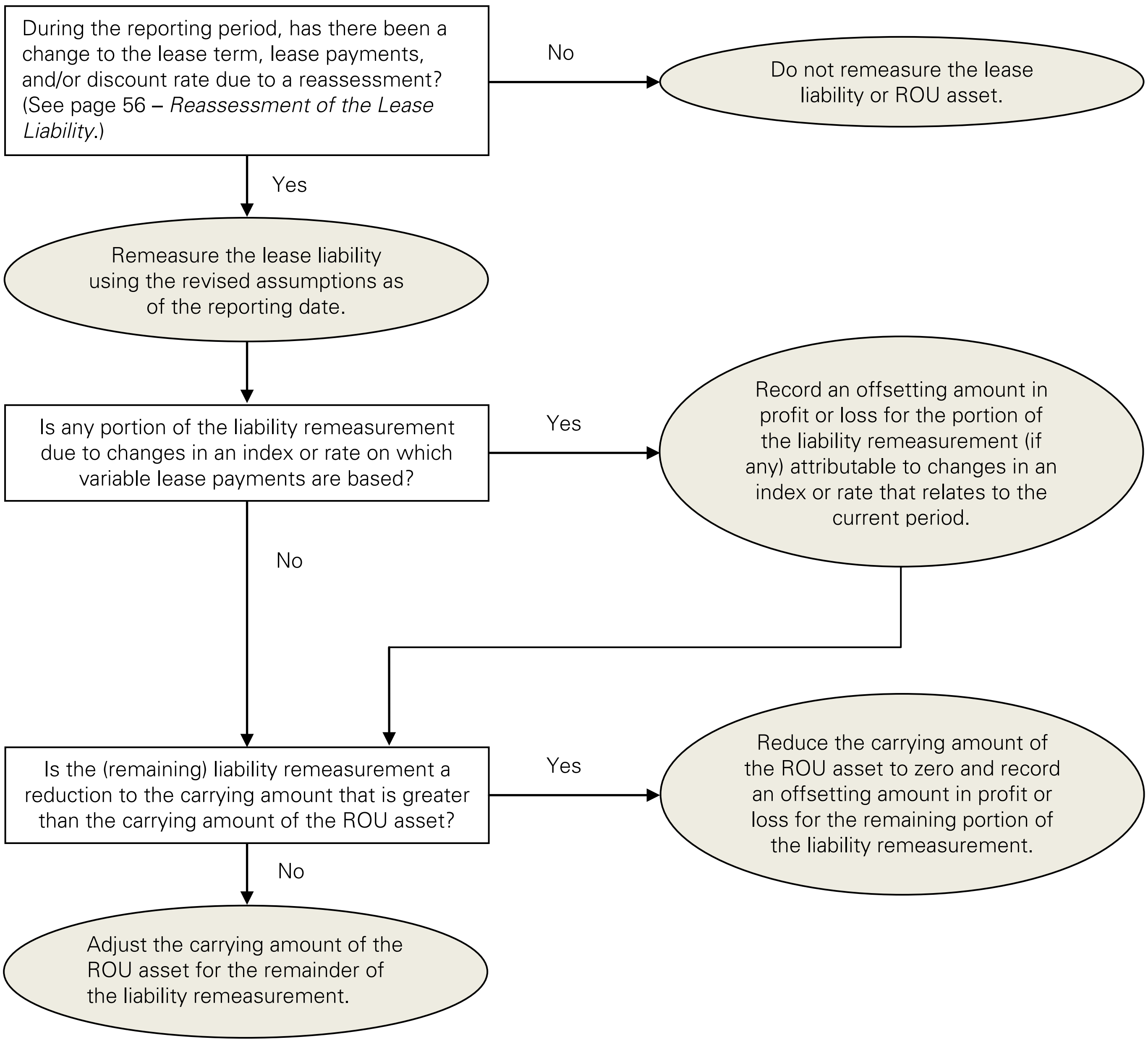
Amortization of ROU Asset – Amortize ROU asset in an amount equal to the greater of zero and:

- The remaining cost of the lease allocated over the remaining lease term on a straight-line basis; less
- The periodic interest on the lease liability.

Assess for impairment in accordance with existing GAAP.

(See page 51 – *Subsequent Measurement of the ROU Asset*.)

Reassessment of the Lease Liability – Type A and Type B Leases



Lessor Accounting – Type A Leases

Initial Recognition and Measurement

Derecognize the underlying asset and initially measure and recognize a lease receivable and net residual asset at lease commencement date. Recognize profit or loss when the fair value and carrying amount of the underlying asset are not equal at the lease commencement date.

Lease Receivable – Initially measure at the PV of lease payments over the lease term. (See page 31 for definitions of lease payments and lease term, and the discount rate to be used).

Profit or Loss at Lease Commencement – Measure upfront profit or loss as [total profit or loss (fair value – carrying amount of underlying asset) × PV of lease payments ÷ fair value of underlying asset].

Net Residual Asset – Initially measure as:

- Gross residual asset (present value of estimated future residual value of underlying asset at end of lease); plus
- PV of estimated variable lease payments included in determining the lessor's discount rate; less
- Unearned profit or loss (total profit or loss – upfront profit or loss).

(See page 73 – *Residual Asset*.)

Income Recognition and Subsequent Measurement of Lease Receivable and Residual Asset

Income recognition – Recognize the following in profit or loss:

- Upfront profit or loss in a manner that best reflects the lessor's business model – i.e., on a gross basis (e.g., as revenue and cost of goods sold) or on a net basis (e.g., as a gain or loss in other income);
- Periodic interest income on the lease receivable and from accretion of the gross residual asset; and
- Additional periodic income equal to:
  - Variable lease payments (VLPs) not included in the lease receivable earned during the period; less
  - An amount equal to the derecognized portion of the net residual asset attributable to VLPs (if any) considered in determining the lessor's discount rate.

Lease Receivable – Subsequently measure the lease receivable on an amortized cost basis using the effective interest method. Assess for impairment in accordance with financial instruments guidance.

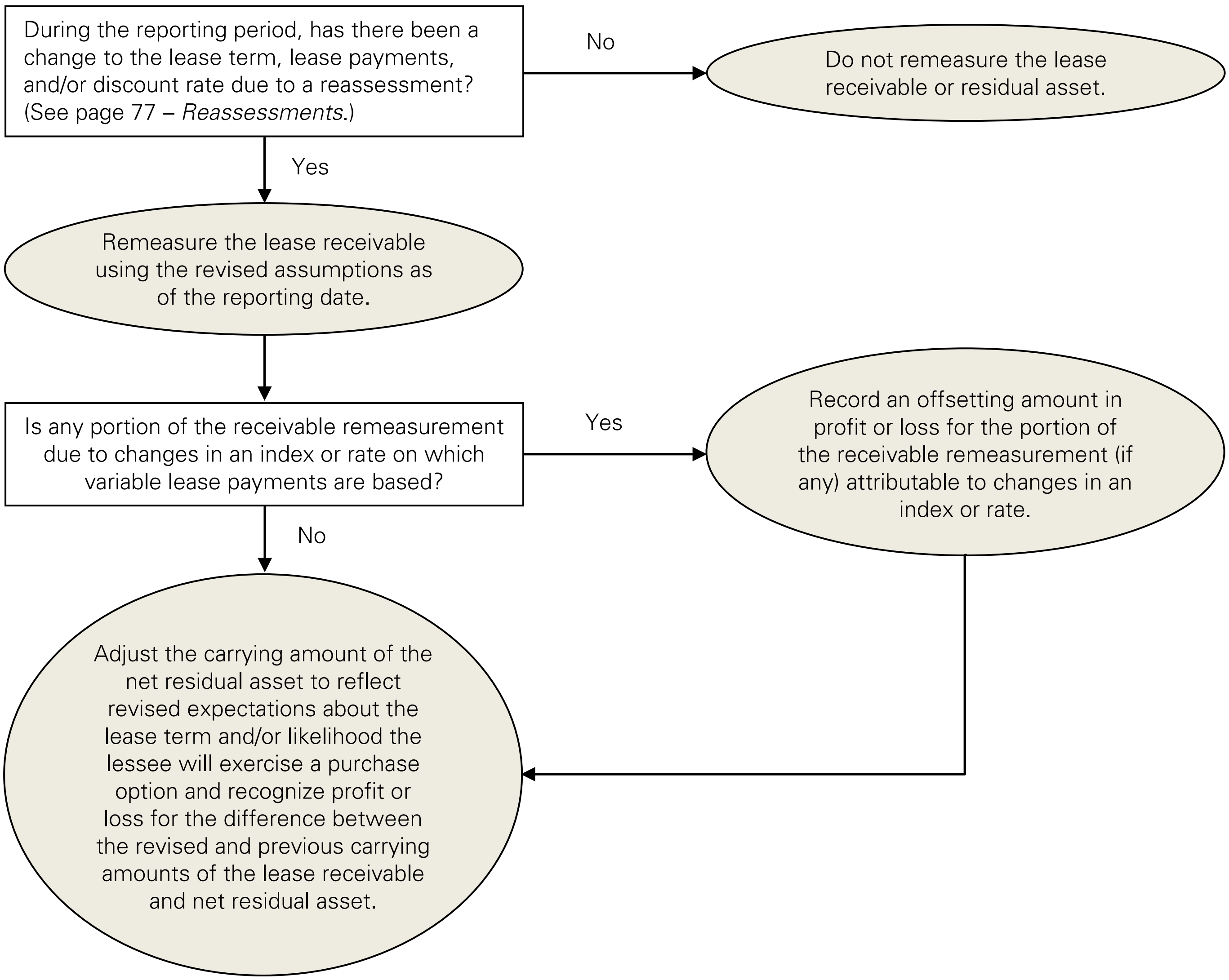
Residual Asset – Subsequently measure the net residual asset as follows:

- Accrete the gross residual asset at the lessor's discount rate;
- If estimated VLPs were considered in determining the lessor's discount rate, derecognize an amount each period equal to [original estimate of VLPs for the reporting period ÷ original estimate of VLPs for the lease term × PV of original estimate of VLPs for the lease term × carrying amount of underlying asset at lease commencement ÷ fair value of underlying asset at lease commencement];
- Assess for impairment in accordance with existing GAAP for fixed assets; and
- Do not recognize unearned profit or loss until a reassessment occurs that affects the measurement of the residual asset, the residual asset is either sold or re-leased, or an impairment of the residual asset is recognized.

Appendix – Application of the Lease Accounting Proposals (continued)

Lessor Accounting – Type A Leases (continued)

Reassessments



Lessor Accounting – Type B Leases

Initial Recognition and Measurement

Continue to recognize the underlying asset at its carrying amount.

Income Recognition and Subsequent Measurement

Recognize lease payments other than VLPs as income on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis would be used. Recognize VLPs as income as earned. Depreciate the underlying asset over its estimated useful life. Assess the underlying asset for impairment in accordance with existing GAAP for fixed assets.

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