

Dataline



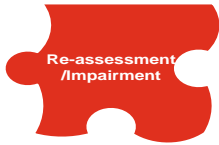
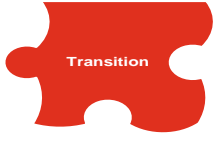

A look at current financial reporting issues

No. 2013-13 (Supplement)
June 13, 2013

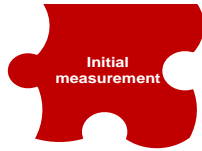
Leases

The Great Divide: The new leases landscape

Illustrative example supplement

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Initial measurement



Example 1: Separating components of a contract

Background: A customer enters into a contract to lease a specialized piece of equipment for four years. The lessor will perform all maintenance service on the equipment during the lease term. The arrangement is priced as a package; therefore, the contract does not specify a price for the use of the equipment separate from the price for the maintenance. The total consideration for the contract is \$1 million, payable in four annual installments of \$250,000. Based on information available from other suppliers, the price for maintenance services on similar equipment over a four year period is \$200,000 paid in equal annual installments of \$50,000.

Issue: How should the lessee separate the components of the contract?

Analysis: In order to measure the right-of-use asset and the lease liability, the lessee must exclude the value of the maintenance (a non-lease component) from the lease payments. The lessee can look to the observable, stand-alone price for the maintenance components of the contract to determine the portion attributable to the lease component. Therefore, the lessee would ascribe \$800,000 or 80% of the total payments made under the contract to the lease.

Example 2: Lessee initial measurement

Background: On 01/01/20x0, ABC Co. ("lessee") enters into a contract to lease property to be used as a retail store from XYZ Landlord Co. ("lessor").

| Key terms of the lease contract | |
|---|---|
| Lease commencement date | 01/01/x0 |
| Initial lease term | 5 years |
| Extension option | 3 years |
| Annual contractual payments in the initial term | \$115,000 (includes \$15,000 per year for executory costs) |
| Annual lease payments in the extension period | \$110,000 (excluding executory costs) |
| Payment date | 12/31 at the end of each year |
| Initial direct costs | \$10,000 |
| Discount rate | The lessee does not know the discount rate implicit in the lease. The lessee's incremental borrowing rate would be 5% for a five year term or 5.75% for an eight year term. |
| Lease increase based on changes in the Consumer Price Index ("CPI") | The annual lease payment increases in line with the annual increase in the CPI. The payment is based on the CPI at the beginning of the year. For example, the payment due on 12/31/x0 is based on the CPI at 01/01/x0. The CPI at lease commencement is 120. |
| Variable payment based on sales | An additional lease payment of 1% of the annual retail store sales in excess of \$1.0 million is due 90 days after the end of each lease year. |

Issue: How should the lessee initially measure the lease liability and right-of-use asset?

Analysis: In order to calculate the initial lease liability and right-of-use-asset ("ROU asset"), the lessee will:



Step 1) Determine the lease term

Based on conditions that exist at the commencement date, the lessee determines that it does not have a significant economic incentive to exercise the extension option; therefore the lease term is five years.

Step 2) Identify the lease payments

The annual contractual payment is \$115,000. However, \$15,000 of each annual payment is allocated to the executory costs and is excluded from the measurement of the lease liability. Therefore, the payments included in the initial measurement of the lease liability are \$100,000 due on 12/31 of each year. The variable payments based on sales are excluded because they are based on performance. Additional payments based on changes in CPI are initially calculated using the index at inception, which would yield no additional payments. At the contract's rent reset date, changes in CPI since inception or the most recent previous reset date will need to be reflected in the right of use asset and liability.

Step 3) Determine the discount rate

Since the lessee does not know the interest rate implicit in the lease agreement, the lessee will use its incremental borrowing rate for similar terms as in the lease (amount, duration, and collateral) which is 5%.

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

The lessee paid initial direct costs of \$10,000.

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

Based on the amounts above, the amounts recorded on the balance sheet on 01/01/20x0 are as follows:

Lease liability is \$432,948 and is calculated as follows:

| Payments made at the end of each year | | | | | | |
|---------------------------------------|-----------|-----------|-----------|-----------|-----------|------------------|
| Year | 1 | 2 | 3 | 4 | 5 | Total |
| Payment | \$100,000 | \$100,000 | \$100,000 | \$100,000 | \$100,000 | \$500,000 |
| Discount | (4,762) | (9,297) | (13,616) | (17,730) | (21,647) | (67,052) |
| Present value | \$95,238 | \$90,703 | \$86,384 | \$82,270 | \$78,353 | \$432,948 |

Right-of-use asset is \$442,948 and is calculated as follows:

| | Amount |
|--------------------------|------------------|
| Lease liability | \$432,948 |
| Initial direct costs | 10,000 |
| Total right-of-use asset | \$442,948 |

Expense recognition



Example 3: Lessee expense recognition

Background: Assume the same facts as in Example 2 for initial measurement.

Issue: How should the lessee recognize expense?

Analysis: This is a lease of property, so the presumption under the proposed standard is that this will be a Type B lease. However, to highlight the differences between the two models, we show both Type A and Type B expense recognition.

Type A

Interest expense: The table below details the interest expense calculation for each year.

| Year | Remaining cash payments | Discount | Liability beginning balance | Interest expense | Lease payment | Liability ending balance |
|------|-------------------------|----------|-----------------------------|------------------|---------------|--------------------------|
| 1 | \$500,000 | \$67,052 | \$432,948 | \$21,647 | \$100,000 | \$354,595 |
| 2 | 400,000 | 45,405 | 354,595 | 17,730 | 100,000 | 272,325 |
| 3 | 300,000 | 27,675 | 272,325 | 13,616 | 100,000 | 185,941 |
| 4 | 200,000 | 14,059 | 185,941 | 9,297 | 100,000 | 95,238 |
| 5 | 100,000 | 4,762 | 95,238 | 4,762 | 100,000 | - |

Amortization expense: The lessee has concluded that a straight-line amortization pattern best represents the pattern in which it will consume the asset. Therefore, the annual amortization is as follows:

| | Year | | | | |
|----------------------------|---------------|---------------|---------------|---------------|---------------|
| | 1 | 2 | 3 | 4 | 5 |
| Beginning balance | \$442,948 | \$354,358 | \$265,769 | \$177,179 | \$88,590 |
| Annual amortization | 88,590 | 88,590 | 88,590 | 88,590 | 88,590 |
| Ending balance | \$354,358 | \$265,769 | \$177,179 | \$88,590 | \$ - |

Total annual interest and amortization expense based on the CPI at lease commencement is as follows:

| Expense type | | | |
|--------------|----------|--------------|-----------|
| Year | Interest | Amortization | Total |
| 1 | \$21,647 | \$88,590 | \$110,237 |
| 2 | 17,730 | 88,590 | 106,319 |
| 3 | 13,616 | 88,590 | 102,206 |
| 4 | 9,297 | 88,590 | 97,887 |
| 5 | 4,762 | 88,590 | 93,351 |
| Total | \$67,052 | \$442,948 | \$510,000 |

Variable payments: Variable lease payments based on a percentage of sales will be expensed in the period incurred. The lease liability must be re-measured each period for the change in the CPI. See Example 5 for an illustration.

Executory costs: These costs are generally recognized as incurred.

Type B

For a Type B lease, a lessee will show a single lease expense on the statement of comprehensive income. The lease expense will be the straight-line amount of the lease costs calculated as follows:

| | Lease cost (a) | Lease term (b) | Straight-line expense (a)/(b) |
|---------------------|-------------------|-------------------|----------------------------------|
| Lease payments | \$500,000 | 5 | \$100,000 |
| Initial direct cost | 10,000 | 5 | 2,000 |
| Total lease cost | \$510,000 | | \$102,000 |

However, the single lease expense must be allocated between amortization of the lease liability and the right-of-use asset, as follows:

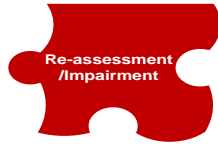
Lease liability: The lease liability is subsequently measured in the same manner as the Type A lease. Therefore, the interest component of the straight-line expense will equal the interest expense calculated as for a Type A lease, above.

Right-of-use asset: The right-of-use asset "amortization" is computed as the balancing figure between straight-line expense and "interest" expense computed using the effective interest method as follows.

| Year | Asset beginning balance | "Interest" component (d) | Straight-line expense (e) | "Amortization" component (e) – (d) | Asset ending balance |
|------|-------------------------|--------------------------|---------------------------|------------------------------------|----------------------|
| 1 | \$442,948 | \$21,647 | \$102,000 | \$80,353 | \$362,595 |
| 2 | 362,595 | 17,730 | 102,000 | 84,270 | 278,325 |
| 3 | 278,325 | 13,616 | 102,000 | 88,384 | 189,941 |
| 4 | 189,941 | 9,297 | 102,000 | 92,703 | 97,238 |
| 5 | 97,238 | 4,762 | 102,000 | 97,238 | - |

Variable payments: Variable lease payments based on a percentage of sales will be expensed in the period incurred. The lease liability must be re-measured each period for the change in the CPI. See Example 5 for an illustration.

Re-assessment



Example 4: Lessee lease term re-assessment

Background: Assume the same facts as in Examples 2 and 3 for initial and subsequent measurement. As noted in Example 2, the lessee did not have a significant economic incentive to exercise the 3-year extension option at the lease commencement date. However, assume that on December 31, 20x2 (the last day of year 3 of the lease), the lessee installed unique tenant improvements into the retail store with an estimated 5-year economic life. The lessee determined that it will only recover the cost of the improvements if it exercises the extension option, creating an economic incentive to extend.

The lessee's incremental borrowing rate based on the revised term of the lease is 6% on December 31, 20x2 (based on the incremental borrowing rate of the lessee using market interest rates at the time of the reassessment). This rate differs from the equivalent rate calculated at inception.

Issue: How should the lessee account for the change in lease term?

Analysis: This is a lease of property, so the presumption under the proposed standard is that this will be a Type B lease. However, to highlight the differences between the two models, we show both Type A and Type B expense recognition.

Type A

The lessee must re-assess the lease term when it determines that there is a significant economic incentive to exercise the extension option. In this example, it is December 31, 20x2 or the end of year 3 of the lease.

Calculate the adjustment to the lease liability and the right-of-use asset: The lease liability is re-measured based on the present value of the remaining future lease payments for the new term using the revised discount rate of 6%. The new term is now eight years in aggregate with five years remaining, i.e., the remaining two years in the initial term plus the three years in the extension period. The re-assessment occurred at the end of year 3, so the next payment occurs at the end of year 4. The revised lease liability is \$445,026 at the end of year 3, determined as follows:

| Payments made at the end of each year | | | | | | |
|---------------------------------------|-----------|-----------|-----------|-----------|-----------|------------------|
| Year | 4 | 5 | 6 | 7 | 8 | Total |
| Payment | \$100,000 | \$100,000 | \$110,000 | \$110,000 | \$110,000 | \$530,000 |
| Discount | 5,660 | 11,000 | 17,642 | 22,870 | 27,802 | 84,974 |
| Present value | \$94,340 | \$89,000 | \$92,358 | \$87,130 | \$82,198 | \$445,026 |

The adjustment is calculated as follows:

| | Amount |
|--|------------------|
| Revised liability balance per above | \$445,026 |
| Liability balance at the end of year 3 (<i>see Example 3 for this balance</i>) | 185,941 |
| Adjustment | \$259,085 |

The adjustment is recorded as follows:

| Journal entry | Debit | Credit |
|--------------------|-----------|-----------|
| Right-of-use asset | \$259,085 | |
| Lease liability | | \$259,085 |

Expense recognition: The interest and amortization expense will change based on the revised term and discount rate, as shown below.

Interest expense: The interest expense would be updated to reflect the revised discount rate and lease term.

| Year | Remaining cash payments | Discount | Liability beginning balance | Interest expense | Lease payment | Liability ending balance |
|------|-------------------------|----------|-----------------------------|------------------|---------------|--------------------------|
| 4 | \$530,000 | \$84,974 | \$445,026 | \$26,702 | \$100,000 | \$371,728 |
| 5 | 430,000 | 58,272 | 371,728 | 22,304 | 100,000 | 294,031 |
| 6 | 330,000 | 35,969 | 294,031 | 17,642 | 110,000 | 201,673 |
| 7 | 220,000 | 18,327 | 201,673 | 12,100 | 110,000 | 103,774 |
| 8 | 110,000 | 6,226 | 103,774 | 6,226 | 110,000 | (0) |

Amortization expense: The revised straight-line amortization is as follows:

| Component | Amount |
|--|------------------|
| Original asset balance at the end of year 3 (<i>see Example 3 for this amount</i>) | \$177,179 |
| Adjustment calculated above | \$259,085 |
| Total revised balance | \$436,264 |
| Revised remaining lease term | 5 |
| Annual amortization | \$87,253 |

The balance of the right-of-use asset at each period end is as follows:

| | Year | | | | |
|-----------------------|------------------|------------------|------------------|-----------------|-------------|
| | 4 | 5 | 6 | 7 | 8 |
| Beginning balance | \$436,264 | \$349,011 | \$261,758 | \$174,506 | \$87,253 |
| Annual amortization | 87,253 | 87,253 | 87,253 | 87,253 | 87,253 |
| Ending balance | \$349,011 | \$261,758 | \$174,506 | \$87,253 | \$ - |

Type B

The lessee must re-assess the lease term when it determines that there is a significant economic incentive to exercise the extension option. In this Example, it is December 31, 20x2 or the end of year 3 of the lease.

Calculate the adjustment to the lease liability and the right-of-use asset: The adjustment to the lease liability and the right-of-use asset is the same as in a Type A lease discussed above. Therefore, the revised lease liability is \$445,026. The revised right-of-use asset is calculated as follows:

| | Amount |
|---|------------------|
| Right of use asset at the end of year 3 (<i>see Example 3 for this balance</i>) | \$189,941 |
| Adjustment per above | 259,085 |
| Re-measured right-of-use asset balance | \$449,026 |

Recalculate the straight-line expense: The single lease expense will change based on the revised term, as shown below.

The lessee must first adjust the total lease costs for the change in undiscounted lease payments that arose due to the change in the lease term, as follows:

| | Amount |
|---|------------------|
| Initial lease payments | \$500,000 |
| Initial direct costs | 10,000 |
| Additional lease payments in the extension period | 330,000 |
| Total revised lease costs | \$840,000 |

Next, the lessee would recalculate the straight-line lease expense based on the revised total lease cost and term as follows:

| | Amount |
|--------------------------------------|------------------|
| Total revised lease costs per above | \$840,000 |
| Less lease costs already recognized | \$306,000* |
| Adjusted lease costs | \$534,000 |
| Revised remaining lease term | 5 |
| Revised straight-line expense | \$106,800 |

*Lease costs already recognized in this example are calculated as follows:

| | |
|---|------------------|
| Initial annual straight-line lease expense | \$102,000 |
| Annual periods with expense recognized | 3 |
| Total lease costs already recognized | \$306,000 |

Subsequent measurement: The lessee would subsequently measure the lease liability as in the Type A lease shown above. The lessee would subsequently measure the right-of-use asset as follows:

| Year | Asset beginning balance | "Interest" expense | Straight-line expense | "Amortization" expense | Asset ending balance |
|------|-------------------------|--------------------|-----------------------|------------------------|----------------------|
| 4 | \$449,026 | \$26,702 | \$106,800 | \$80,098 | \$368,928 |
| 5 | 368,928 | 22,304 | 106,800 | 84,496 | 284,431 |
| 6 | 284,431 | 17,642 | 106,800 | 89,158 | 195,273 |
| 7 | 195,273 | 12,100 | 106,800 | 94,700 | 100,574 |
| 8 | 100,574 | 6,226 | 106,800 | 100,574 | - |

Example 5: Lessee re-assessment based on changes in an index

Background: Assume the same facts as in Example 2 and Example 3 for initial measurement and subsequent measurement. As noted in Example 2, the CPI at lease inception (01/01/x0) was 120 and the first annual payment due on 12/31/x0 was based on that CPI. The next annual payment is due on 12/31/x1 and the amount due is based on the CPI at 01/01/x1. The CPI at 01/01/x1 is 125.

Issue: How should the lessee account for the change in CPI?

Analysis: This is a lease of property, so the presumption under the proposed standard is that this will be a Type B lease. However, to highlight the differences between the two models, we show both Type A and Type B expense recognition.

Type A

Calculate the adjustment to the lease liability and the right-of-use asset:

Calculate the future lease payments based on the new CPI of 125 as follows:

| | |
|---|-----------|
| CPI at 01/01/x0 | 120 |
| CPI at 01/01/x1 | 125 |
| Change in index | 5 |
| % change | 4% |
| Annual lease payment in prior year | \$100,000 |
| Revised annual lease payment based on % change in CPI | \$104,000 |

Next, the lease liability is re-measured based on the present value of the revised future lease payments of \$104,000. The discount rate of 5% used at lease commencement is still used to discount these payments. The revised lease liability at 01/01/x1 is \$368,779 as calculated below.

| Annual lease payment | | | | | |
|------------------------|-----------|-----------|-----------|-----------|------------------|
| Year | 2 | 3 | 4 | 5 | Total |
| Revised payments | \$104,000 | \$104,000 | \$104,000 | \$104,000 | \$416,000 |
| Present value discount | 4,952 | 9,669 | 14,161 | 18,439 | 47,221 |
| Present value | \$99,048 | \$94,331 | \$89,839 | \$85,561 | \$368,779 |

The adjustment is calculated as follows:

| | Amount |
|--|-----------------|
| Revised liability balance per above | \$368,779 |
| Liability balance at the end of year 1 (<i>see Example 3 for this balance</i>) | 354,595 |
| Adjustment | \$14,184 |

The adjustment is recorded as follows:

| Journal entry | Debit | Credit |
|--------------------|----------|----------|
| Right-of-use asset | \$14,184 | |
| Lease liability | | \$14,184 |

Revise the expense recognition: The interest and amortization expenses will change based on the revised lease payments, as shown below.

Interest expense: The revised interest expense based on the change in CPI is as follows:

| Year | Remaining cash payments | Discount | Liability beginning balance | Interest expense | Lease payment | Liability ending balance |
|------|-------------------------|----------|-----------------------------|------------------|---------------|--------------------------|
| 2 | \$416,000 | \$47,221 | \$368,779 | \$18,439 | \$104,000 | \$283,218 |
| 3 | 312,000 | 28,782 | 283,218 | 14,161 | 104,000 | 193,379 |
| 4 | 208,000 | 14,621 | 193,379 | 9,669 | 104,000 | 99,048 |
| 5 | 104,000 | 4,952 | 99,048 | 4,952 | 104,000 | - |

Amortization expense: The revised straight-line amortization is as follows:

| | Amount |
|--|------------------|
| Original asset balance at the end of year 1 (<i>see Example 3 for this amount</i>) | \$354,358 |
| Adjustment calculated above | \$14,184 |
| Total revised balance | \$368,542 |
| Remaining lease term | 4 |
| Annual amortization | \$92,135 |

The balance of the right-of-use asset at each period end is as follows:

| | Year | | | |
|-----------------------|------------------|------------------|-----------------|-------------|
| | 2 | 3 | 4 | 5 |
| Beginning balance | \$368,542 | \$276,406 | \$184,271 | \$92,135 |
| Annual amortization | 92,135 | 92,135 | 92,135 | 92,135 |
| Ending balance | \$276,406 | \$184,271 | \$92,135 | \$ - |

Type B

Calculate the adjustment to the lease liability and the right-of-use asset: The adjustment to the lease liability and the right-of-use asset is the same as in a Type A lease discussed above. Therefore, the revised lease liability is \$368,779. The revised right-of-use asset is as follows:

| Component | Amount |
|---|------------------|
| Right- of- use asset at the end of year 1 (<i>see Example 3 for this balance</i>) | \$362,595 |
| Adjustment per above | 14,184 |
| Revised right-of-use asset balance | \$376,779 |

Recalculate the straight-line expense: The single lease expense will change based on the revised payments as shown below.

The lessee must first adjust the initial total lease costs for the change in undiscounted lease payments that arose due to the change in CPI, as follows:

| | Amount |
|--|------------------|
| Initial lease payments | \$500,000 |
| Initial direct costs | 10,000 |
| Additional lease payment based on increased CPI (<i>\$4,000 annual increase x 4 years</i>) | 16,000 |
| Total revised lease costs | \$526,000 |

Next, the lessee would recalculate the straight-line lease expense based on the revised total lease cost as follows:

| | Amount |
|--------------------------------------|------------------|
| Total revised lease costs per above | \$526,000 |
| Less lease costs already recognized | \$102,000* |
| Adjusted lease costs | \$424,000 |
| Remaining lease term | 4 |
| Revised straight-line expense | \$106,000 |

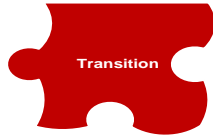
*Lease costs already recognized in this example are calculated as follows:

| | |
|--|------------------|
| Initial annual straight-line lease expense (See Example 3) | \$102,000 |
| Annual periods with expense recognized | 1 |
| Total lease costs already recognized | \$102,000 |

Subsequent measurement: The lessee would subsequently measure the lease liability in the same manner as the Type A lease shown above. The lessee would subsequently measure the right of use asset as follows:

| Year | Asset beginning balance | "Interest" expense | Straight-line expense | "Amortization" expense | Asset ending balance |
|----------|-------------------------|--------------------|-----------------------|------------------------|----------------------|
| 2 | \$376,779 | \$18,439 | \$106,000 | \$87,561 | \$289,218 |
| 3 | 289,218 | 14,161 | 106,000 | 91,839 | 197,379 |
| 4 | 197,379 | 9,669 | 106,000 | 96,331 | 101,048 |
| 5 | 101,048 | 4,952 | 106,000 | 101,048 | - |

Transition



Example 6: Modified retrospective approach: existing lessee operating lease of equipment

Background: Assume that the effective date of the proposed guidance is 01/01/x3 and the initial application date is 01/01/x1, i.e., the beginning of the earliest period presented assuming a three-year comparative financial statements for public companies. A lessee has an existing operating lease of equipment with the following terms:

| Key terms | |
|--|--------------------|
| Lease commencement date | 01/01/x0 |
| Initial lease term | 5 years |
| Annual lease payments for the first two years | \$200,000 |
| Annual lease payments for the last three years | \$210,000 |
| Payment date | 12/31 of each year |
| Initial direct costs | \$10,000 |
| Accrued rent balance at 01/01/x1 | \$6,000 |
| Discount rate at the effective date | 10% |

Issue: How should the lessee record the lease at the initial application date of 01/01/x1?

Analysis: The lessee must first determine the lease classification (Type A or Type B) based on the proposed guidance. This is a lease of equipment, so the presumption under the proposed standard is that this will be a Type A lease. However, to highlight the differences between the two models, we show both Type A and Type B expense recognition. The lessee would initially measure the lease liability and right-of-use asset as of the initial application date.

Type A

Lease liability is \$656,581 calculated as follows:

| | Payments made at the end of each year | | | | |
|---------------|---------------------------------------|-------------|-------------|-------------|------------------|
| Year | 20x1 | 20x2 | 20x3 | 20x4 | Total |
| Payment | \$200,000 | \$210,000 | \$210,000 | \$210,000 | \$830,000 |
| Discount | 18,182 | 36,446 | 52,224 | 66,567 | 173,419 |
| Present value | \$181,818 | \$173,554 | \$157,776 | \$143,433 | \$656,581 |

Right-of-use asset is calculated based on the following steps:

Step 1) Calculate the average of the remaining lease payments

| Payment date | Annual lease payments |
|---|------------------------------|
| 12/31/x1 | \$200,000 |
| 12/31/x2 | \$210,000 |
| 12/31/x3 | \$210,000 |
| 12/31/x4 | \$210,000 |
| Total lease payments | \$830,000 |
| Divided by the remaining lease term | 4 |
| Average remaining lease payments | \$207,500 |

Step 2) Calculate the present value of the average remaining lease payments assuming the average payment is paid evenly over the entire lease term (note the use of average as opposed to actual lease payments)

| | Payments made at the end of each year | | | | | |
|---------------|---------------------------------------|-------------|-------------|-------------|-------------|------------------|
| Year | 20x0 | 20x1 | 20x2 | 20x3 | 20x4 | Total |
| Payment | \$207,500 | \$207,500 | \$207,500 | \$207,500 | \$207,500 | \$1,037,500 |
| Discount | 18,864 | 36,012 | 51,602 | 65,775 | 78,659 | 250,912 |
| Present value | \$188,636 | \$171,488 | \$155,898 | \$141,725 | \$128,841 | \$786,588 |

Step 3) Calculate the pro-rata amount that should be attributed to the remaining lease term

| | |
|---|-------------|
| Estimated commencement date lease liability per Step 2) above | \$786,588 |
| Multiplied by the remaining lease term | 4 |
| | \$3,146,352 |
| Amount calculated above | \$3,146,352 |
| Divided by the entire lease term | 5 |
| Right-of-use asset before accrued rent adjustment | \$629,270 |

Transition adjustment

Based on the calculations above, the lessee would record the following journal entries:

| Account | Debit | Credit |
|--------------------|-----------|-----------|
| Right-of-use asset | \$629,270 | |
| Retained earnings | 27,311 | |
| Lease liability | | \$656,581 |
| Accrued rent(1) | 6,000 | |
| Right-of-use asset | | 6,000 |

(1) Represents accumulated accrued rent for the operating lease computed under existing accounting as of the initial application date.

Type B

Lease liability is \$656,581. This amount is calculated in the same manner as for a Type A lease discussed above.

Right-of-use asset is calculated as follows:

| | Amount |
|--|------------------|
| Total lease liability per above | \$656,581 |
| Less: accrued rent at the initial application date | 6,000 |
| Total right-of-use asset | \$650,581 |

Based on the calculations above, the lessee records the following journal entries:

| Account | Debit | Credit |
|--------------------|-----------|-----------|
| Right-of-use asset | \$650,581 | |
| Accrued rent | 6,000 | |
| Lease liability | | \$656,581 |

Lessor accounting



Example 7: Lessor initial measurement (Type A lease – receivable and residual approach)

[Note: Interest rate has been rounded.]

Background: On 01/01/20x0, ABC Co. ("lessee") enters into a contract to lease a piece of equipment used in ABC's manufacturing process from XYZ Co. ("lessor").

[Note: The calculation for a Type B lease is not illustrated as the accounting is similar to current operating lease accounting.]

| Key terms of the lease contract | |
|---|--|
| Lease commencement date | 01/01/x0 |
| Initial lease term | 5 years |
| Extension option | 3 years |
| Annual contractual payments in the initial term | \$110,000 (The annual payment includes \$10,000 per year for executory costs.) |
| Annual lease payments in the extension period | At market rents. |
| Payment date | 12/31 of each year |
| Carrying amount and fair value of equipment at lease inception | \$555,000 |
| Expected residual value of equipment at end of initial lease term | \$250,060 |
| Initial direct costs | \$10,000 |
| Discount rate | The rate the lessor is charging the lessee calculated to be 8.80%. |

Issue: How should the lessor initially measure the lease receivable and the residual asset?

Analysis: The lessor would calculate the initial lease receivable and residual asset as follows:

Step 1) Determine the lease term

Based on conditions that exist at the commencement date, the lessor determines that the lessee does not have a significant economic incentive to exercise the extension option; therefore the lease term is five years.

Step 2) Identify the lease payments

The annual contractual payment is \$110,000. However, \$10,000 of each annual payment is allocated to executory costs and is excluded from the measurement of the lease receivable. Therefore, the payments included in the initial measurement of the lease receivable are \$100,000 due on 12/31 of each year.

Step 3) Determine the discount rate

The rate the lessor charges the lessee is 8.80%, which is the rate that causes the present value of the lease payments and the estimated value of the asset at the end of the lease term to equal the fair value of the vehicle at the commencement date.

Step 4) Identify the additional elements of the lessor receivable

The lessor paid initial direct costs of \$10,000. Such costs are to be included in the initial measurement of the lease receivable. These costs will be included in the determination of the imputed rate which will be used by the lessor to recognize interest income on the receivable over the lease term (as further described below).

Calculation of the initial lease receivable and residual asset

The journal entry recorded on 01/01/20x0 is as follows:

| Account | Debit | Credit |
|---|-----------|-----------|
| Lease receivable | \$390,985 | |
| Residual interest in leased asset | 164,015 | |
| Lease receivable (initial direct costs) | 10,000 | |
| Equipment | | \$555,000 |
| Cash (initial direct costs) | | \$10,000 |

Lease receivable is \$390,985 and is calculated as the present value of each payment of \$100,000 discounted back over the appropriate number of years, i.e., 1 through 5, at 8.80%.

Note that the actual lease receivable recorded on the balance sheet at commencement of the lease would also include the \$10,000 initial direct costs incurred by the lessor (\$390,985 + \$10,000 = \$400,985) as shown in the separate journal entry above.

Residual asset is \$164,015 and is calculated as the present value of \$250,000 discounted back 5 years at 8.80%.

Equipment of \$555,000 is derecognized.

Profit on the receivable and deferred profit on the residual asset: Since there is no difference between the carrying amount and the fair value of the equipment at lease commencement, the lessor does not recognize any profit at that date or any unearned profit relating to the residual asset.

Example 8: Lessor subsequent measurement (Type A lease – receivable and residual approach)

[Note: Interest rate has been rounded.]

Issue: How should the lessor subsequently account for the lease receivable and the residual asset?

Analysis: The lessor would calculate interest income on the lease receivable and accretion income on the residual asset as follows:

[Note: The calculation for a Type B lease is not illustrated as the accounting is similar to current operating lease accounting.]

Step 1) Calculate the amount of interest income to be recorded each period

Since the initial direct costs are included in the receivable, the lessor must determine the imputed rate that will reduce the balance of the lease receivable to zero by the end of the lease term. The imputed rate for this lease is 7.84%. The lessor should apportion each payment received by the lessee between interest income and the principal reduction of the receivable balance using the effective interest method.

| Accounting for the lease receivable | | | | |
|-------------------------------------|-------------------------------------|-----------------|-----------------------------------|------------------------------------|
| Year | Gross lease payments to be received | Interest income | Principal reduction of receivable | Remaining lease receivable balance |
| Initial lease receivable | | | | \$400,985 |
| 1 | \$100,000 | \$31,428 | \$68,572 | 332,413 |
| 2 | 100,000 | 26,054 | 73,946 | 258,466 |
| 3 | 100,000 | 20,258 | 79,742 | 178,724 |
| 4 | 100,000 | 14,008 | 85,992 | 92,732 |
| 5 | 100,000 | 7,268 | 92,732 | - |

Step 2) Recognize accretion income on the residual asset

The residual asset must be accreted up to its estimated fair value of \$250,000 at the end of the 5 year lease term. This is calculated and recorded as follows:

| Accounting for the residual asset | | | |
|-----------------------------------|---|-----------------------------|---|
| Year | Residual asset balance (Beginning of year) | Accretion of residual asset | Residual asset balance (End of year) |
| 1 | \$164,015 | \$14,435 | \$178,450 |
| 2 | 178,450 | 15,705 | 194,155 |
| 3 | 194,155 | 17,087 | 211,242 |
| 4 | 211,242 | 18,591 | 229,833 |
| 5 | 229,833 | 20,227 | 250,060 |

Note: accretion of the residual asset is calculated as the beginning residual asset multiplied by the rate implicit in the lease, i.e., 8.8%.

Summary

The following summarizes the transaction economics as compared to the total income recorded over the five year lease period by the lessor:

| Summary of overall economics | |
|---|------------------|
| Total cash payments to be received by lessor | \$500,000 |
| Expected residual value of asset at end of lease | 250,060 |
| Less: initial direct costs incurred by lessor | (10,000) |
| Less: cost basis of equipment on lessor's books | (555,000) |
| Economic profit from transaction | \$185,060 |
| | |
| Income recorded over 5 years (see table below) | \$185,060 |

Income recorded over 5 years would be as follows:

| Total lessor income recorded over the lease term | | | |
|--|-------------------------------------|------------------------------------|-----------------------------------|
| Year | Interest income on lease receivable | Accretion income on residual asset | Total income recognized each year |
| 1 | \$31,428 | \$14,435 | \$45,863 |
| 2 | 26,054 | 15,705 | 41,759 |
| 3 | 20,258 | 17,087 | 37,345 |
| 4 | 14,008 | 18,591 | 32,599 |
| 5 | 7,268 | 20,227 | 27,495 |
| Total | | | \$185,060 |

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