Dataline

A look at current financial reporting issues

No. 2013-13
June 13, 2013

What's inside:

Leases

The Great Divide: The new leases landscape

Overview

At a glance

- The FASB and IASB (the "boards") issued a revised *Leases* exposure draft on May 16, 2013 (the "revised ED"). The proposal would fundamentally change the accounting for lease transactions and have significant business implications.

- Under the revised ED, virtually all leases must be reflected on the balance sheet. In a significant shift from the original ED, a dual model is proposed for lessee income/expense recognition and lessor accounting.

- Preparers will need to apply the guidance to all leases existing as of the beginning of the earliest comparative period presented, i.e., no grandfathering.

- We do not expect a final standard before 2014. An effective date is unlikely before 2017.

Background of the project

.1 Leasing arrangements satisfy a wide variety of business needs, from short-term asset use to long-term asset financing. Leases allow lessees to use a wide range of assets, including office and retail space, equipment, trucks/cars, and aircraft, without having to make large initial cash outlays. Sometimes, leasing is the only option available to obtain the use of a physical asset when it is not available for purchase, e.g., it is generally not possible to buy one floor of an office building or a single store in a mall.

.2 Many observers have long believed that the accounting model for an operating lease is inconsistent with the boards' conceptual frameworks, which provide the underpinnings for their accounting standards. In the US, the conceptual framework was written well after the issuance of the current lease standard. Some argue that the current model allows lessees to structure lease transactions to achieve operating lease classification, and therefore off-balance sheet financing. Critics of the current standards believe it is illogical for a commercial airline to not report any airplanes as assets or record any financing obligations associated with the payments it makes for the use of leased airplanes on its balance sheet.

.3 In responses to a report by the SEC in June 2005, and as part of their global convergence process, the boards added a joint project on leases to their agendas in 2007 and have been working since then to create a single, converged, worldwide leasing standard. The initial ED was published by the boards in August 2010. In early 2011, the boards began redeliberations to address concerns raised in the initial comment letter process.

Key changes from existing GAAP

.4 The table below details aspects of the revised ED that would represent a significant change from existing GAAP.

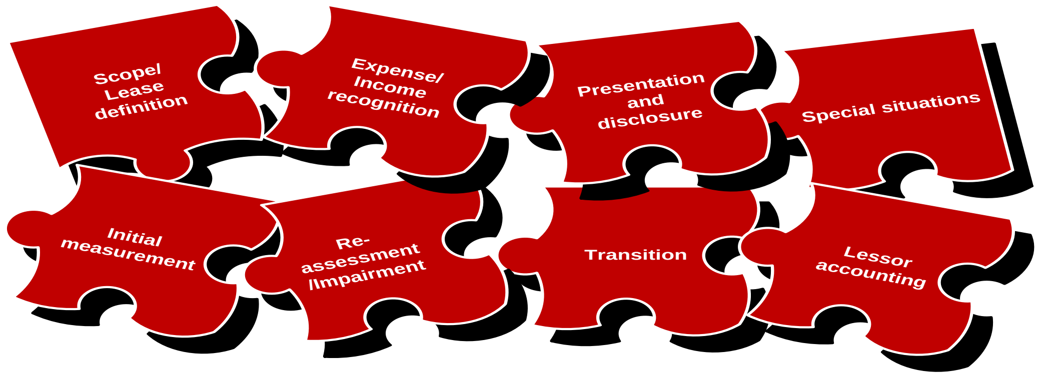
Topic	Proposal	Observations
Definition of a lease	A lease is present only when an arrangement conveys the right to “control” the use of an “identified asset”.	Under current guidance, many leases that are embedded in a contract are not accounted for separately because the accounting for an operating lease and a service/supply arrangement is generally similar, i.e., there is no recognition on the balance sheet, and expense is recognized straight-line over the contract term. Determining when an arrangement contains a lease would change significantly as a result of this new guidance, and the determination is likely to be much more important since most leases will require recognition of both an asset and a liability.
Balance sheet recognition and measurement	**Lessees:** Lessees will recognize a right-of-use asset and a liability measured at the present value of future lease payments. Lessees may elect to exclude short-term leases, which can continue to be accounted for like operating leases today. **Lessors:** For most non-property leases, the lessor will derecognize the leased asset and recognize both a receivable and a residual asset. For most property leases, the lessor will continue to recognize the underlying asset.	The elimination of off-balance sheet treatment for leases currently classified as operating represents a significant change. Under the proposed model, it will not be uncommon for both a lessee and a lessor to have the leased asset (or at least a portion of it) reflected on their balance sheet for certain types of leases, especially property leases.

Topic	Proposal	Observations
Income and expense recognition and presentation	Both lessors and lessees would recognize income or expense based on a dual model that considers the nature of the leased asset and the lessee's "consumption" of that asset. The financing model (Type A) reports income/expense as interest and amortization over the lease term. There is also a model that reports income/expense on a straight line basis over the lease term in a single line item (Type B). **Lessees:** For most non-property leases, a lessee would recognize both interest and amortization expense, similar to other financed asset purchases. For most property leases, lessee expense recognition would be presumed to follow a straight-line pattern. **Lessors:** For most non-property leases, a lessor will recognize a portion of the profit (if any) from the sale of the property at the commencement of the lease, and recognize interest income over the lease term. For most property leases, lessor income recognition will follow a straight-line pattern.	Judgment would be required to determine whether certain leases are property or not. The difference between property and non-property may not follow current practice or even existing legal definitions. Lessee and lessor expense/income recognition would not necessarily be symmetrical as measurement guidance would differ in certain areas. The most significant differences would be in accounting for residual value guarantees and payments based on an index, e.g., leases with periodic increases based on changes in CPI.
Reassessment	The proposal requires that lessees perform an ongoing reassessment and re-measurement of lease assets and liabilities to reflect revisions to the estimated lease term and variable lease payments that depend on rates or indices.	Today there is no requirement to re-assess lease accounting unless there is a contract modification. Significant judgment will be required to properly reflect the accounting impact resulting from a re-assessment.

The proposed model

The leases puzzle

.5 This *Dataline* puts together the pieces to the puzzle of understanding the proposed model for lease accounting.



.6 The revised ED proposes changes to both lessee and lessor accounting. Lessors and lessees will have to apply most of the proposed standard's scope, concepts, definitions and judgments similarly. However, the proposed standard is likely to impact lessees' financial statements significantly more than lessors. Accordingly, while many of the descriptions in this Dataline also apply to lessors, this Dataline is written principally from a lessee's perspective. Where appropriate, we highlight lessor considerations throughout the document and in a separate section beginning at paragraph .83.

Scope and definition of a lease

Scope

.7 The proposals in the revised ED would be applicable to all leases, with the exception of the following:

- Leases of intangible or biological assets; and
- Leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources.

.8 Under current GAAP, ASC 350-40-25-16 states that to account for a license of internal-use software, entities should analogize to the leasing guidance in ASC 840-10. The proposal in the revised ED deletes this reference to allow licensee accounting for software to be addressed holistically at a later date.

Definition of a lease: general concepts

.9 The proposal defines 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". The legal form does not matter — a lease can be embedded in a larger arrangement such as a service contract and may need to be broken out and accounted for separately from the other elements of the contract. This requires assessing when:

a. the fulfillment of the contract depends on the use of an **identified asset**; and

b. the contract conveys the **right to control** the use of the identified asset for a period of time in exchange for consideration.

PwC observation:

There is likely to be a greater focus on identifying whether an arrangement is or contains a lease, or several leases. Although many contracts are written legally as leases, other contracts contain the characteristics of lease but are not identified as such. In addition, certain arrangements may contain embedded operating leases. Currently, lessees often do not separate the embedded lease from the contract because the accounting for an operating lease and a service/supply arrangement has generally been similar, i.e., there is no recognition on the balance sheet and straight-line expense is recognized over the contract term. Because of the need to recognize virtually all leases on the balance sheet, and the potentially different income/expense recognition patterns, lessees will likely need to identify and separately account for embedded leases. If the contract includes both a lease and a service (or other non-lease executory components), contract consideration will need to be allocated to the components.

.10 The determination as to whether a contract contains a lease may be subject to reconsideration due to changes that occur during the contract term.

What is an identified asset?

.11 An asset is generally considered identified when it is either explicitly or implicitly specified in a contract. However, if the supplier has the substantive right to substitute the asset, then the asset may not be considered to be identified even if it is explicitly specified in the contract.

.12 For substitution rights to be substantive, it must be practical and economically feasible for the supplier to substitute the asset at any time throughout the term of the contract without the customer's consent and without barriers (economic or otherwise) to the supplier's substitution. For example, it may not be practical for a lessor to substitute a branded, customized airplane; therefore such a contract would typically depend on an identified asset. Furthermore, if the right to substitute an asset existed only if the asset were not operating properly, then the substitution right may be more analogous to a warranty and would not change the conclusion that an asset is identified.

.13 An identified asset could be a physically distinct portion of a larger asset, such as one floor of a multi-level building. However, a capacity portion of an asset, e.g., a contract for the right to use a percentage of an oil pipeline's capacity, may not be identified because the capacity portion is not physically distinct.

PwC observation:

For the majority of lease contracts, we believe determining whether an asset is an identified asset will be straight forward. While some believe that a lease contract must specify a serial or other identifying number of an asset to be considered an identified asset, contracts, such as master lease agreements for smaller, homogeneous assets such as PC's, rarely contain such information in the initial lease document. From a practical perspective, when a contract calls for a particular asset to be delivered to the customer site, and the asset has been accepted by the customer, it would be difficult to assert that it does not meet the definition of an identified asset, subject to an evaluation of any substitution clauses in the contract.

What is the right to control?

.14 A contract conveys the right to control the use of an identified asset if the customer has the ability to direct the use of, and derive the benefits from, the asset throughout the term of the arrangement. The table below details indicators of the right to control.

The right to control	
Ability	**Indicators**
Directing the use of an asset	The customer directs the use of an asset if it has the ability to make decisions that significantly affect the economic benefits received. Examples of such decisions are as follows: The lessee determines or is able to change: • how and for what purpose the asset is used during the term of the contract, subject to what is permitted by the contract; • how the asset is operated during the term of the contract; or • who operates the asset, if the customer is unable or chooses not to operate the asset itself. Restrictions on a customer's use of an asset typically do not, in isolation, prevent the customer from having the ability to direct the use of an asset. The ability to specify the output of an asset without other decision-making rights would not, in isolation, mean that the customer has the ability to direct the use of that asset. If a customer was involved with the design of an asset at or before the lease commencement date, that involvement should be considered in the assessment of whether the customer has the ability to direct the use of an asset.
Deriving the benefits from the use of an asset	A customer derives the benefits from the use of an asset if it has the right to obtain substantially all of the potential economic benefits from the use of the asset throughout the term of the contract. An asset's economic benefits include: • primary output • by-products in the form of products or services • other economic benefits arising from the use of the asset that could be realized from a commercial transaction with a third party, e.g., renewable energy credits (RECs) that are, in addition to physical electricity output, generated by power plant assets. A customer does not have the ability to derive the benefit from the use of an asset if both of the following occur: • the only way that the customer can obtain the benefit is in conjunction with additional goods or services provided by the supplier and these goods or services are not sold separately by the supplier or other suppliers, and

The right to control	
Ability	**Indicators**
	• the asset is incidental to the delivery of services because the asset has been designed to function only with the additional goods or services provided by the supplier. In these cases, the customer receives a bundle of services or goods that together deliver an overall service.

Separating components of a contract

.15 After determining that a contract contains more than one leased asset, an entity would then need to determine which components (asset or group of assets) are subject to evaluation under the guidance in the revised ED.

.16 An asset is evaluated and accounted for separately if both of the following criteria are met:

- The lessee can benefit from the use of the asset either on its own or together with other resources that are readily available to the lessee. Resources that are readily available are goods or services that are leased or sold separately or resources that the lessee has already obtained. These resources can be obtained from either the lessor or another supplier.

- The underlying asset is neither dependent on nor highly interrelated with other underlying assets in the contract.

.17 A group of assets that must be used together would not meet the above criteria and would be accounted for as a single component.

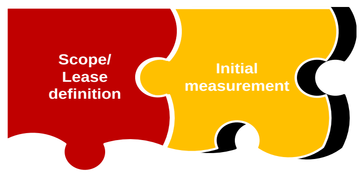
.18 Some components may have the characteristics of both property and non-property, e.g., a building with an electrical generator. In such cases, the entities would determine whether to apply the guidance applicable to property or non-property on the basis of the "primary asset" in the component. The primary asset would be the predominant asset for which the lessee has contracted the right to use. The primary asset will determine which classification model would be used for expense/income statement recognition. The presumptions used to determine income statement classification differ for property and non-property leases as explained in further detail in the expense/income statement recognition section of this Dataline beginning at paragraph .39.

PwC observation:

Under the proposal, it would not be uncommon for a single lease agreement to contain multiple components. For example, a master lease of 300 laptop computers would likely result in 300 distinct lease components, i.e., 300 separate units of account. However, the income statement presentation would be the same for each component since each one has the same primary asset type for classification purposes.

A lease that contains a bundle of assets, e.g., land, building, integral equipment, and furniture, requires judgment to determine the number of lease components and the primary asset for each component. In this example, there could be three components (land/building, integral equipment, and furniture) or there could be two components (land/building/integral equipment and furniture). Once the components are identified, the pattern of expense recognition is dependent on the primary asset in each component.

Initial measurement



General concepts

.19 One of the most significant impacts of the proposed standard will be the impact on the lessee's balance sheet. At the commencement date (the date on which the lessor makes the underlying asset available to the lessee), a lessee would be required to record:

- **A lease liability** equal to the present value of the lease payments to be made during the lease term, discounted using the rate that the lessor charges the lessee. If this rate is not available, the payments would be discounted using the lessee's incremental borrowing rate; and

- **A right-of-use asset** measured at the initial measurement amount of the lease liability, plus any lease payments made to the lessor at or before the commencement date (less any lease incentives received from the lessor), and any initial direct costs.

PwC observation:

A core principle of the project has been that lease contracts give rise to assets and liabilities that must be recognized on the balance sheets of both lessees and lessors. Measuring the right-of-use asset and lease liability at the commencement date rather than the inception date would simplify today's guidance, especially in build-to-suit leasing transactions.

Short-term leases—Policy election

.20 Lessees would have the ability to elect to account for leases that have a maximum possible term of 12 months or less (including any options to renew or extend), in a manner similar to today's accounting for operating leases. Rent-free periods would also be considered when determining if the lease is short-term. Lessees would make an accounting policy choice to follow the simplified short-term lease guidance on an asset class basis, i.e., it would need to be consistently applied to all assets in that class. A different policy may be applied to different asset classes.

PwC observation:

This simplification for short-term leases will alleviate the burden of identifying and tracking short-term leases at each reporting period and may alleviate the need to determine if certain short-term contracts include an embedded lease.

Since different elections may be made for each asset class, entities may elect to apply the new guidance to individually significant leased assets, e.g., drilling rigs, but then elect to apply the simplification to insignificant short-term leases, such as a short-term auto lease.

Calculating the initial lease liability and right-of-use asset

.21 In order to calculate the lease liability and the right-of-use asset ("ROU asset") as described in paragraph .19 above, a lessee would perform the four steps described below. [Note: See Example 2 in the illustrative example supplement to this Dataline for a detailed example of applying the four steps.]

Step 1) Determine the lease term

.22 The lease term is the non-cancellable term of the lease plus any options to extend or terminate when a significant economic incentive to exercise exists. A lease is cancellable when the party evaluating its right to terminate the lease can do so without permission from the other party and with no more than an insignificant penalty.

.23 An entity should consider all contract-based, asset-based, entity-based, and market-based factors together in assessing whether a lessee has a significant economic incentive to exercise an option. The assessment will often require the consideration of a combination of factors since the stated indicators are often interrelated.

.24 As detailed in the proposal, the factors that a lessee should consider when assessing whether the threshold of significant economic incentive has been met are:

- explicit contractual terms that could affect whether the lessee exercises the option when compared to market rates, such as the amount of lease payments in any optional period (discounted, market, or fixed rate);

- the existence or amount of any variable lease payments or other contingent payments under termination penalties or residual value guarantees;

- the terms and conditions of any options that are exercisable after initial optional periods, e.g., the impact of a fixed-price purchase option that is only exercisable at the end of an extension period;

- leasehold improvements that are expected to have significant economic value to the lessee when the option to extend or to purchase the asset becomes exercisable but which would have no value if the lease were not extended. This may be because the lessee has to walk away from the leasehold improvements when the lease ends. Where the value of those leasehold improvements is significant, the lessee may be compelled to exercise the option to permit its continued use of those leasehold improvements, creating an economic incentive to exercise;

- costs associated with returning the underlying asset to a contractually specified condition or location, e.g., the acceleration of an asset retirement obligation; and

- the importance of the underlying asset to the lessee's operations considering, for example, whether the underlying asset is a specialized asset or the unique location of the underlying asset make it highly likely that the extension options will be exercised, e.g., so called "mission critical" assets.

PwC observation:

One of the primary reasons for initially including extension options under the original exposure draft, and not limiting the accounting to the non-cancellable lease term, was to limit the potential for structuring opportunities. For example, a 10-year lease of property could be structured with a one year non-cancellable term and nine, one year renewal options. With the requirement to consider the costs attendant with leaving after year one, it will be much harder to structure around a desired outcome either initially, or as those incentives change over the lease term. In practice, structuring a short non-cancellable initial term is costly, and perhaps impractical, as the lessor would charge a significant premium to compensate for the uncertainty regarding the lease term and to ensure it recovers its investment.

In reassessing the threshold for including extension options from the initial ED, the boards made a practical compromise that is less complex and more operational while still providing reasonable protection against structuring concerns. The threshold is relatively consistent with today's consideration of renewal terms, i.e., when they are "reasonably certain" of being exercised, but represents an ongoing requirement rather than today's "set it and forget it" model.

Step 2) Identify the lease payments

.25 The table below details what would be included or excluded from the definition of lease payments:

Included
• Fixed payments, less any lease incentives receivable from the lessor • Variable payments that are initially based on a rate or an index at lease commencement (these payments are subsequently re-measured based on changes in the index) • "Disguised" or "in-substance" fixed lease payments • Any portion of residual value guarantees that are expected to be paid, except for amounts payable under guarantees provided by an unrelated third party for lessees. While the lessees' liability includes only the portion of the guarantee they are expected to pay, lessors would include the entire guaranteed amount as a "payment to be received" irrespective of whether it is guaranteed by the lessee or by a third party. From the lessor's point of view, a guarantee is equivalent to a fixed payment at the end of a lease. • The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that purchase option, e.g., a bargain purchase option • "Term option penalties" should be included in a manner that is consistent with the accounting for options to extend or terminate a lease. For example, if a lessee would be required to pay a penalty if it does not renew the lease and the renewal period is excluded from the lease term, then that penalty should be included in the recognized lease payments.

Excluded
• Variable lease payments that are usage or performance-based, e.g., based on the number of miles a leased car is driven, unless the variable lease payments are “disguised” or in-substance fixed lease payments • “Term option penalties” should be excluded in a manner that is consistent with the accounting for options to extend or terminate a lease. For example, if a lessee would be required to pay a penalty if it does not renew the lease and the renewal period is included in the lease term, then that penalty should be excluded from the recognized lease payments. • Non-lease components **Lessees** would allocate payments between lease and non-lease components based on their relative observable standalone purchase prices. If the purchase price of one component is observable, the residual method can be used to determine the price of components with no observable purchase prices. However, when there are no observable prices for any of the components, lessees must account for the entire contract as a lease. **Lessors** would apply applicable revenue recognition guidance in order to determine the amount of payments allocated to non-lease components of a transaction.

Lease and non-lease component

.26 Lessees would allocate payments between lease and non-lease components. Depending on the type of lease, this allocation may require significant judgment.

.27 The following types of leases are common with respect to real estate:

- **Net lease:** These types of leases are common for a retail/industrial property and a single-tenant property where the tenant is billed by the lessor for executory costs incurred (typically on a pro rata basis for multi-tenant properties) or such costs are paid directly by the tenant.

- “**Modified gross” or “base year” lease:** These leases are common for office property where the tenant’s rent is set during the first year of the lease, i.e., the “base year”, which includes executory costs (on a pro rata basis for multitenant leases). In subsequent years, the tenant pays additional amounts for executory costs to the extent they exceed the tenant’s pro rata share of the aggregate of those expenses in the “base year.”

- **Gross lease:** The quoted base rent includes all executory costs. In many cases, especially for real estate, a tenant neither knows nor cares what these executory costs are — its focus is solely on the all-in costs of occupancy.

.28 See Example 1 in the illustrative example supplement to this Dataline for a detailed example of allocating lease and non-lease elements in a contract.

PwC observation:

Lessees: Net lease, modified gross or base year leases: In these types of leases, the determination of lease and non-lease components will be relatively straightforward.

Gross lease: Gross leases have historically been very simple. However, with the new requirements under the revised ED, judgment will be needed to allocate payments between the lease and non-lease components. We recommend that a lessee obtain the amounts being billed for these services from the lessor or make estimates of these amounts using market-based information.

Lessor non-lease components: The boards presume that vendor/lessors are always able to allocate the consideration from an arrangement between the lease and non-lease elements. It may take significant judgment to apply this allocation guidance when a multiple element contract provides for both fixed and variable payments. We believe that this evaluation will be facts and circumstances driven.

Variable lease payments

.29 Variable lease payments based on a rate or index would initially be measured using the index or rate at lease commencement. For example, leases with payments based on LIBOR would use the LIBOR spot rate on the lease commencement date to measure all lease payments.

.30 Leases with payments that change based on a consumer price index (CPI) would not use the expected rate of change in that index. Thus, a lease with fixed payment increases of 2% per annum as a proxy for inflation would include such adjustments in the initial measurement, while a lease with rental increases based on changes to CPI (even though it may be expected to increase at the same rate of 2% per annum) would not. In the latter case, subsequent changes to the index would result in an adjustment to the asset and liability once the actual increase is known. The adjustment would consider all future payments subject to the escalation.

PwC observation:

The proposal strikes a balance between the complexity of including contingencies and the concern over structuring opportunities if all contingencies were excluded. The elimination of the requirement to estimate future changes in variable payments using a probability-weighted approach, as proposed in the initial ED, would improve operationality of the standard. However, there will still be significant complexity related to the treatment of variable lease payments upon the re-assessment of lease payments (see the re-assessment section of this Dataline beginning at paragraph .49).

.31 Variable lease payments that are usage or performance-based, e.g., percentage rent, are not included in lease payments, unless the variable lease payments are "disguised" or in-substance fixed lease payments. Expenses related to variable lease payments would be recognized in the period in which the obligation for those payments is incurred.

PwC observation:

Determining whether a contingent payment is a "disguised" or an in-substance fixed lease payment would require significant judgment. The proposal includes examples of in-substance fixed payments to clarify the principle. The examples provided in the revised ED, however, each involve transactions in which the lessee would be required to make significant payments in the event the contingency requiring the variable payment does not occur. The boards also discussed the fact that payments associated with certain arrangements with only variable lease payments would not be considered in-substance fixed payments. Examples include lease payments based solely on a percentage of sales, e.g., a retail store, or based on output, e.g., wind or solar farms.

Careful consideration would need to be given to these arrangements, particularly when such payments are inconsistent with norms for the asset or industry.

Step 3) Determine the appropriate discount rate

.32 The implicit rate is the rate that the lessor charges the lessee. Lessors price the lease based on a variety of factors, typically taking into account the nature and expected residual value of the asset, duration, payment terms, credit risk and other relevant factors, e.g., inflation. Cash value and expected residual are necessary to determine the implicit rate.

.33 The lessee may not know or be able to calculate the rate implicit in the lease. For example, the lessee may not know the expected residual value of the asset at the end of the lease, or may not know the lessor's tax considerations. Accordingly, absent knowledge of the implicit rate, the lessee should use its incremental borrowing rate at the lease commencement date. The lessee's incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow over a similar term, payment profile and security, the funds necessary to obtain an asset of a similar value to the right of use asset at lease commencement.

PwC observation:

Lessees are not obligated to seek out the rate the lessor is charging in the lease. The rate the lessor is charging is more likely to be identified in equipment leases, particularly when the lease contains a residual value guarantee, or when the equipment may also be purchased outright. When determining an implicit rate, a lessee should not make blanket assumptions for different type of arrangements. For example, it would not be reasonable to assume the discount rate for a 10-year lease of generic office space in New York is the same as a 20-year lease of a unique industrial asset in a remote location in Russia. For real estate leases with rents based on cost per square foot, the lessee rarely knows the implicit rate that the lessor is charging because it is typically not relevant to the negotiations.

.34 Nonpublic entities may elect an accounting policy to use a risk-free discount rate with a term comparable to that of the lease term.

PwC observation:

Private companies with no third party debt, and group entities where lease arrangements are executed by different subsidiaries, may find determining the incremental borrowing rate more challenging. We have heard from many preparers that they believe more guidance should be provided on how to assess the appropriate discount rate in these and similar circumstances. As noted above, private companies can elect to use the risk-free discount rate. However, if this rate is used, it will cause the lease liability and right-of-use asset to be higher as compared to when the incremental borrowing rate is used.

Step 4) Identify the additional elements of the right-of-use asset

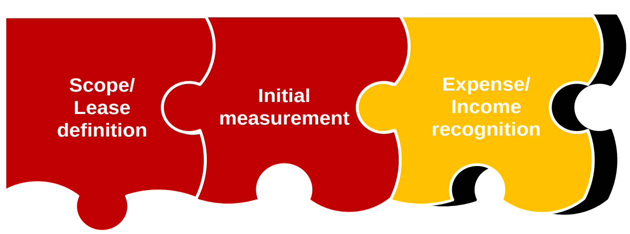
.35 In addition to the lease liability amount, the right-of-use asset includes any lease payments made to the lessor at or before the commencement date (less any incentives received from the lessor), and any initial direct costs (net of any reimbursements by the lessor).

.36 Initial direct costs are defined as costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been entered into, e.g., commissions, legal fees, payments made to existing tenants to obtain the asset for lease, preparing/processing lease documents and negotiating the lease terms.

.37 Lessors also recognize initial direct costs on their balance sheet, but record them as deferred expenses. The subsequent amortization of such initial direct costs over the lease term would differ for lessors depending on whether the lease is a Type A lease (deferred costs would be amortized using the effective interest method) or a Type B lease (deferred costs expensed on a straight line basis). See paragraphs .39 - .46 for details on lease classification.

.38 Prior to lease commencement, lease payments made to the lessor at or before lease commencement, less any cash lease incentives received from the lessor, would be recognized by the lessee as prepaid assets.

Expense/income recognition



General concepts

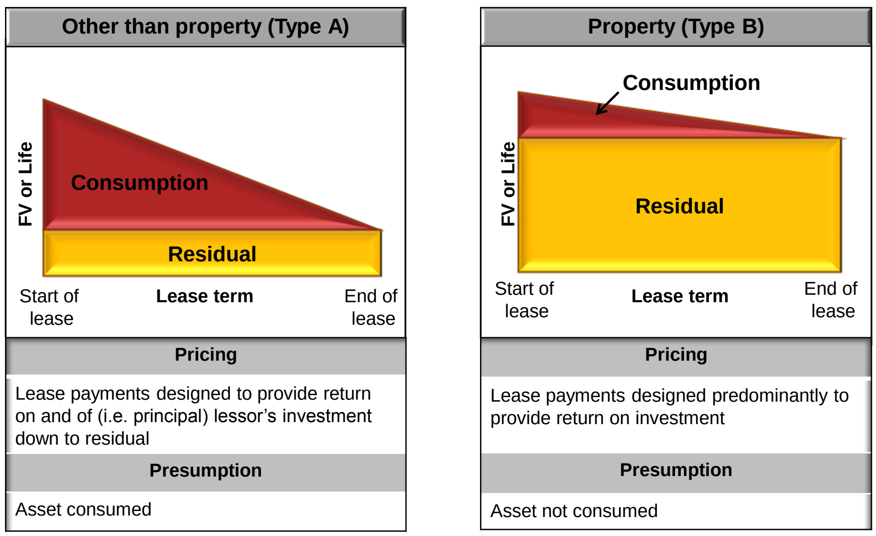
Determining the lease type

.39 At the commencement date, the lessor and lessee would be required to classify a lease as either Type A or Type B. This classification would not be re-assessed after the commencement date unless there is a contract modification.

.40 The boards observed that most leases contain an element of financing merely as a result of the fact that they provide for payments over time. However, certain types of leases are inherently more consistent with financing arrangements because the value of asset is largely "used up" by the lessee during its usage period. The boards discussed various single model methods of accounting for this "consumption of the asset" but ultimately concluded that such models would be overly complex in application. Accordingly, the proposal includes a dual model for expense/income recognition based on the nature of the leased asset and the lessee's presumed "consumption" of that asset.

.41 Property is defined in the proposal as land or a building, or part of a building, or both. As illustrated below, leases for other than property are presumed to be Type A, while property leases are presumed to be Type B.

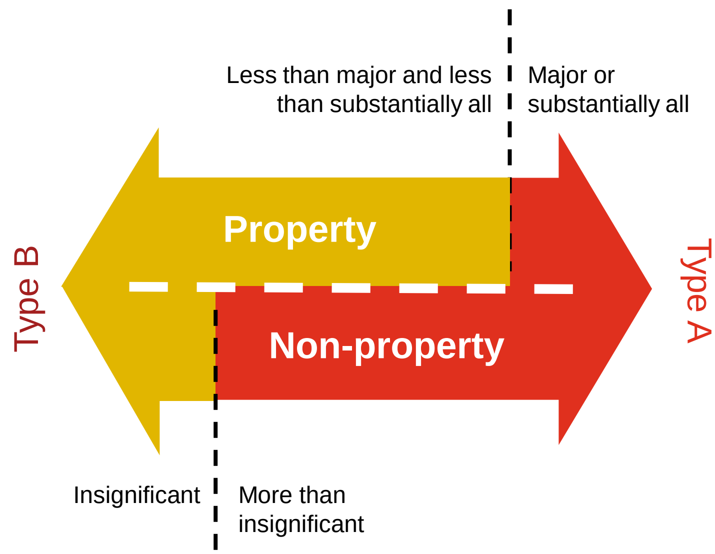
Consumption based principle



.42 The principle depicted in the illustration above is based on a presumption by asset type. The presumptive treatment of property and other than property would likely result in the appropriate classification of most leases. However, the presumption can be overcome in some circumstances. See the table below for factors to overcome the presumption.

Asset type	Presumption	The presumption is overcome if the following factors exist:
Non-property	Type A	The lease term is an insignificant portion of the underlying asset's economic life; or
		The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.
Property	Type B	The lease term is for the major part of the underlying asset's economic life; or
		The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

.43 The following illustration depicts the dual model as discussed above. In determining which approach to apply, significant judgment would be required to determine what constitutes major or substantially all and insignificant.



.44 When classifying a sublease, an entity would evaluate the sublease with reference to the underlying asset, e.g., the property, plant, or equipment that is the subject of the lease, rather than the right-of-use asset.

PwC observation:

The decision to introduce a new dividing line into the model is likely to generate significant interest and debate, given that one of the project's objectives was to remove the existing "bright-lines" between operating and capital leases. When making the determination, it is unclear whether the intent was to use qualitative and/or quantitative, e.g., 90%, 10%, thresholds. For example, when assessing long-term land leases, e.g., those greater than 25 years, a quantitative analysis would likely indicate the lessee is obtaining "substantially all" of the fair value of the underlying asset and would imply that Type A classification is appropriate. However, this would be inconsistent with the underlying concept of consumption.

.45 Under US GAAP today, "integral equipment" is considered "real estate" and is subject to the scope of various real estate-related accounting standards. This could include telecommunication tower lessors, who view their business as similar to other lessors of multi-tenant property (such as office buildings or other commercial property types). Accordingly, many US constituents would like to view "integral equipment" as "property" for purposes of determining which model to apply. The concept of integral equipment does not exist internationally, but the boards' discussed this issue as part of re-deliberations on the revised exposure draft.

.46 The boards did not replace or expand the definition of property to encompass the more expansive US concept. Instead, the boards decided to provide the application guidance for those leased assets that have multiple components (discussed in paragraphs .15 - .18 above) by suggesting that lessees and lessors would need to determine the "primary asset" involved in the leasing transaction when evaluating the dividing line.

PwC observation:

This could introduce some application difficulties and may produce results that certain lessees and lessors do not believe will faithfully represent the economics of their leasing transactions. While this item could impact both lessees and lessors, it will be particularly concerning for certain lessors due to the complexities involved in applying the receivable and residual approach to multi-tenant assets, e.g., cell towers.

Lessee expense recognition

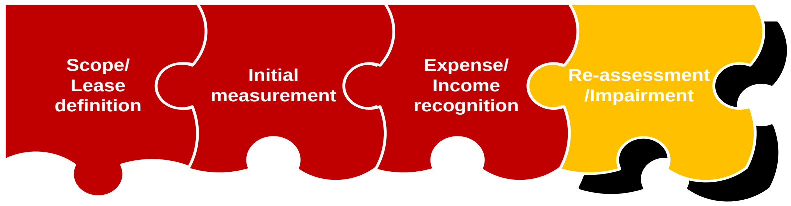
.47 The following tables detail the dual expense recognition model for lessees under the revised ED (see lessor considerations below):

Type A lease (presumed for leases of assets other than property)	
Interest expense	**Amortization of ROU asset**
Recognize interest expense by unwinding the present value "discount" on the lease liability using a constant rate of interest. Interest expense will be reported separately in the income statement.	Recognize amortization expense on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the benefits). Amortization will be shown separately in the income statement.

Type B lease (presumed for leases of property)
Single lease expense
The expense recognition pattern for Type B leases is determined in a manner that is similar to the accounting for operating leases under current guidance. Rent expense is reflected as a single line item on the income statement. Straight line expense recognition is created by adjusting the allocation of the expense between the portion attributed to amortization of the discount and amortization of the right-of-use asset as follows: • **Lease liability**: Amortization of the discount is calculated in the same manner as that for a Type A lease. • **Right-of-use asset:** Asset amortization is a balancing figure, calculated as the difference between the straight-line expense and the amortization of the discount on the lease liability.

.48 See Example 3 in the illustrative example supplement to this Dataline for a detailed example of lessee expense recognition.

Re-assessment/impairment



General concepts

Lease liability re-assessment

.49 According to the revised ED, a lessee will re-measure the lease liability to reflect any changes in the following:

- lease term, as a result of either (1) a change in the assessment of whether the lessee has a significant economic incentive to exercise an existing contractual option to extend the lease (other than changes in market conditions), or (2) the lessee either irrevocably electing to exercise an extension option that was not included in the original lease term or not exercise an option that was included in the original lease term;

- relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset;

- variable lease payments based on a change in the index or rate that has already occurred which will be used to determine lease payments for future periods; and

- amounts expected to be payable under a residual value guarantee.

.50 The discount rate is re-assessed when there is a change in the lease payment due to changes in:

- lease term;

- relevant factors that result in the lessee having or no longer have a significant economic incentive to exercise an option to extend the lease or purchase the underlying asset; or

- referenced interest rates, if variable lease payments are determined using those rates.

PwC observation:

As noted above, a change in the lease term requires the discount rate to be re-assessed. This could lead to volatility and complexity in the accounting.

.51 A lessee would determine the revised discount rate at the date of the re-assessment using the rate that the lessor charges the lessee at that date, if known, or the lessee's incremental borrowing rate at that date on the basis of the remaining lease term.

.52 Changes in the measurement of the lease liability because of a re-assessment would be recorded as an adjustment to the right-of-use asset unless it relates to the following two changes (for which measurement changes would be recognized in the income statement):

- changes in an index or a rate used for variable lease payments that are attributable to the current or prior periods; or
- if the carrying amount of the right-of-use asset is reduced to zero.

Re-assessing lease classification

.53 Lease classification would be re-assessed only when there is a substantive contract modification. The modified contract would be accounted for as a new contract at the date that the modifications become effective.

.54 Examples of a substantive contract modification include changes to the contractual lease term or to the amount of contractual lease payments that were not part of the original terms and conditions of the lease.

PwC observation:

As noted above, the boards decided that even though the lease term can change after lease commencement, lease classification, i.e., whether Type A or Type B, should not be re-assessed. The boards compared this situation to current accounting where, absent a modification or actual renewal, lessees and lessors would not re-assess lease classification for changes in circumstances.

Lease term re-assessment

.55 The lease term would be reassessed if either of the following occur:

- a change in a relevant factor that causes the lessee to either have or no longer have a significant economic incentive to exercise an option or terminate the lease; or
- the lessee either elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so or does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

.56 Assume that a lessee is leasing a building under a ten-year lease that includes a five-year renewal option. At lease commencement, the lessee concludes that it does not have a significant economic incentive to exercise the extension option. The lease is classified as a Type B lease. Four years into the initial lease term, the lessee significantly renovates the building which results in significant additional leasehold improvements which are expected to have substantial remaining value at the end of the original lease term. As a result of the renovation, the lessee concludes that it has an economic incentive to exercise the extension option because of the value of the improvements that would be lost in the event of non-renewal. Therefore, the lessee would re-assess the lease term and adjust the lease liability and right-of-use asset. However, the lessee would not re-assess the lease classification due to this event, i.e., Type A or Type B.

PwC observation:

The revised exposure draft does not clearly address when the lease term would be reassessed. For example, in the above situation in which, subsequent to commencement, the tenant in a property lease makes a significant improvement to the property. It is currently not clear when the lease term should be reassessed: when the lessee commits to renovate, or when renovation activities begin. The timing of this change would affect balance sheet measurement and can affect expense recognition patters under either Type A or Type B leases (the latter if there are additional escalations in the added lease term).

.57 A change in market rents, in isolation, would not cause an entity to re-assess whether there is a significant economic incentive to exercise the option and re-assess the lease term.

.58 For both a Type A and Type B lease, the lessee would re-measure the lease liability and right-of-use asset by calculating the present value of the remaining lease payments over the revised term using the discount rate at the re-assessment date. The revised lease payments would reflect the change in amounts payable under purchase options or termination penalties.

.59 For a Type A lease, a lessee would revise the interest expense prospectively based on the interest rate selected at the re-assessment date. Amortization expense would be determined by calculating a new straight-line amortization based on the revised asset value and lease term.

.60 For a Type B lease, a lessee would revise the straight-line expense as follows:

1) Adjust the initial total lease costs for the change in undiscounted lease payments that arose due to the re-assessment;

2) Subtract straight-line expense already recognized for the lease from the amount calculated in 1) above; and

3) Divide the amount calculated in 2) above by the remaining periods in the lease terms.

.61 See Example 4 in the illustrative example supplement to this Dataline for a detailed example of re-assessment based on a change in lease term.

.62 Re-assessment of purchase options would follow the same accounting as discussed above for renewal options. A lessee would determine the revised lease payments on the basis of the new lease term or to reflect the change in amounts payable under the purchase options.

PwC observation:

The requirement to re-assess the lease term is a significant change from the “set it and forget it” model used today. From a practical perspective, changes as a result of a re-assessment will likely be more aligned with the timing of actual business decisions. However, the requirement to re-assess requires judgment. The systems and processes that would need to be developed and maintained to continually monitor the need for re-assessment may add significantly to the cost of implementation, particularly for those entities with a significant portfolio of lease contracts.

Variable lease payment re-assessment

.63 Re-assessing lease payments based on a rate or index would require lessees to re-measure their right-of-use asset and lease liability, and lessors to re-measure their receivable asset, each time rates and indices change, which may be as often as each reporting period. Lessees would account for this change in profit and loss when it relates to the current accounting period and as an adjustment to the right-of-use asset when it relates to future periods.

.64 Lessors applying the Type A model would account for all changes in the lease payments due to changes in a rate or an index immediately in the income statement, which would be a significant change from the current model. For example, assume there is a 10-year equipment lease classified as Type A. Rents increase annually with changes in CPI over the base year. A change in the index after year 1 impacts years 2-10. The present value of the differential would be recorded in the income statement in one lump sum at the date of re-measurement. This is not symmetrical to lessee accounting and could result in significant volatility in, and front loading of, earnings relative to contract rents.

.65 See Example 5 in the illustrative example supplement to this Dataline for a detailed example of re-assessment based on changes in an index.

Residual value guarantee re-assessment

.66 Lessees would re-assess the amounts payable under a residual value guarantee when events or circumstances indicate that there has been a significant change in the amounts expected to be paid. Since lessors include the total guaranteed payment in their receivable recorded at lease commencement for a Type A lease or in the total lease payments for a Type B lease, there is no need for lessors to re-assess.

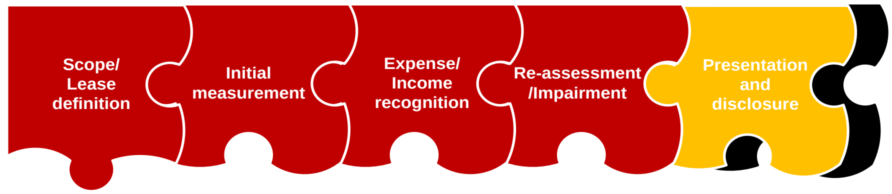
Impairment

.67 Lessees would follow existing guidance on impairment of long-lived assets with respect to its right-of-use assets. Lessors would follow the same guidance for assets subject to a Type B lease, as well as for the residual asset recorded under a Type A lease. Loan impairment guidance applies to lease receivables recorded under a Type A lease.

PwC observation:

A right-of-use asset accounted for as a Type B lease would have a higher risk of impairment due to the fact that amortization is slower than that for comparable Type A assets. This is because amortization expense for a right-of-use asset in a Type B lease is back-end loaded. If there is an impairment charge for this type of leased asset, it is unlikely to result in a corresponding change to the value of the recorded liability absent a modification to the terms or a reassessment of options to renew, i.e., incentives no longer support inclusion in the measurement of the asset or liability.

Presentation and disclosure



Presentation

.68 The table below details the presentation requirements for lessees (see below for lessor considerations):

Lessee presentation requirements		
Financial statement	**Type A lease**	**Type B lease**
Statement of financial position	Right-of-use assets and lease liabilities would either be: • presented separately or • disclosed within the notes (including disclosure of where it is recorded on the balance sheet). The right-of-use asset would be required to be included in the same line as similar owned assets.	The requirements are the same as Type A. However Type A and Type B components would be presented/disclosed separately.
Statement of comprehensive income	Amortization expense on right-of-use assets and interest expense on lease liabilities would be presented separately.	Amortization expense on the right-of-use assets and interest expense on lease liabilities would be combined in a single line item.
Statement of cash flows	Each lease payment would have a principal and interest component. • Principal payments would be classified as financing activities. • Interest payments would be classified in accordance with ASC 230, *Statement of Cash Flows*. • Variable lease payments and short-term lease payments not included in the lease liability would be classified within operating activities.	All cash lease payments would be classified as operating activities.

PwC observation:

Statement of financial position: We expect most lessees will present the right-of-use asset within property, plant, and equipment. However for financial institutions, it is not clear how regulators will view the right-of-use asset for purposes of determining minimum regulatory capital requirements. If regulators view the right-of-use asset as an intangible, it may not be considered an asset included in the denominator of Tier One leverage ratios and would be subject to a higher risk weighting for the risk-based capital ratios.

The changed profile of the balance sheet and related income statement effects could have implications for state and local tax apportionment as well as franchise taxes, property taxes and foreign taxes.

Statements of comprehensive income and of cash flows: Due to the variety of changes to the statements of comprehensive income and cash flows, i.e., interest expense, amortization expense, etc., lessees with Type A leases will need to assess the potential impact on covenants, compensation agreements, and other contracts. Such an assessment may require significant time. As such, we suggest companies begin the process well in advance of the effective date.

The boards have not specifically discussed how variable lease payments not considered minimum lease payments, e.g., payments based on sales, should be presented in the income statement for a Type B lease. However, we anticipate that these payments would be reflected as an operating cost in the period to which they pertain (similar to the approach under today's guidance), with disclosure in the notes to the financial statements.

Disclosure

.69 The table below summarizes the more significant disclosure requirements included in the proposed guidance. Entities should carefully consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. Entities can aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

Disclosure requirements		
Topic	**Lessee**	**Lessor**
Nature of the lease	• a general description of the lease • variable lease payment information • the details of extension/termination options including which options are included/excluded from the right-of-use asset • a residual value guarantee	Lessors would have similar disclosure requirements , however lessors: • would not be required to disclose restrictions or covenants imposed by the lease • would need to disclose the existence, terms and conditions of lessee purchase options

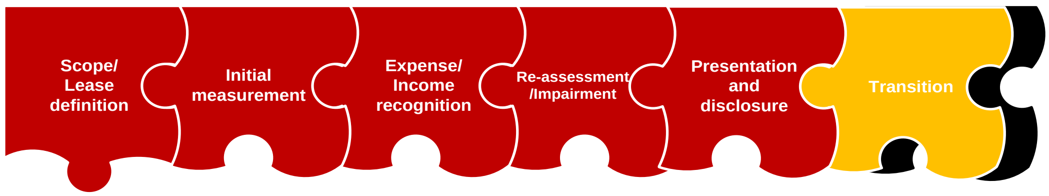
Disclosure requirements		
Topic	**Lessee**	**Lessor**
	• restrictions or covenants imposed by the lease • sub-lease information	• would need to disclose the carrying amount of residual assets covered by residual value guarantees (but not guarantees included in the lease receivable) and disclose how they manage risks related to residual assets
Lease that have not yet commenced	• significant rights and obligations created by the lease prior to lease commencement	• There is no corresponding disclosure requirement.
Significant assumptions and judgments	Information about • the determination of whether the contract contains a lease; • the allocation of the consideration in a contract between lease and non-lease components; and • the determination of the discount rate.	• Discount rates are not required to be disclosed.
Reconciliation of opening and closing balances of the lease liability (for lessees)/lease receivable (for lessors)	• liabilities created due to lease commencement or extension • liabilities extinguished due to leases termination • re-measurement relating to a change in an index or a rate used to determine lease payments • unwinding of the discount • cash paid • foreign currency effects • effects of business combinations • other useful information The above would be required to be disclosed separately for Type A and Type B leases. Additionally, a non-public entity would be able to elect not to provide any of these disclosures.	• similar disclosure requirements for the receivable and residual assets recognized in a Type A lease

Disclosure requirements		
Topic	**Lessee**	**Lessor**
Maturity analysis	• maturity analysis of the lease liability by providing the annual undiscounted cash flows for the first five years of the lease and a total for the remaining years • maturity analysis of commitments for non-lease components related to a lease by providing the annual undiscounted cash flows for the first five years of the lease and a total for the remaining years	• maturity analysis of the lease receivable by providing the annual undiscounted cash flows for the first five years of the lease and a total for the remaining years and, for Type A leases, a reconciliation of such analysis to the lease receivable recognized in the statement of financial position • a separate maturity analysis for Type B leases
Other	• costs recognized in the period relating to variable lease payments not included in the lease liability • the acquisition of right-of-use assets in exchange for lease liabilities, arising from both Type A and Type B leases, as a supplemental non-cash transactions disclosure • related party lease transactions	For Type A leases: • disclose profits recognized at the commencement of a lease • interest income recognized from the unwinding of the discount on the receivable and gross residual assets • information about how risk is managed associated with residual assets, including: – the risk management strategy – the carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor) – any other means by which residual asset risk is reduced For Type B leases: • lease income related to lease payments For both types: • income related to variable payments not included in the lease receivable • short term lease income • related party lease transactions

PwC observation:

Although some changes have been made to the disclosures required in the revised ED as compared to the original ED, the proposed disclosures are extensive, specifically the requirements to provide a number of reconciliations of balance sheet, income statement, and cash flow statement activity. It may also be difficult for users to put together various disclosures in order to obtain decision-useful information about an entity's lease activities.

Transition



General concepts

.70 Lessors and lessees would recognize and measure all leases (except those short-term leases where the election is made to retain existing accounting treatment) that exist at the date of the initial application date. The date of initial application is the start of the earliest comparative period presented in the financial statements in which the lessee first applies the guidance in the revised ED.

.71 Lessors and lessees would need to determine the lease classification in order to calculate the transition adjustment. All available evidence would be used to classify the lease.

.72 The revised ED allows a modified retrospective and full retrospective approach to transition.

.73 The boards decided not to provide relief for leases outstanding at the initial application date but that expire prior to the effective date of the new standard. Additionally, there are no provisions to grandfather existing arrangements. The definition of a lease will be applied retrospectively. That is, any contracts in place as of the initial application date that are determined to be leases under the proposals in the revised ED would follow the new rules. Additionally, there is no transition relief for leases that have less than 12 months remaining at the initial application date unless the lease is truly a short-term lease as defined in the revised ED. For example, if at the adoption date a lessee has 6 months left in a 5 year lease, the lessee would need to account for that lease in accordance with the proposed guidance and could not apply the simplified accounting allowed for a short-term lease.

PwC observation:

The lack of grandfathering for existing leases will mean that extensive data-gathering will be required. For each lease, a process will need to be established to capture information about lease term, renewal options, and fixed and contingent payments. The information required under the revised ED will typically exceed that needed under current accounting. Depending on the number of leases, their commencement dates, and the records available, gathering and analyzing the information could take considerable time and effort. Beginning the process early will help to ensure that implementation of the final standard is orderly and well controlled. Companies should also be cognizant of the proposed model when negotiating lease contracts between now and the effective date of a final standard.

Full retrospective approach

.74 Both lessors and lessees would be able to elect to apply the guidance in the revised ED to each outstanding lease as of its commencement date. The guidance in ASC 250, *Accounting Changes and Error Corrections,* would be followed to record the transition adjustment. Applying this guidance would result in a cumulative catch up entry being booked to equity.

Modified retrospective approach

Existing capital leases, direct financing leases, and sale-type leases

.75 No adjustments to existing assets and liabilities would be required. Lessors and lessees would retain existing carrying amounts at the beginning of the earliest comparative period presented.

.76 Entities would subsequently measure the lease assets and lease liabilities in accordance with the guidance for a Type A lease, i.e., interest and amortization approach/receivable and residual approach. However, the entity would not apply the re-assessment requirements, e.g., lease term/variable payment based on index included in the revised ED.

Existing operating leases

.77 For leases classified as Type A, the lease liability and right-of-use asset would be recorded as described below, with the difference between the two amounts recorded in retained earnings on the initial application date. Additionally, any pre-paid or accrued rent on the balance sheet as of the initial application date would be eliminated and added to or subtracted from the initial measurement of the right-of-use asset.

Type A	
Lease liability	Measure at the present value of the remaining lease payments using the rate at the effective date. Non-public entities are permitted to use a risk-free discount rate with a term comparable to that of the lease term as an accounting policy election for all leases.
Right-of-use asset	Measure based on the applicable proportion of the lease liability at the commencement date. This amount is calculated as follows: 1) Calculate the average of the remaining lease payments as of the effective date. 2) Assume that average payment is paid evenly over the entire lease term from the lease commencement date and calculate the present value of those payments. The discount rate at the effective date is used to present value the payments. 3) Calculate the pro-rata amount that should be attributed to the remaining lease term as follows: *Amount calculated in 2) above times remaining lease term divided by the total lease term*

PwC observation:

When a lessee has an existing operating lease and applies the modified retrospective transition approach to a Type A lease, there will be lease expense recorded as an adjustment directly to retained earnings upon transition due to the difference in the way the lease liability and right-of-use asset are calculated. This adjustment is necessary due to the initial front loading that occurs in the earlier years of the lease. This is expected to provide lessees with higher total profits over the remaining term of the lease than would be the case under the existing operating lease accounting model, or under a full retrospective approach at transition, or for a Type B lease.

.78 For a Type B lease, lessees would calculate the lease liability in the same manner as a Type A lease. The right-of-use asset would equal the lease liability, however any pre-paid or accrued rent on the balance sheet on the initial application date, would be removed and a corresponding adjustment made to the right-of-use asset. There would be no impact to retained earnings.

PwC observation:

A lessee could record a different straight-line expense on a Type B lease after transition compared to the previous operating lease accounting. This is because the lease asset and liability recorded at the initial application date could reflect a different lease term and/or different lease payments, e.g., adjustments for CPI changes, than those used to record straight line expense previously.

.79 See Example 6 in the illustrative example supplement to this Dataline for a detailed example of the modified retrospective approach.

.80 All evidence available (including hindsight) can be used to determine the lease term at transition. For example, if a lessee exercised a renewal option prior to the effective date of the new guidance, it could assume exercise of the renewal period at the initial application date without having to determine whether there was a significant economic incentive to extend the term of the lease at that time.

.81 Lessors and lessees would not be required to evaluate initial direct costs for contracts that began before the effective date. Therefore, initial direct costs would not be included in the measurement of the right-of-use asset or lease receivable for lessors at transition.

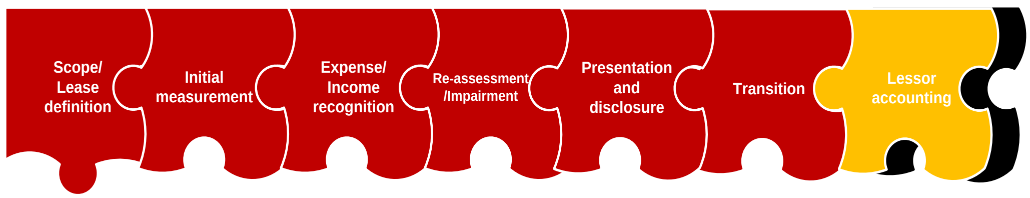
.82 As noted above, the lessee would use its incremental borrowing rate on the effective date, rather than at the lease commencement date, to initially measure the liability to make lease payments. In selecting the discount rate, a separate discount rate would not be needed for each individual lease; rather a discount rate could be determined based on a portfolio of leases, requiring some stratification of leases with reasonably similar characteristics, most likely considering remaining lease term and similarity of payment profile.

PwC observation:

Deferred taxes: Preparers will need to consider the deferred tax implications that will arise on transition as a result of changes that will be made to both the balance sheet and income statement presentation. Deferred tax adjustments, especially for Type A leases, could be significant.

Discount rate: When selecting the discount rate to be applied to a portfolio of leases, a wide variety of factors must be considered to determine whether leased assets have similar characteristics. For example, a lessee has an office building located in New York City and a manufacturing facility located outside of the United States. Both leases have a 20-year term. Due to many factors such as different market values, etc., it would be unlikely that a lessee could utilize the same discount rate for both assets.

Lessor accounting considerations



General concepts

.83 Similar to lessee accounting, the boards are proposing that lessors apply two approaches to accounting for leases. After considerable debate, the boards concluded that the classification criteria should be the same for lessors as it is for lessees for determining Type A or Type B leases.

.84 Issues in how to classify leases are likely to mirror those for lessees. These include determining what is significant and insignificant, how broadly the term "property" should be defined, and application of the guidance to arrangements involving multiple assets and/or services.

.85 Similar questions to those facing lessees would also exist in applying the rebuttable presumption for property when assessing a long-term land leases, e.g., those greater than 25 years. The present value of the lease payments required under the lease would likely represent substantially all of the fair value of land. If so, the practical expedients in the proposals would indicate that the Type A "receivable and residual approach" is appropriate — a surprising result given the underlying principle of consumption that is supposed to be at the heart of the classification requirements.

PwC observation:

We expect many respondents to the revised ED to question how the boards have set the dividing lines. For example, they may question whether:

- consistency with the revenue recognition proposals, e.g., when license revenue is recognized, would be preferable
- a property/non-property distinction is appropriate, e.g., the economics of multi-tenant non-property leases, such as satellites and telecommunication towers, which have many characteristic in common with property but have a different classification presumption
- a dividing line based on the lessor's business model would better reflect the economics
- it is appropriate for the leased asset in a Type B lease (or at least a portion of it) to appear on both the lessee and lessor's balance sheets

Type A leases

.86 When a Type A lease gives a lessee the right to acquire or consume more than an insignificant portion of the underlying asset (typically presumed when the underlying asset is not property), the lessor would apply the receivable and residual approach. Under this approach, at lease commencement the lessor will:

- derecognize the carrying amount of the portion of the asset subject to the lease;
- recognize a receivable measured as the present value of the remaining lease payments, discounted at the implicit rate plus any initial direct costs; and
- recognize a residual asset measured as the present value of the amount the lessor expects to derive from the leased asset at the end of the lease term (discounted using the implicit rate) plus the present value of expected variable lease payment less any deferred profit.

.87 Under the receivable and residual approach, profit is recognized at lease commencement on the portion of the underlying asset conveyed to the lessee via a right-of-use. This profit would be measured as the difference between the present value of the lease receivable and a proportionate amount of the cost basis of the underlying asset. Any profit on the portion of the underlying asset retained by the lessor (related to the lessor's residual interest in the leased asset) would be deferred and only recognized when the residual asset is sold or re-leased. If the underlying asset is re-leased, a new lease calculation is performed with profit recognized at lease commencement of the new lease on the portion of the underlying asset conveyed to the lessee, and profit on the residual asset retained by the lessor is deferred. If the underlying asset is sold at the end of the lease term, the remaining profit would generally be recognized then.

.88 The lease receivable is subsequently measured using the effective interest rate method and would be subject to an impairment guidance in ASC 310, *Receivables*.

PwC observation:

For Type A leases that were previously classified sales type leases, the lessor will recognize less profit under the new guidance because the profit associated with the residual will be deferred. Additionally for Type A leases that were previously classified as operating leases, lessors will realize a portion of the manufacturer's profit associated with the lease term and but still defer the portion associated with the residual.

Application of a Type A model can be extremely complex for leases of a portion of an asset as it involves allocating cost basis to the portion leased for purposes of computing gain or loss on each individual lease.

.89 See Examples 7 and 8 in the illustrative example supplement to this Dataline for detailed examples of initial and subsequent measurement of a Type A lease.

Type B leases

.90 When the lessee does not have a right to acquire or consume more than an insignificant portion of the underlying asset (typically presumed for leases of property), the lessor will apply an approach similar to existing operating lease accounting. Under this approach:

- The underlying leased asset remains on the balance sheet of the lessor.
- No lease receivable or gain/loss is recorded at lease commencement.
- Rental revenue is recognized 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 over the terms of the respective leases.
- The leased asset continues to be depreciated based on its estimated useful life.
- Unbilled rents receivable represent the cumulative amount by which straight-line rental revenue exceeds rents currently billed in accordance with the lease agreement.

Other lessor specific considerations

.91 There are a number of other areas which will require special considerations by lessors. Some situations are discussed below.

Topic	Details	Observations
Residual value guarantees	Lessors would include the entire guaranteed amount as a "payment" (and therefore it would be included in the lease receivable at the commencement of the lease) regardless of whether it is guaranteed by the lessee or by a third party.	The Boards are moving from the "risks and rewards" principles inherent within current lease accounting standards, to principles that are more closely aligned with the notion of "control" of the underlying asset. In doing so, we may begin to see transactions structured as "synthetic leases," wherein the lessee assumes all the risks and rewards associated with the underlying asset, but will not be required to capitalize the entire asset. For example, a lessee may guarantee that the lessor will receive a stipulated amount from the sale of the residual asset at the end of the lease, and pay to (and/or receive from) the lessor any difference between that amount and the proceeds upon the sale of the residual asset. In such a transaction, assuming the stipulated amount equals the

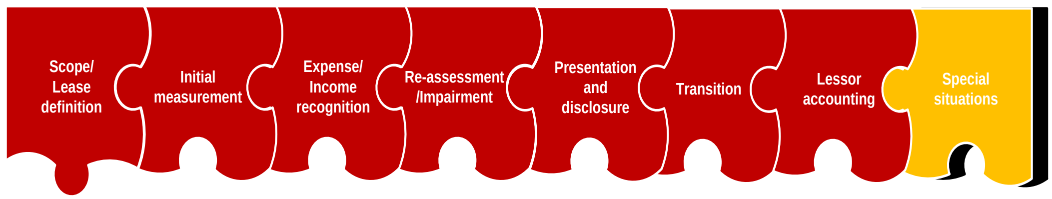
Topic	Details	Observations
		estimated residual value at lease commencement, the lessee would include in its lease liability and right-of-use asset only the amount of the guarantee that they are *expected* to pay, which would be zero at lease commencement. Thus, a lessee would record only a portion of the asset in such a transaction. The lessor, on the other hand, would include both the payments it will receive from the lessee and the *guaranteed* amount as a receivable asset at lease commencement, and it will not defer any profit to a later date related to the sale of the residual asset. The asymmetry is clear; at lease commencement, the lessor "sells" the entire asset and recognizes all the profit while the lessee "purchases" only a portion of the asset.
Leveraged leases	Leveraged lease accounting would be eliminated and a lessor would be required to apply the general lessor approach appropriate for the underlying asset.	Since pre-existing leases will not be grandfathered, companies with leveraged leases could have significant increases to debt due to the presentation of non-recourse borrowings on a gross basis. Deferred taxes arising from leveraged leases will also be recorded, and may differ from amounts previously computed under leveraged lease accounting. Finally, significant transition adjustments to retained earnings may result as the expense recognition patterns will change. The unwinding of leveraged lease accounting is expected to present significant transition complexities.
Securitizations of lease receivables	The term "financing receivable" subject to securitization guidance in ASC 860, *Transfers and Servicing* would be amended to include Type A lease payments and guaranteed residual values.	The accounting guidance for securitizing financing receivables does not apply to unrecognized financial assets, such as operating lease receivables under existing guidance. As a result, lessors have typically had to account for

Topic	Details	Observations
		the proceeds from securitizing operating lease payments under existing guidance as financings rather than as proceeds from the sale of receivables. Under the proposed standard, the classification criteria may result in most equipment operating leases being accounted for by lessors as Type A leases with financing receivable assets recorded on the balance sheet. Accordingly, those receivables would be subject to guidance applicable to securitizations. The proposed standard does not address how lessors should transition existing financing obligations to reflect proposals in the revised ED. We expect this issue to attract significant interest from lessors and financial institutions.
Participation by third parties	Under current accounting guidance, a sale of property subject to an operating lease, or of property that is intended to be leased by a third party purchaser to another party, cannot be treated as a sale if the seller retains "substantial risks of ownership" in the leased property. Neither the proposed lease standards nor the proposed revenue standards explicitly address this scenario.	As noted above, the boards are moving from the "risks and rewards" principles inherent within current lease accounting standards, to principles that are more closely aligned with the notion of "control" of the underlying asset. Many forms of seller continuing involvement with an asset sold involve either retaining risks associated with that asset, or, less commonly, sharing in the rewards of the asset they sold. These risks and rewards are not necessarily determinative as to whether a seller has relinquished control of the sold asset. Accordingly, while sellers and lessors will have to consider the accounting for such provisions, many forms of involvement that currently may preclude a seller from recognizing a sale under current guidance, e.g., agreeing to remarket the property at the

Topic	Details	Observations
		end of the buyer's lease to its customer, may not preclude sale treatment under the proposed standards.
Sales with residual value guarantees	Under current guidance, a manufacturer is precluded from recognizing a sale of equipment if the manufacturer guarantees the resale of the equipment to the purchaser. Rather, the manufacturer, i.e., the seller accounts for the transaction as a lease. In deliberating the proposed Revenue standard, the boards agreed that a residual value guarantee provided by the seller would not preclude revenue recognition unless the seller has an explicit or implicit obligation to repurchase the asset.	As a result of the guidance in the proposed Revenue standard, many transactions that were previously accounted for as leases because they did not qualify for sale treatment will be accounted for as sales.
Captive finance companies	An entity might sell a product to an intermediary such as a dealer, and then repurchase that product through a leasing subsidiary in order to lease the property to an end-user. Under current guidance, the manufacturer would not be precluded from recognizing a sale if: • the dealer is a substantive and independent enterprise; • the product is delivered to the dealer and the risks and rewards of ownership transfer; • the financing affiliate has no legal obligation to provide financing at the time the product is delivered to the dealer; and • other financing options are available to the customer from parties unaffiliated with the manufacturer and the customer is in control of the selection of the financing alternative.	A sale may therefore be recognized for the sale to the intermediary, if control transfers. Manufacturers with captive leasing subsidiaries that sell into a dealer network will have to evaluate whether control transfers. We expect that some of the conditions in the existing guidance would continue to be helpful in evaluating whether control transfers to the dealer.

Topic	Details	Observations
	The boards discussed but decided not to include the existing explicit guidance into the proposed Revenue standard.	

Special situations



General

.92 There are a number of special situations addressed by the revised ED that would be expected to have broad-based relevance, including:

- Subleasing
- Foreign exchange rate implications
- Leases in a business combination
- Build-to-suit leasing transactions
- Sale and leaseback transactions
- Related party leases

Subleases

.93 Subleases would be accounted for as two separate transactions. That is, a sublessor would utilize lessee accounting on the head lease and lessor accounting on the sublease.

PwC observation:

Lessees should be mindful that head leases and subleases may be classified differently. For example, there could be situations in which the head lease is classified as a Type A lease and the sublease is classified as a Type B lease, depending on the provisions of the two leases.

Foreign exchange rate implications

.94 When leases are denominated in a foreign currency that is not the entity's functional currency, the impact of changes in the exchange rate related to lease liabilities and right-of-use assets should be recognized in the income statement, consistent with existing guidance for monetary assets and liabilities under ASC Topic 830, *Foreign Currency Matters*.

.95 When leases are denominated in the functional currency of a reporting entity and that reporting entity's functional currency is different than the parent's reporting currency, the impact of changes in the exchange rates related to lease liabilities and assets should be part of the cumulative translation adjustment, consistent with existing guidance in ASC Topic 830, *Foreign Currency Matters*.

PwC observation:

Some respondents to the original ED questioned whether exchange rate differences should result in an adjustment to the right-of-use asset and the liability to make lease payments. However, the boards decided the accounting should be consistent with how foreign exchange differences would be measured for an asset acquisition that is financed with debt in a non-functional currency.

Leases in a business combinations

General concepts

.96 The acquirer would classify leases on the basis of the contractual terms and conditions at the commencement date of the lease, i.e., the acquiree's commencement date. If the contractual terms and conditions of a lease are modified in connection with the acquisition, and result in a substantive change to the original lease, the lease would be considered a new lease and classified based on the terms and conditions at the commencement date of the new lease, which might be the acquisition date.

.97 If the acquiree is a lessee with Type A and/or Type B leases, the acquirer would recognize liabilities to make lease payments and right-of-use assets. The acquirer would measure the liability as the present value of future lease payments as if the acquired lease were a new lease at the acquisition date. The lessee's right-of-use asset recognized at the acquisition date should be the same amount as the liability adjusted for any off-market terms in the lease contract or any other intangible asset associated with the lease.

.98 If the acquiree is a lessor with Type A leases, the acquirer should similarly recognize a receivable and a residual asset. The acquirer should measure the receivable at the present value of future lease payments at the acquisition date as if the acquired lease were a new lease as of the acquisition. The residual asset would be recorded as the difference between the fair value of the underlying asset at the acquisition date and the carrying value for the receivable asset.

.99 If the acquiree is a lessor of a Type B lease, the acquirer would take into account the terms and conditions of the lease in measuring the acquisition date fair value of the underlying asset, such as a building, that is subject to the lease. The acquirer would not recognize a separate asset or liability if the terms of the lease are either favorable or unfavorable when compared with market terms nor would it ascribe value to in-place lease intangibles or lease customer relationships.

PwC observation:

The proposed accounting for an acquirer obtaining a Type B lease as a lessor clearly represents a significant change for prospective transactions that today would have a significant lease intangible associated with above/ below market terms, in-place lease values and customer tenant relationships.

For Type A leases, not allocating to lease intangibles is consistent with acquiring financial assets, i.e., the receivable, and inherently does not apply to the residual asset. However, it is not clear that the same holds true in a Type B lease when the acquirer is acquiring a non-financial asset/business. Inherently, the value of the leased item as encumbered by the lease is different than unencumbered by the lease, e.g., the value of a building that is 100% leased, even at market rents, is worth more than a vacant building.

.100 The acquirer would not recognize assets or liabilities at the acquisition date for leases that, at that date, have a remaining maximum possible term under the contract of twelve months or less.

PwC observation:

This could result in substantial off-market long-term leased assets that happen to be less than a year from termination at acquisition date not being recognized.

Transition

.101 A lessee with existing assets or liabilities recorded in accordance with ASC 805, *Business Combinations,* relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, would derecognize the asset or liability, and record a corresponding adjustment to the carrying amount of the right-of-use asset.

.102 A lessor of Type B leases would not derecognize such existing assets and liabilities. However, a lessor of Type A leases would derecognize the assets and liabilities and record a corresponding adjustment to equity at the beginning of the earliest comparative period presented.

Build-to-suit leasing transactions

.103 A lessee may negotiate a lease before the underlying asset is available for use. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. In other cases, the lessee may incur payments relating to the design or construction of the asset prior to lease commencement. This is commonly referred to as a build-to-suit leasing transaction.

.104 Build-to-suit leasing transactions and the related accounting that exists today in US GAAP had no equivalent in international standards. Such transactions were specifically not addressed by the proposed guidance in the joint standard — thereby eliminating the concept. When a lessee is involved in a build-to-suit leasing transaction, it would no longer be required to consider whether it must account for the asset under construction during the construction period, although other guidance such as applicable to consolidation guidance should be considered.

.105 If a lessee incurs costs prior to lease commencement, the lessee would recognize those amounts as prepayments and add them to the right-of-use asset at lease commencement.

.106 Disclosure would be required of significant build-to-suit lease transactions prior to commencement of the lease.

PwC observation:

This would significantly change current accounting for build-to-suit leasing transactions in the United States.

With the elimination of build-to-suit considerations from the proposed guidance, the lessee will no longer be required to consider and then possibly recognize the leased asset as if it were the legal owner during the construction period. This means that leased assets and liabilities will not be recognized until lease commencement when construction is complete. The elimination of build to suit accounting would also affect measurement of the asset and liability during the lease term since the right-of-use asset and lease liability will be measured as a lease rather than as an owned asset with a mortgage.

Sale-leaseback transactions

General concepts

.107 In a sale-leaseback transaction, the sale would be recognized pursuant to the revenue recognition guidance, while the leaseback would be subject to the revised ED. Entities would apply the control criteria in the proposed revenue recognition standard to determine whether a sale has occurred. If a sale has not occurred, the entire transaction would be accounted for, by both lessee and lessor, as a financing. When consideration received does not equal the fair value of the asset sold, the assets, liabilities, gains or losses recognized should be adjusted to reflect current market rentals.

Not a purchase and sale

.108 If the transferee does not obtain control of the underlying asset pursuant to the revenue recognition guidance, the transferor would not derecognize the transferred asset and would recognize any payments received as a financial liability. The transferee would not recognize the transferred asset but would recognize the amounts paid as a receivable.

.109 The existence of a leaseback does not, in isolation, prevent the transferee from obtaining control of the underlying asset. However, if the leaseback provides the transferor with the ability to direct the use of and obtain substantially all of the remaining benefits from the underlying asset, then the transferee does not obtain control of the underlying asset and the transfer is not a sale. The transferor is considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset if the following conditions are met:

- the lease term is for the major part of the remaining economic life of the asset; or
- the present value of the lease payments accounts for substantially all of the fair value of the asset.

.110 Sale-leaseback transactions are fairly common for lessors of both property and non-property assets, and the boards' decision to align the sale criteria with the proposed revenue recognition standard may result in more transactions qualifying as a sale.

PwC observation:

The decision on how to evaluate sale-leasebacks fundamentally requires a separate evaluation of the sale from the leaseback. It may be appropriate to recognize the full gain on sale immediately. In longer duration leasebacks, some have argued that the seller/lessee retains a significant portion of the right-of-use the asset and fundamentally only the residual asset was sold, e.g., the sale of a building and subsequent lease-back of 30 of the 40 floors. In these cases, many believe only the portion of the gain relating to the sale of the residual asset, i.e., 10 floors should be recognized.

Disclosure

.111 A transferor that enters into a sale-leaseback transaction would be required to disclose the terms and conditions of that transaction, and identify any gains or losses arising from the transaction separately from gains or losses on other disposals of assets.

Transition of sale-leaseback

.112 The transition requirements for historical sale-leaseback transactions will depend on how the lease was originally accounted for.

- **Sale/capital lease:** The existing lease accounting will be allowed to run its course without any transition adjustments if the sale-leaseback transaction resulted in the seller/lessee accounting for the lease as a capital lease. The deferred gain or loss that was previously recognized in respect to the sale-leaseback transaction will continue to be amortized.

- **Sale/operating lease, i.e., "qualified" sale lease-backs, or the transaction did not achieve sale accounting under existing GAAP ("failed sale lease-backs"):** Both the seller/lessee and buyer/lessor would re-evaluate the sale transaction on transition in accordance with the proposed revenue recognition guidance. If the sale conditions are met, then the seller/lessee would measure the right-of-use asset and lease liability under the revised ED. Upon initial application, any deferred gain on that date from a qualified sale leaseback would be recorded through retained earnings as part of transition.

PwC observation:

Under current accounting guidance, buyer/lessors typically account for sale and leaseback transactions as a purchase and lease, without evaluating whether they have obtained control of the underlying asset. However, upon transition, buyer/lessors are required to re-assess all existing transactions in which the lessor accounted for its lease as an operating lease. This is to determine whether the buyer/lessor must re-characterize its investment in the property as a loan. For some lessors this could require significant effort and could result in significant transition adjustment to retained earnings.

For the seller/lessee, any previously recorded deferred gain from a qualified sale leaseback that occurred prior to the initial application date would be recorded through retained earnings upon transition. In certain cases, this could result in significant gains never getting recorded through the income statement. For example, consider a real estate sale-leaseback that took place shortly before the initial application date. Under current GAAP the seller/lessee would typically be required to defer profit on the sale and recognize it over the lease term. Upon the initial application of the standard, the seller/lessee would be required to adjust the previously deferred gain to retained earnings.

Related party leases

.113 All leases, including related party leases, are subject to the recognition and measurement requirements based on the legally enforceable terms and conditions of the lease.

.114 The FASB, however, acknowledged that some related party transactions may not be documented and the terms may not be at arm's length. Lessees and lessors will be required to understand the economic substance of the transaction in order to apply the provisions of the proposals.

.115 Related party leases are subject to the existing disclosure requirements outlined in ASC 850, *Related Party Disclosures*

Private company considerations

.116 The revised ED is expected to have a significant cost impact on all lessees, creating a potential need to hire additional staff, update technology and revise internal controls and financial reporting processes. Private companies have argued that these cost increases are likely to be higher for them on a relative basis in comparison to a public company. As a result, private companies have pushed for further relief in the final standard due to their size and resource constraints. In addition to arguments relating to the cost burden associated with the leases proposals, private company lessees also support specific changes because of the different needs of their financial statement users, primarily private investors, lenders and management, as opposed to shareholders, analysts and rating agencies.

.117 To mitigate some of these concerns, the boards are proposing the following practical expedients for lessees that are private companies:

- **Discount rate:** Private companies would be able to elect an accounting policy to use a risk-free discount rate to measure the lease liability.
- **Reconciliation disclosures:** Private companies would not be required to provide a reconciliation of opening and closing balances of the lease liability.

PwC observation:

The FASB will likely face additional questions from private companies in the comment letter process. The FASB has specifically requested feedback from private companies on these practical expedients and whether additional changes should be proposed.

Alternative views

.118 Three of the seven FASB members disagreed with the issuance of the revised ED. They expressed concerns about whether all of the core objectives of the project have been met, the cost-benefit of the proposal, the level of complexity, the conceptual basis for a dual model for income/expense recognition, and the usefulness of the proposed disclosures. While not part of the FASB ED, the revised ED includes the alternative views of two IASB members who support the application of a single lease model under which all leases would be reflected as financing transactions for financial reporting in the balance sheet and cash flow presentation, and for income/expense recognition.

PwC observation:

Three of the FASB members provided dissenting views in the revised ED. The term of Leslie Siedman, the current FASB chairman, expires in June. Leslie has generally been a supporter of the project. As the FASB contemplates appointing a replacement member, it is unclear what, if anything, this will mean for the completion or provisions of a final standard on leases.

Will convergence be achieved?

.119 The FASB and IASB are aligned on most key decisions, however, some US GAAP / IFRS differences will remain relating to guidance that interacts with the leases proposals. For example, current requirements differ for impairment, accounting for investment properties, and scope, e.g., leases of intangibles.

More information

.120 For more historical information on the background of this project and the initial ED, refer to Dataline 2010-38, *A new approach to lease accounting—Proposed rules would have far reaching implications* (which provides an overview and various insights into the ED), and Dataline 2011-05, *Leasing—The responses are in* . . . (which summarizes comment letters received).

.121 For details on the redeliberations, refer to Dataline 2012-11, *Leases: One size does not fit all—A summary of the boards' redeliberations* . . . (which summarizes key decisions made by the boards during the redeliberation process).

The path forward

.122 The revised ED will have a 120-day comment period with comments due on September 13, 2013. The boards are expected to issue the final standard in 2014.

.123 The effective date will be set after the boards consider feedback received on the revised exposure draft.

Questions

.124 PwC clients who have questions about this Dataline should contact their engagement partner. Engagement teams that have questions should contact members of the Leasing team in the National Professional Services Group (1-973-236-7805).

Authored by:

Chad Soares
Partner
Phone: 1-973-236-4569
Email: chad.c.soares@us.pwc.com

David Humphreys
Partner
Phone: 1-973-236-4023
Email: david.humphreys@us.pwc.com

Tom Wilkin
Partner
Phone: 1-646-471-7090
Email: tom.wilkin@us.pwc.com

Suzanne Stephani
Director
Phone: 1-973-236-4386
Email: suzanne.stephani@us.pwc.com

Marc Jerusalem
Director
Phone: 1-973-236-4714
Email: marc.jerusalem@us.pwc.com

Krystyna Niemiec
Senior Manager
Phone: 1-973-236-5574
Email: krystyna.m.niemiec@us.pwc.com

Lou DeFalco
Senior Manager
Phone: 1-312-298-3476
Email: louis.defalco@us.pwc.com