Leases: Outline of Decisions to Date (April 2015)

Below is copy of "Leases—Joint Project of the FASB and the IASB," with commentary by Bill Bosco in bold italics

Source of FASB outline: www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011123

PROJECT OBJECTIVE AND SUMMARY OF THE PROPOSED MODEL

Leasing is an important activity for many organizations—whether a public or private company or a not-for-profit organization. It is a means of gaining access to assets, obtaining financing, and reducing an organization's exposure to the risks of asset ownership. Many organizations lease assets such as real estate, airplanes, trucks, ships, and construction and manufacturing equipment. Because of the prevalence of leasing, it is important for users of financial statements to have a complete and understandable picture of an organization's leasing activities.

The existing accounting models for leases require lessees and lessors to classify their leases as either capital leases or operating leases and to account for those leases differently. Those models have been criticized for failing to meet the needs of users of financial statements because they do not always provide a faithful representation of leasing transactions.

As a result, there has been a widespread request from users of financial statements and other stakeholders to change the accounting guidance so that lessees would be required to recognize assets and liabilities arising from leases.

In addition, the U.S. Securities and Exchange Commission (SEC) issued a report on off-balance sheet activities in 2005 and recommended that changes be made to the existing lease accounting requirements to ensure greater transparency in financial reporting. A number of academic studies have made similar recommendations.

The objective of the project is to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and disclosing key information. This represents an improvement over existing leases standards, which do not require lease assets and lease liabilities to be recognized by many lessees.

A lessee would recognize assets and liabilities for leases with a lease term of more than 12 months.

Bill Bosco Commentary: Existing lease accounting may be criticized for their all or nothing recognition in the balance sheet, but the model is based upon their being a difference between leases that are the temporary use of an asset leases that are the same as the acquisition of an asset and the incurrence of debt. This model is well understood, as future commitments are disclosed and the income and cash flow statements are appropriately presented. Additionally

accounting for leases is a special case of accounting for contracts, as operating leases will be the first executory contact to be capitalized and whatever model is finally used here may have broader applicability. It is fair to ask if we really need a major change in the accounting for leases when the SEC has started a program to simply financial analysis, specifically allowing footnoted information like operating lease obligations to be downloaded by users of financial statements.

SUMMARY OF TENTATIVE DECISIONS REACHED TO DATE (AS OF APRIL 7, 2015)

Accounting Models

Lessee Accounting Model
The FASB decided on a dual approach for lessee accounting, with lease classification determined in accordance with the principle in existing lease requirements (that is, determining whether a lease is effectively an installment purchase by the lessee). Under this approach, a lessee would account for most existing capital/finance leases as Type A leases (that is, recognizing amortization of the right-of-use (ROU) asset separately from interest on the lease liability) and most existing operating leases as Type B leases (that is, recognizing a single total lease expense). Both Type A leases and Type B leases result in the lessee recognizing a ROU asset and a lease liability.

Bill Bosco Commentary: The FASB decision to separate the accounting for leases based upon their substance is a significant development and will give users better information than they have today. It basically results in lessees capitalizing operating leases as, unique assets and liabilities, and treats the P&L lease cost as an operating expense, which is consistent with current GAAP. Under current GAAP lease expense is essentially a periodic level cost for the periodic use of the leased asset. The capitalization calculations will allow users to get a consistent picture of an entity's leasing activities, The decision leaves the current regime in place where accounting rules, tax law and commercial law each have the same risks and rewards philosophy (with minor differences in the actual criteria and tests for each discipline) to determine if a lease contract is a financed purchase or a rental contract. In order to minimize the opportunities for confusion, we hope the FASB reverts to terminology in current GAAP and renames the lease types capital leases and operating leases. The Type A & B terminology that is used in the project is confusing and does not apply any longer since the project is back on track with current GAAP classification concepts. We also understand that the FASB is considering going back to the "FAS 13" bright lines (90% for the PV test and 75% for the useful life test) and that would allow for more consistent application of the rules and it would be simpler. Since all leases will be capitalized (the primary goal) it makes the issues of classification criteria less important.

The IASB decided on a single approach for lessee accounting. Under that approach, a lessee would account for all leases as Type A leases (that is, recognizing amortization of the ROU asset separately from interest on the lease liability).

Bill Bosco Commentary: The IASB approach forces operating leases into what is essentially a capital lease model, misreporting the balance sheet and misrepresenting the P&L cost of a lease. As a result important information for lenders and credit analysts will not be readily available. It will force CFOs to recast operating leases for tax compliance, bank capital and debt covenant relief and to meet information requests of lenders and credit analysts. This approach is presented as a simplification, but what appears to be simple becomes complex when considered in this context.

Lessor Accounting Model
The Boards decided that a lessor should determine lease classification (Type A versus Type B) on the basis of whether the lease is effectively a financing or a sale, rather than an operating lease (that is, on the concept underlying existing U.S. GAAP and on IFRS lessor accounting). A lessor would make that determination by assessing whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset. In addition, the FASB decided that a lessor should be precluded from recognizing selling profit and revenue at lease commencement for any Type A lease that does not transfer control of the underlying asset to the lessee. This requirement aligns the notion of what constitutes a sale in the lessor accounting guidance with that in Topic 606, which evaluates whether a sale has occurred from the customer's perspective.

Lessor Type A Accounting

For all Type A leases, a lessor will be required to apply an approach substantially equivalent to existing IFRS finance lease accounting (and U.S. GAAP sales type/direct financing lease accounting).

Bill Bosco Commentary: The FASB's decision to stay with the current lessor risks and rewards models is a welcome decision. The decisions regarding sales type accounting will have some impact on lessors using residual insurance to achieve sales lease classification. I believe lessor can "sell" rights to elements of the leased asset to more than one party but the FASB decision is presented as being in line with the Revenue Recognition (Rev Rec) decisions that are based on when a lessor transfer "control" to the lessee only – no third party involvement. The other issue regarding the Revenue Recognition model's control concept vs. Leases' risks and rewards concept comes up in sale leaseback accounting and is described below. The FASB has also eliminated leveraged lease accounting (unfortunate given the economic model) but they are at least grandfathering existing leveraged leases on the transition date – including any done up to the transition date (1/1/2108 for calendar year companies). We are hoping the FASB will address ITC and tax grant accounting in the final standard, by making explicit that ITC/tax grants directly related to a leased asset are revenue items in Type A leases or reduce the asset cost to be depreciated in Type B leases.

Scope

Definition of a Lease
The Boards decided that a lease should be defined as "a contract that conveys the right to use an

asset (the underlying asset) for a period of time in exchange for consideration." An entity would determine whether a contract contains a lease by assessing whether:

1. The use of an identified asset is either explicitly or implicitly specified. A contract would not involve the use of an identified asset if a supplier has the substantive right to substitute the asset used to fulfill the contract. A supplier would have the substantive right to substitute an asset if:
    a. It has the practical ability to substitute the asset; and
    b. It can benefit from exercising that right of substitution.
2. The customer controls the use of the identified asset. A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to:
    a. Direct the use of the identified asset; and
    b. Obtain substantially all of the economic benefits from directing the use of the identified asset.

The Boards decided that a customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use. If neither the customer nor the supplier controls how and for what purpose the asset is used throughout the period of use, the customer is considered to have the right to direct the use of the identified asset in *either* of the following circumstances:

1. The customer has the right to operate the asset or to direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions); or
2. The customer designed the asset, or caused the asset to be designed, in a way that predetermines during the period of use:
    a. How and for what purpose the asset will be used; or
    b. How the asset will be operated.

In addition, the Boards decided that a supplier's protective rights over the identified asset typically define the scope of the customer's use of the asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset.

Bill Bosco Commentary: The right to substitute may be an opportunity for full service lessors to avoid lease accounting and stay in service contract accounting, which would not result in the recognition of an asset and liability. Real estate office space leases often contain right of substitution clauses that are exercised fairly often – this may mean that those contracts would not be leases and would remain off balance sheet. Ultimately, we need to see the full final words to best understand the new definition.

<u>Small-Ticket Leases</u>

The Boards decided to permit the leases guidance to be applied at a portfolio level by lessees and lessors. The FASB decided to include the portfolio guidance in the basis for conclusions; the IASB decided to include the portfolio guidance in the application guidance.

The IASB decided to provide an explicit recognition and measurement exemption for leases of small assets for lessees.

Bill Bosco Commentary: The portfolio option may be impractical to manage and is not likely to be a cost saver, but it does help by moving the focus of the accounting to the contract level. The IASB proposal would allow many small items to be excluded could result in a lessee not recognizing a material amount on its balance sheet, but it also appears that this proposal will not result in significant relief for most IFRS companies.

Short-Term Leases (Lessee)

The Boards decided to retain the recognition and measurement exemption for a lessee's short-term leases. The Boards also decided that the short-term lease threshold should remain at 12 months or less. Additionally, the Boards decided to change the definition of a short-term lease so that it is consistent with the definition of lease term.

Bill Bosco Commentary: This is a good decision. It may mean that 12 month auto fleet leases, for example, would remain off balance sheet (but we need to see the final words.

Measurement

Lease Term and Purchase Options
The Boards decided that, when determining the lease term, an entity should consider all relevant factors that create an economic incentive to exercise an option to extend, or not to terminate, a lease. An entity should include such an option in the lease term only if it is reasonably certain that the lessee will exercise the option having considered the relevant economic factors. Reasonably certain is a high threshold substantially the same as reasonably assured in existing U.S. GAAP. The Boards decided that a lessee should reassess the lease term only upon the occurrence of a significant event or a significant change in circumstances that are within the control of the lessee.

The Boards decided that a lessor should not be required to reassess the lease term.

The Boards decided that an entity should account for purchase options in the same way as options to extend, or not to terminate, a lease.

Bill Bosco Commentary: The intent is to be the same as current GAAP where whether the option is a bargain or compelling defines whether it is included in minimum lease payments. The final words, however, may result in some changes to existing practice.

Variable Lease Payments
The Boards decided that only variable lease payments that depend on an index or a rate should be included in the initial measurement of lease assets and lease liabilities and that an entity should measure those payments using the index or rate at lease commencement.

The FASB decided that a lessee should reassess variable lease payments that depend on an index or a rate only when the lessee remeasures the lease liability for other reasons (for example, because of a reassessment of the lease term).

The IASB decided that a lessee should reassess variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for other reasons (for example, because of a reassessment of the lease term) and when there is a change in the cash flows resulting from a change in the reference index or rate (that is, when an adjustment to the lease payments takes effect).

The Boards decided that a lessor should not be required to reassess variable lease payments that depend on an index or a rate.

In-Substance Fixed Payments

The Boards decided (1) to retain the principle that variable lease payments that are in-substance fixed payments should be included in the definition of lease payments and provide additional clarifying guidance and (2) to note in the Basis for Conclusions that the concept that some variable lease payments are in-substance fixed payments exists under current practice.

Bill Bosco Commentary: These decisions are all helpful as they are practical and meant to be consistent with existing practice. It does seem the FASB decision to not remeasure lease liabilities when the contractual payments change due to a change in variable payments means a lessee preparer will have to track the changes for footnote disclosures.

Discount Rate

With respect to the determination of the discount rate, the Boards decided:

1. To clarify in the implementation guidance what "value" refers to in the definition of the lessee's incremental borrowing rate, but otherwise make no changes to the definition in the May 2013 Exposure Draft.
2. To describe the rate the lessor charges the lessee as the rate implicit in the lease, consistent with existing lessor guidance.
3. To include initial direct costs of the lessor in determining the rate implicit in the lease.

With respect to reassessment of the discount rate, the Boards decided:

1. To require a lessee to reassess the discount rate only when there is a change to either the lease term or the assessment of whether the lessee is (or is not) reasonably certain to exercise an option to purchase the underlying asset.
2. Not to require a lessor to reassess the discount rate.

Bill Bosco Commentary: These decisions are all helpful as they are practical.

Nonpublic Business Entity Discount Rate Considerations
The FASB decided to retain the accounting policy election to use the risk-free rate for nonpublic business entities (that is, all other entities beside public business entities).

Bill Bosco Commentary: We do not expect nonpublic companies to use the risk free rate as the result would be an overstatement of lease assets and liabilities.

Lease Modifications and Contract Combinations
The Boards decided to define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease and that the substance of the modification should govern over its form.

The Boards decided that both a lessee and a lessor should account for a lease modification as a new lease, separate from the original lease, when (1) the lease grants the lessee an additional right-of-use not included in the original lease and (2) the additional right-of-use is priced commensurate with its standalone price (in the context of that particular contract).

For lease modifications that are not accounted for as separate new leases, the Boards decided that:

1. When a lease modification results in a change in the scope or consideration of the lease, a lessee should remeasure the lease liability using a discount rate determined at the effective date of the modification. For modifications that increase the scope of, or change the consideration paid for, the lease, the lessee should make a corresponding adjustment to the right-of-use asset. For modifications that decrease the scope of the lease, the lessee should decrease the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease and should recognize a gain or a loss on a proportionate basis to the decrease in scope.
2. A lessor should account for (a) modifications to a Type B lease as, in effect, a new lease from the effective date of the modification, considering any prepaid or accrued lease rentals relating to the original lease as part of the lease payments for the modified lease and (b) modifications to a Type A lease in accordance with IFRS 9, *Financial Instruments* (IFRS), or Topic 310, Receivables (U.S. GAAP).

The Boards decided to include contract combination guidance in the final leases standard, similar to that which is included in Topic 606 that would indicate when two or more contracts should be considered a single transaction.

Bill Bosco Commentary: These are all good decisions, except for the Board's decision to not combine the sale leaseback contracts and to account for each portion of the transaction separately, as discussed below. For these transactions

Separating Lease and Nonlease Components
The Boards decided to retain guidance similar to that proposed in the 2013 Exposure Draft for both lessees and lessors on identifying separate lease components.

The Boards decided to retain guidance similar to that proposed in the 2013 Exposure Draft for lessors on separating lease components from nonlease components and allocating consideration in the contract to those components. That is, a lessor should apply the guidance in Topic 606 on allocating the transaction price to separate performance obligations. A lessor also should reallocate the consideration in a contract when there is a contract modification that is not accounted for as a separate, new contract.

The Boards decided to change the proposals in the 2013 Exposure Draft for lessees regarding separating lease components from nonlease components and allocating consideration in a contract to those components as follows:

1. A lessee should separate lease components from nonlease components unless it applies the accounting policy election discussed below.
2. A lessee should allocate the consideration in a contract to the lease and nonlease components on a relative standalone price basis. Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract. A lessee also should reallocate the consideration in a contract when (a) there is a reassessment of either the lease term or a lessee's purchase option or (b) there is a contract modification that is not accounted for as a separate, new contract.
3. A lessee should use observable standalone prices, if available, and otherwise it would use estimates of the standalone price for lease and nonlease components (maximizing the use of observable information).

The Boards decided to permit a lessee, as an accounting policy election by class of underlying asset, to not separate lease components from nonlease components. Instead, a lessee should account for lease and nonlease components together as a single lease component.

Bill Bosco Commentary: These are all good decisions, especially the decision to allow lessees to use estimates to bifurcate the gross payment into the lease and service components, but with one significant caveat. Certain costs that are now considered executory costs, such as property taxes, may be considered a lease element under the proposals and become an element of the lease liability and asset.

<u>Initial Direct Costs</u>
The Boards decided that only incremental costs should qualify as initial direct costs.

The Boards decided that initial direct costs should include only incremental costs that an entity would not have incurred if the lease had not been obtained (executed) (for example, commissions or payments made to existing tenants to obtain the lease).

The Boards decided that both lessees and lessors should apply the same definition of initial direct costs.

The Boards decided the following regarding the accounting for initial direct costs:

1. A lessor in a Type A lease (except those who recognize selling profit at lease commencement) should include initial direct costs in the initial measurement of the lease receivable by taking account of those costs in determining the rate implicit in the lease. A lessor who recognizes selling profit at lease commencement should recognize initial direct costs associated with a Type A lease as an expense at lease commencement.
2. A lessor in a Type B lease should recognize initial direct costs as an expense over the lease term on the same basis as lease income.
3. A lessee should include initial direct costs in the initial measurement of the right-of-use asset and amortize those costs over the lease term.

Bill Bosco Commentary: This is a change from current GAAP which allows internal costs to also be included in initial direct costs. This will require lessors to have separate IDC pools for their leases and loans.

Subleases

The Boards decided that an intermediate lessor (that is, an entity that is both a lessee and a lessor of the same underlying asset) should account for a head lease and a sublease as two separate contracts (accounting for the head lease in accordance with the lessee accounting proposals and the sublease in accordance with the lessor accounting proposals), unless those contracts meet the contract combinations guidance adopted by the Boards at the April 2014 joint Board meeting.

The FASB decided that, when classifying a sublease, an intermediate lessor should determine the classification of the sublease with reference to the underlying asset (for example, the item of property, plant, and equipment that is the subject of the lease), rather than with reference to the ROU asset arising from the head lease.

The IASB decided that, when classifying a sublease, an intermediate lessor should determine the classification of the sublease with reference to the ROU asset arising from the head lease. The Boards decided that an intermediate lessor should not offset lease assets and lease liabilities arising from a head lease and a sublease that do not meet the respective IFRS and GAAP financial instruments requirements for offsetting.

The Boards decided that an intermediate lessor should not offset lease income and lease expense related to a head lease and a sublease, unless it recognizes sublease income as revenue and acts as an agent (assessed in accordance with the “principal-agent” guidance in Topic 606 on revenue from contracts with customers).

Bill Bosco Commentary: These are all good decisions by the FASB. The IASB decision will result in capital lease accounting on the head lease and operating lease accounting for the sublease in many cases. This will result in a mismatch of costs and revenue. This is a result of choosing a one lease model for lessees that does not reflect the substance of an operating lease.

Sale and Leaseback Transactions

Determining Whether a Sale Has Occurred

The Boards decided to retain the guidance in the 2013 Exposure Draft that in order for a sale to occur in the context of a sale and leaseback transaction, the sale must meet the requirements for a sale in Topic 606. The Boards reaffirmed that the presence of the leaseback does not, in isolation, preclude the seller-lessee from concluding that it has sold the underlying asset to the buyer-lessor.

The FASB decided that if the seller-lessee determines that the leaseback is a Type A lease, assessed from the seller-lessee's perspective, then no sale has occurred.

The IASB decided not to include any additional application guidance in the final leases standard regarding the determination of the sale. The IASB clarified, however, that if the seller-lessee has a substantive repurchase option with respect to the underlying asset, then no sale has occurred.

Accounting for the Sale/Purchase

The Boards decided to retain the guidance in the 2013 Exposure Draft that a buyer-lessor should account for the purchase of the underlying asset consistent with the guidance that would apply to any other purchase of a nonfinancial asset (that is, without the presence of the leaseback).

The Boards decided to retain the guidance in the 2013 Exposure Draft that a seller-lessee should account for any loss on a completed sale in a sale and leaseback transaction consistent with the guidance that would apply to any other similar sale.

The FASB decided to retain the guidance in the 2013 Exposure Draft that a seller-lessee should account for any gain on a completed sale in a sale and leaseback transaction consistent with the guidance that would apply to any other similar sale.

The IASB decided that the gain recognized by a seller-lessee on a completed sale in a sale and leaseback transaction should be restricted to the amount of the gain that relates to the residual interest in the underlying asset at the end of the leaseback.

Repurchase Options in a Sale and Leaseback Transaction

The FASB decided to follow the guidance in Topic 606 and clarify that a repurchase option exercisable only at the then-prevailing fair market value would not preclude sale treatment, provided that the underlying asset is nonspecialized and readily available in the marketplace. The repurchase option must be substantive in order to affect the accounting for the transaction. In reaching this decision, some FASB members thought that this application was consistent with language provided in the basis for conclusions of Topic 606.

Application Guidance for Determining Whether a Sale Has Occurred

The FASB decided to include application guidance, with respect to determining whether a sale occurs in the context of a sale and leaseback transaction, in the final leases standard.

Accounting for the Leaseback

The Boards decided to retain the guidance in the 2013 Exposure Draft that if a sale is completed, the seller-lessee and the buyer-lessor should account for the leaseback in the same manner as any other lease.

Accounting for "Off-Market" Terms

The Boards decided that an entity should determine any potential "off-market" adjustment on the basis of the difference between either (1) the sale price and the fair value of the underlying asset or (2) the present value of the contractual lease payments and the present value of fair market value lease payments, whichever is more readily determinable.

For sale and leaseback transactions entered into at "off-market" terms, the Boards decided that an entity should account for:

1. Any deficiency in the same manner as a prepayment of rent.
2. Any excess as additional financing provided by the buyer-lessor to the seller-lessee.

Accounting for Failed Sale and Leaseback Transactions

The IASB decided to retain the guidance proposed in the 2013 Exposure Draft that both a seller-lessee and a buyer-lessor would account for a "failed" sale and leaseback transaction as a financing transaction.

The FASB decided that if a sale and leaseback transaction does not result in a sale, the "failed" sale should be accounted for as a financing transaction by the seller-lessee and buyer-lessor.

Bill Bosco Commentary: Sale leasebacks with non-bargain but fixed priced purchase options are very common in equipment leasing. The "good" decision by the FASB to account for operating leases as Type B leases will be negated by the decision to allow the Revenue Recognition concept of control to supersede the Leases concept of risks and rewards when determining the accounting for a lease in a sale leaseback. Said another way, a failed sale lease back due to the presence of a non-bargain purchase option will force the lessee to report an asset that they do not "own" legally and a debt obligation that is really a Type B non-debt "other " liability. Since the asset will remain on the lessee's balance sheet and the lease obligation will be accounted for as a financing, the asset and liability would be overstated. What the lessee really has in a failed sale leaseback with a non-bargain purchase option is an ROU asset and an operating lease obligation.

This decision will likely add complexity to transaction structuring in order to avoid this accounting outcome. Some transactions may eliminate fixed price purchase options and in other cases lessees and lessors will strive to use the "agent" exemption in Revenue Recognition. To undertake a sale leaseback with a fixed price purchase option the lessee may have to sign an agency agreement with a prospective lessor stating they are acting as agent, choosing the asset to be leased and introducing the seller to the lessor. In addition, lessors and lessees may need clarification of the events that put the lessee in the chain of ownership – for

example, will issuing a purchase order, committing to an order position, making a down payment, or making a progress payment mean that the lessee "controls' the physical asset before delivery. These are implementation issues that where we will need guidance. This area should not be left for interpretation.

Related Party Leasing Transactions

The FASB decided to retain the related party leases guidance proposed in the 2013 Exposure Draft. The FASB reaffirmed that lessees and lessors should be required to account for their related party leases on the basis of the legally enforceable terms and conditions of the lease.

Leveraged Leases

The FASB reaffirmed the proposal in the 2013 Exposure Draft that leveraged lease accounting should be eliminated. That is, the lessor should account for leases that currently qualify as leveraged leases consistent with all other leases within the new leases guidance.

The FASB decided that existing leveraged leases should be grandfathered during transition.

Bill Bosco Commentary: We are sorry to see leveraged lease accounting go. It is a great concept that truly accounts for the assets at risk, the effects of the tax credits, payments associated with the leased asset and the matching of funding costs. The cost of leasing large ticket assets to lessees will rise as this structure will no longer be available. The good news, however, is the grandfathering of leveraged leases existing at the transition date. It means lessors can continue using the product until 2018 and trade in them thereafter.

Presentation

Balance Sheet Presentation

Lessee ROU Asset

The FASB decided that a lessee should either present as separate line items on the balance sheet or disclose in the notes Type A ROU assets (which are effectively purchases of the underlying asset) and Type B ROU assets. If a lessee does not present Type A ROU assets or Type B ROU assets as separate line items on the balance sheet, the lessee should disclose in the notes which line items in the balance sheet include Type A ROU assets and Type B ROU assets. A lessee is prohibited from presenting Type A ROU assets within the same line item as Type B ROU assets.

The IASB decided that a lessee should either present as a separate line item on the balance sheet or disclose in the notes ROU assets. If a lessee does not present ROU assets as a separate line item on the balance sheet, the lessee should present ROU assets within the same line item as the corresponding underlying assets would be presented if they were owned, and disclose in the notes which line item in the balance sheet includes ROU assets.

Bill Bosco Commentary: These are all good decisions by the FASB, but the IASB's decisions are not as good for lessees, as one can no longer determine which assets are owned vs. rented under the one lease model

Lessee Lease Liability

The FASB decided that a lessee should either present as separate line items on the balance sheet or disclose in the notes Type A lease liabilities and Type B lease liabilities. If a lessee does not present Type A lease liabilities or Type B lease liabilities as separate line items on the balance sheet, the lessee should disclose in the notes which line items in the balance sheet include Type A lease liabilities and Type B lease liabilities. A lessee is prohibited from presenting Type A lease liabilities within the same line item as Type B lease liabilities.

The IASB decided that a lessee should either present as a separate line item on the balance sheet or disclose in the notes lease liabilities. If a lessee does not present lease liabilities as a separate line item on the balance sheet, the lessee should disclose in the notes which line item in the balance sheet includes lease liabilities.

Bill Bosco Commentary: These are all good decisions by the FASB. Under the IASB's proposals, however, a user of financial statements cannot tell what the lessee's "true" debts are versus executory liabilities that are not debt in a bankruptcy liquidation. The IASB does not have the same definition of debt as is used by lenders and credit analysts. The analysts and lenders consider debt to be liabilities that have a claim on assets in a bankruptcy liquidation. An operating lease obligation behaves differently when the lease is rejected in bankruptcy and the asset is returned to the lessor. Analysts call operating lease obligations "debt-like" obligations – they do not call them debt. Under the FASB model the operating lease liabilities will not cause technical defaults of debt covenants that limit debt of a lessee – these are very common in loan agreements. The operating lease liabilities will be a debt covenant issue for IFRS preparers under the IASB one lease model. Here again an IFRS preparer CFO will either have to renegotiate debt covenants or recast the operating lease accounting to show lenders that the debt covenant is not really violated.

Cash Flow Presentation

Lessee

The FASB decided to retain the guidance in the 2013 Exposure Draft requiring a lessee to classify:

1. Cash payments for the principal portion of the lease liability arising from Type A leases within financing activities
2. Cash payments for the Interest portion of the lease liability arising from Type A leases within operating activities
3. Cash payments arising from Type B leases within operating activities.

The IASB decided to retain the guidance in the 2013 Exposure Draft for Type A leases requiring a lessee to classify:

1. Cash payments for the principal portion of the lease liability within financing activities
2. Cash payments for the interest portion of the lease liability in accordance with the requirements relating to interest paid in IAS 7, Statement of Cash Flows.

The IASB also decided to require a lessee to disclose a single figure for lease cash outflows elsewhere in the financial statements.

Lessor

The Boards decided to retain the guidance in the 2013 Exposure Draft requiring a lessor to classify cash receipts from leases within operating activities.

Disclosures

<u>Lessee</u>
Overall Disclosure Objective

The Boards decided that the final leases standard should include a disclosure objective, which would be to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. The Boards also decided to retain the 2013 ED proposal requiring a lessee to consider the level of detail necessary to satisfy the disclosure objective.

FASB Qualitative Disclosure Requirements

The FASB decided to retain the qualitative disclosure requirements proposed in the 2013 ED, requiring a lessee to disclose the following qualitative items:

1. Information about the nature of its leases (and subleases), including:
    a. A general description of those leases;
    b. The basis, and terms and conditions, on which variable lease payments are determined;
    c. The existence, and terms and conditions, of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of the ROU assets and lease liabilities and those that are not;
    d. The existence, and terms and conditions, of residual value guarantees provided by the lessee; and
    e. The restrictions or covenants imposed by leases.
2. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee.
3. Information about significant assumptions and judgments made in applying the requirements of the leases standards, which may include the following:
    a. The determination of whether a contract contains a lease;
    b. The allocation of the consideration in a contract between leases and nonlease components; and
    c. The determination of the discount rate.
4. The main terms and conditions of any sale and leaseback transactions.
5. Whether an accounting policy election was made for the short-term lease exemption.

The FASB decided if the short-term lease expense does not reflect the lessee's short-term lease commitments, a lessee should disclose that fact and the amount of its short-term lease commitments.

Bill Bosco Commentary: While these represent significant disclosure obligations, they are not unexpected.

IASB Qualitative Disclosure Requirements

The IASB decided not to retain the qualitative disclosure requirements proposed in the 2013 ED and, instead, require a lessee to disclose sufficient additional information to satisfy the overall disclosure objective. The IASB decided to supplement this requirement with a list of specific disclosure objectives and to include illustrative examples in the final leases standard to demonstrate how a lessee might comply with this requirement.

FASB Quantitative Disclosure Requirements

The FASB decided not to retain the 2013 ED proposal requiring a lessee to disclose a reconciliation of the opening and closing balances of its lease liabilities.

The FASB decided to require a lessee to disclose the following quantitative items:

1. Type A lease expense, segregated between amortization of ROU assets and interest on lease liabilities.
2. Type B lease expense.
3. Short-term lease expense, excluding expenses relating to leases with a lease term of one month or less.
4. Variable lease expense.
5. Sublease income.
6. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows and between Type A and Type B leases.
7. Supplemental noncash information on lease liabilities arising from obtaining ROU assets segregated between Type A and Type B leases.
8. Weighted-average remaining lease term, disclosed separately for Type A and Type B leases.
9. Weighted-average discount rate for Type A and Type B leases as of the reporting date.
10. Gains and losses arising from sale and leaseback transactions.

The FASB decided to clarify that the expense items disclosed would also include any amounts capitalized as part of the cost of another asset.

The FASB decided to retain the 2013 ED proposal for a lessee to disclose a maturity analysis of its lease liabilities, 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 reconciling the undiscounted cash flows to the discounted lease liabilities recognized in the statement of financial position.

The FASB decided not to retain the 2013 ED proposal requiring a lessee to disclose a maturity analysis of commitments for nonlease components related to a lease.

Bill Bosco Commentary: While these represent significant disclosure obligations, they are not unexpected.

IASB Quantitative Disclosure Requirements

The IASB decided not to retain the 2013 ED proposal requiring a lessee to disclose a reconciliation of the opening and closing balances of its lease liabilities. The IASB decided not to retain the 2013 ED proposal requiring a lessee to disclose a reconciliation of the opening and closing balances of its ROU assets.

The IASB decided to require a lessee to disclose the following quantitative items:

1. Amortization of ROU assets, split by class of underlying asset.
2. Interest on lease liabilities.
3. Short-term lease expense, excluding expenses relating to leases with a lease term of one month or less.
4. Small asset lease expense.
5. Variable lease expense.
6. Income from subleasing ROU assets.
7. Total cash outflow for leases.
8. Additions to ROU assets.
9. Gains and losses arising from sale and leaseback transactions.
10. Closing carrying amount of ROU assets, split by class of underlying asset.

The IASB decided to require a lessee to present all lessee disclosures in a single note or separate section in its financial statements. The IASB also decided to require a lessee to present the quantitative lessee disclosures in a tabular format, unless another format is more appropriate.

The IASB decided that a lessee should be required to disclose a maturity analysis of its lease liabilities in accordance with paragraphs 39 and B11 of IFRS 7, *Financial Instruments: Disclosures*. A lessee would be required to disclose this maturity analysis separately from the maturity analyses of other financial liabilities.

Nonpublic Business Entity Considerations

The FASB decided not to provide any specified reliefs from the disclosure requirements for nonpublic business entities (that is, all other entities besides public business entities). Therefore, the lessee disclosure package is equally applicable to both public and nonpublic business entities.

<u>Lessor</u>
The Boards decided that a lessor should be required to disclose:

1. Information about the nature of its leases, as well as information about significant assumptions and judgments made in applying the leases requirements;
2. A table of lease income during the reporting period; and
3. Information about how a lessor manages its risk associated with the residual value of its leased assets.

The Boards decided that a lessor should treat assets subject to Type B leases as a class of property, plant, and equipment (IFRS) or a major class of depreciable assets (U.S. GAAP), further distinguished by significant class of underlying asset. Accordingly, a lessor should provide the required property, plant, and equipment disclosures for assets subject to Type B leases separately from owned assets held and used by the lessor.

The Boards also decided that a lessor should be required to disclose:

1. For Type A leases, a maturity analysis of the undiscounted cash flows that comprise the lessor's lease receivables for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter. A lessor should reconcile the maturity analysis to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes; and
2. For Type B leases, a maturity analysis of the undiscounted future lease payments to be received for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter.

The FASB decided that a lessor should be required to provide an explanation of the significant changes in the components of the net investment in Type A leases other than the lease receivable during the reporting period. The FASB will consider disclosures related to Type A lease receivables when it discusses disclosures in its project on accounting for financial instruments—credit impairment.

The IASB decided that a lessor should be required to provide a qualitative and quantitative explanation of the significant changes in the net investment in Type A leases during the reporting period.

Bill Bosco Commentary: While these represent significant disclosure obligations, they are not unexpected, although there may be a lot of "boilerplate' words to describe large lessors' businesses, portfolios, residual risks, risk management methods, etc.

<u>Related Party</u>
The FASB decided that lessees and lessors should be required to apply the disclosure requirements for related party transactions in accordance with Topic 850.

Transition

<u>Lessee Transition</u>
The FASB decided to require a lessee to apply a modified retrospective transition approach for capital and operating leases existing at, or entered into after, the beginning of the earliest

comparative period presented in the financial statements (the date of initial application). The modified retrospective approach would not require any transition accounting for leases that expired before the date of initial application. The FASB decided to not permit a full retrospective transition approach.

The modified retrospective transition approach should be applied to existing leases as follows:

Capital Leases

1. A lessee should initially recognize a Type A ROU asset and lease liability at the later of (a) the date of initial application and (b) the date of initial recognition under Topic 840 measured at the carrying amount of the capital lease asset and capital lease obligation under Topic 840 immediately before that date.
2. Any unamortized initial direct costs not included in the capital lease asset under Topic 840 that would have qualified for capitalization under the new leases standard should be subsumed into the Type A ROU asset; otherwise, those costs that would not have qualified for capitalization should be written off as an adjustment to equity.
3. Before the effective date, a lessee should subsequently measure the Type A ROU asset and lease liability in accordance with the subsequent measurement guidance in Topic 840.
4. Beginning on the effective date, a lessee should subsequently measure the Type A ROU asset and lease liability in accordance with the subsequent measurement guidance in the new leases standard, except that a lessee should not remeasure the Type A ROU asset or lease liability for changes in the amount the lessee expects to pay under residual value guarantees unless it remeasures the asset or liability for other reasons (for example, because of a change in the lease term resulting from a reassessment).
5. Beginning on the effective date, if a lessee modifies the lease (and that modification is not a separate lease) or is required to remeasure the lease liability for any reason, it should follow the new leases standard.

Operating Leases

1. A lessee should initially recognize a Type B ROU asset and lease liability at the later of (a) the date of initial application and (b) lease commencement.
2. Unless the lease is modified (and that modification is not a separate lease), or the lease liability is required to be remeasured, on or after the effective date, a lessee should initially and subsequently measure the lease liability at the present value of the sum of:
    a. The remaining *minimum rental payments* (as defined under Topic 840) plus
    b. Any amounts the lessee expects to pay to satisfy a residual value guarantee, using a discount rate established in accordance with the new leases standard as of the "later of" date.
3. A lessee should measure the Type B ROU asset throughout the lease at an amount equal to the lease liability, adjusted for any prepaid or accrued rent, lease incentives,

or unamortized initial direct costs that would have qualified for capitalization under the new leases standard.

4. Any unamortized initial direct costs at the "later of" date that would not have qualified for capitalization under the new leases standard should be written off as an adjustment to equity.
5. Beginning on the effective date, if a lessee modifies the lease (and that modification is not a separate lease) or is required to remeasure the lease liability for any reason, it should follow the new leases standard.

The FASB further decided to permit a lessee to elect the following specified reliefs, which must be elected as a package and must be applied to all of a lessee's leases (that is, they cannot be elected on a lease-by-lease or relief-by-relief basis):

1. A lessee need not reassess whether any expired or existing contracts are or contain leases.
2. A lessee need not reassess the lease classification for any expired or existing leases.
3. A lessee need not reassess initial direct costs for any existing leases (that is, whether those costs would have qualified for capitalization under the new leases standard).

Lastly, the FASB also decided to permit a lessee to elect to use hindsight with respect to lease renewals and purchase options when accounting for existing leases. This specified relief may be elected separately or in conjunction with the above specified reliefs as an accounting policy election (that is, it cannot be elected on a lease-by-lease basis).

Bill Bosco Commentary: These are all good decisions by the FASB. Transition to the IASB's lease model for former operating leases will be complex, will result in a charge to equity and the establishment of a deferred tax asset, neither of which is likely to reverse in the near term. The deferred tax asset is caused by the difference in the book and tax treatment of a lease in the U.S. – for tax purposes rent is the deduction not the book amounts computed for depreciation and imputed interest. Deferred tax assets are a serious issue for bank capital calculations as they attract more capital than other assets.

Lessor Transition

The FASB decided to require a lessor to apply a modified retrospective transition approach for sales-type, direct financing, and operating leases existing at, or entered into after, the date of initial application. The modified retrospective approach would not require any transition accounting for leases that expired before the date of initial application. The FASB decided to not permit a full retrospective transition approach.

The modified retrospective transition approach should be applied to existing leases as follows:

Sales-Type/Direct Financing Leases

1. A lessor should not reassess whether a sales-type lease would have qualified for upfront selling profit recognition in accordance with the new leases standard.

2. A lessor should initially recognize a net investment in the lease at the later of (a) the date of initial application and (b) lease commencement, measured at the carrying amount of the net investment in the lease under Topic 840 immediately before that date. For a direct financing lease, the net investment in the lease should include any unamortized initial direct costs that were capitalized in accordance with Topic 840.
3. Before the effective date, a lessor should subsequently measure its net investment in the lease in accordance with the subsequent measurement guidance in Topic 840.
4. Beginning on the effective date, a lessor should subsequently measure the net investment in the lease in accordance with the subsequent measurement guidance in the new leases standard.
5. Beginning on the effective date, if a lessor modifies the lease (and that modification is not a separate lease), it should follow the new leases standard.

Operating Leases

1. The carrying amount of the underlying asset and any lease assets or liabilities (for example, prepaid or deferred rent) should be the same as that recognized under Topic 840 at the later of (a) the date of initial application and (b) lease commencement.
2. If a lessor had previously securitized receivables arising from leases that were classified as operating leases in accordance with Topic 840, the lessor should account for those transactions as secured borrowings in accordance with other Topics.
3. A lessor should recognize any initial direct costs that would have qualified for capitalization under the new leases standard as an expense over the lease term on the same basis as lease income; otherwise, those costs that would not have qualified for capitalization should be written off as an adjustment to equity as of the applicable "later of" date.

The FASB decided that a lessor may apply the same specified reliefs as permitted for a lessee subject to the same restrictions. The FASB decided that the specified relief elections must be consistently applied by an entity for all lessee and lessor leases (that is, an entity that is a lessee and a lessor must make the same specified relief elections).

Bill Bosco Commentary: These are all reasonable decisions.

<u>Lessee and Lessor Transition Disclosures</u>

The FASB decided that lessees and lessors should provide transition disclosures consistent with Topic 250, Accounting Changes and Error Corrections, without the disclosure of the effect of the change on income from continuing operations, net income, any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted (that is, without the requirements in paragraph 250-10-50-1(b)(2)).

<u>Sale and Leaseback Transition</u>

Accounting for Previous Sale and Leaseback Transactions

The FASB decided that an entity should not reassess whether a transaction previously accounted for as a sale and leaseback transaction under Topic 840 would have qualified as a sale (or purchase) in accordance with Topic 606, Revenue from Contracts with Customers.

The FASB decided that an entity should account for the leaseback in any transaction that qualified as a sale and leaseback under Topic 840 in accordance with the lessee and lessor transition requirements.

Deferred Gain or Loss Treatment for Sale and Capital Leaseback

The FASB decided that for any transaction previously accounted for as a sale and *capital* leaseback transaction under Topic 840, the seller-lessee should continue to amortize any deferred gain or loss.

Deferred Gain or Loss Treatment for Sale and Operating Leaseback

The FASB decided that for any transaction previously accounted for as a sale and *operating* leaseback transaction under Topic 840:

1. The seller-lessee should recognize any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to equity at the later of the date of initial application and the date of sale.
2. Any seller-lessee deferred gains or losses that resulted from off-market sales and leaseback terms should be recognized as an adjustment to the leaseback ROU asset (if a deferred loss) or accounted for as a remaining financial liability (if a deferred gain) at the date of initial application.

Bill Bosco Commentary: These are all reasonable decisions.

<u>Build-to-Suit Lease Arrangements</u>
The FASB decided to affirm its current tentative decision to not include specific guidance about lessee involvement in asset construction in the new leases standard other than the guidance that was proposed in the 2013 Exposure Draft (paragraph 842-40-55-2).

The FASB decided to require a lessee to apply a modified retrospective transition approach for build-to-suit lease arrangements existing at, or entered into after, the date of initial application. The modified retrospective approach would not require any transition accounting for build-to-suit leases that expired before the date of initial application.

The modified retrospective transition approach should be applied to existing build-to-suit leases as follows:

1. An entity that has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840 should derecognize those assets and liabilities at the later of (a) the date of initial application and (b) the date that the lessee is determined to be the accounting owner of the asset under existing

build-to-suit guidance. Any difference between the amounts of the assets and the liabilities derecognized should be recorded as an adjustment to equity at that date. The lessee should then follow the general lessee transition guidance for the lease itself as it would have had the lease not been accounted for in accordance with the build-to-suit guidance.

2. For build-to-suit lease arrangements in which the construction period ended before the date of initial application, but the lease term is not expired as of that date, and the transaction qualified as a sale and leaseback transaction under the existing guidance in Subtopic 840-40 before that date, the entity should apply the lessee transition requirements.

Bill Bosco Commentary: We would prefer more guidance regarding build-to-suit transactions as well as sale leasebacks, particularly around the question of when a lessee controls an asset that is to be leased and to understand when is a transaction considered a sale and leaseback.

Nonpublic Business Entity Considerations

The Board decided that there should not be any alternative recognition, measurement, disclosure, presentation, or transition guidance provided for nonpublic business entities reporting under GAAP (except for the practical expedient to allow the use of a risk-free rate to measure lease liabilities – as discussed under the measurement section).

NEXT STEPS

The staff has begun drafting a final leases standard based on the tentative decisions reached by the Board. Later in the drafting process, the Board will discuss any “sweep” issues that arise during drafting, the benefits and costs of the new leases standard, and effective date.

Please see the Current Technical Plan for more information about the project timeline: http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FTechnicalAgendaPage&cid=1175805470156

Bill Bosco Commentary: We do not expect the decisions to change materially from what is reported above. It looks like the Boards may actually finish and issue the standard by the end of 2015. It looks like 2018 will be the transition year so if you are a calendar year reporter, you will have to begin accounting for leases under the new rules on 1/1/2018. Public companies will also have to present comparative data for 2016 and 2017. The comparative data will be much easier for FASB preparers than IFRS preparers because for FASB preparers the P&L cost will be the same as current GAAP and only the PV of rents has to be added as an asset and liability to the balance sheets presented.