THOMSON REUTERS
CHECKPOINT®

AN OVERVIEW OF THE REVISED PROPOSED ACCOUNTING MODEL FOR LEASES

JUNE 2013

Leasing is a very popular way of obtaining the right to use assets, of financing activities, and of reducing a reporting entity's risks associated with the ownership of assets. Because leasing is so widespread, the accounting and reporting for leases is important for both reporting entities and users of their financial statements.

On May 16, 2013, the FASB issued Proposed Accounting Standards Update (proposed ASU) No. 2013-270: Leases (Topic 842), a revision of the 2010 Proposed FASB Accounting Standards Update, Leases (Topic 840). This proposed ASU is attempting to address the main criticisms of the current reporting model that does not require lessees to recognize assets and liabilities arising from operating leases.

The FASB and the IASB have worked jointly to develop a new approach that would require a lessee to recognize assets and liabilities arising from all leases. At the same time, the Boards decided to make lessor accounting consistent with the model proposed for lessees. As a result, Proposed ASU No. 2013-270 introduces significant changes to the way both lessors and lessees account for and report leases. If the proposed ASU is adopted, all entities that enter into leases would be affected by the proposed changes.

AN OVERVIEW OF THE REVISED PROPOSED ACCOUNTING MODEL FOR LEASES

The current accounting model for leases has been highly criticized for not requiring lessees to recognize assets and liabilities arising from operating leases. It has also been controversial because it provides bright lines that enable lessees to structure leases to achieve a desired accounting presentation rather than providing an objective assessment of lease positions.

As a result, on May 16, 2013, the FASB issued Proposed Accounting Standards Update (proposed ASU) No. 2013-270: Leases (Topic 842), a revision of the 2010 Proposed FASB Accounting Standards Update, Leases (Topic 840). This proposed ASU is based on a joint project with the IASB intended to restructure comprehensively the existing lease accounting guidance for both lessees and lessors. If approved, this proposed ASU would supersede Topic 840, Leases and introduce a new Topic 842, Leases.

The changes proposed in proposed ASU No. 2013-270 are very significant to both lessors and lessees and affect most aspects of lease accounting.

OBSERVATION: The proposed changes to lease accounting represent a seismic shift in lessee accounting for operating leases, in particular. With few exceptions, all leases must be capitalized, leading to significant effects on the reporting and documentation requirements of lessee preparers. Capitalization also is expected to affect key ratios, such as debt-to-equity and return on assets.

Another significant modification to existing guidance is the removal of specialized accounting treatment for leveraged leases, which would affect the key ratios of lessors. Readers are encouraged to monitor closely the progress of this proposed ASU in order to anticipate and prepare adequately for the additional reporting and recordkeeping requirements, as well as for alterations in their reported or contractual financial ratios.

Scope of the proposed new guidance on leases

Proposed ASU No. 2013-270 defines a lease as a contract that provides the right to use an asset (also called the underlying asset) for a period of time in exchange for consideration. A contract is or contains a lease if:

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

b. The contract provides the right to control the use of an identified asset for a period of time in exchange for consideration.

The scope of Proposed ASU No. 2013-270 includes all leases and subleases, except for leases of:

- Intangible assets;
- Biological assets; and
- Exploration or use of non-regenerative assets (e.g., oil and gas).

The right to use an asset in a sublease would also be within the scope of the proposed guidance.

Definition and classification of a lease

Proposed ASU No. 2013-270 includes a revised definition of a lease. It also proposes a new lease classification that would determine how the lease would be accounted for.

Revised definition of a lease

A contract is or contains a lease if both of the following conditions are met:

a. The fulfillment of the contract depends on the use of an identified asset:

A leased asset can be identified either explicitly or implicitly. If the lessor has the right to substitute an asset for another, this right must be evaluated to determine whether it is substantive. A substantive right of substitution would preclude an asset to be specifically identified in the contract.

A physical portion of a broader asset, such as one floor of a building can be identified as a leased asset in the contract.

b. The contract provides the right to control the use of an identified asset for a period of time in exchange for consideration:

The right to use an identified asset is based on both:

- The ability to direct the use of the identified asset (in other words, whether the lessee has the ability to make decisions about the use of the asset in a way that significantly affects the economic benefits to be obtained from the asset over the contract term), and
- The right to obtain substantially all of the potential economic benefits from the use of the asset throughout the lease term. These economic benefits include the primary outputs and by-products of the asset, but may take many other forms.

Once an entity has identified a contract as a lease, it must account for each lease component, if any, within the lease separately and must therefore allocate the consideration to each component. The proposed ASU provides additional guidance to determine when a component must be accounted for separately.

Classification of a lease

The accounting for the lease will depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits of the leased asset. In order to assist with this determination, leases are classified under two categories:

a. Type A leases: leases of assets other than property, unless the lease term represents a small portion of the total economic life of the leased asset or the present value of the lease payments is insignificant as compared to the fair value of the leased asset.

b. Type B leases: leases of property, unless the lease term is for a major part of the remaining economic life of the leased asset or the present value of the lease payments substantially equals the fair value of the leased asset.

The classification of a lease is determined at inception and is not reassessed at a later date unless the contract is subsequently modified.

OBSERVATION: The distinction between Type A and Type B leases was introduced in the revised proposed ASU as a simplified approach to categorize leases based on their economic nature. The FASB decided to remove the bright-line tests in the current guidance (as they were highly criticized), but was concerned with the level of judgment that would be required to classify a lease. While this approach does not remove judgment, it is designed to keep the approach as straight forward as possible.

FASB members were divided on lease classification and this concept may be revisited during future deliberations.

New accounting models for lessees and lessors in the proposed ASU

Proposed new accounting model for lessees

The proposed ASU contains a new accounting model for lessees recognizing a right-of-use asset for all leases (other than short-term leases):

- The lessee would recognize an asset quantifying its right to use the underlying leased asset during the term of the lease. The lessee also would recognize an obligation for the related lease payments.
- The initial measurement of the lease asset and obligation would be based on the required lease payments over the life of the lease, discounted for the time-value of money. The discount rate to use is the rate charged by the lessor, if available. If that rate is not available to the lessee, the lessee may use its incremental borrowing rate as a practical expedient.
- The recognition of expenses depends on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the leased asset:
  - For most leases of assets other than property (referred to as Type A leases in the proposed ASU), the lessee would have to amortize the right-of-use asset and in addition recognize the unwinding of the discount on the lease liability as interest expense. In other words, the lessee would recognize front-loaded expenses.
  - For property leases (referred to as Type B leases in the proposed ASU), the lessee would recognize a single lease expense on a straight-line basis, representing both the unwinding of the discount on the lease liability and the amortization of the right-of-use asset.

OBSERVATION: For lessees, the classification of leases between Type A and Type B does not affect the recognition or initial measurement of the lease. It does, however, make a difference in the subsequent measurement of the contract and the pattern of expenses in the income statement. For lessees, the new model for Type A leases will lead to an income statement that shows front-loaded expenses, which is similar to the current model for capital leases. The new model for Type B leases will lead to an income statement that recognizes the lease costs on a straight-line basis, as does the current model for operating leases.

CLASSIFICATION OF A LEASE

TYPE A LEASES

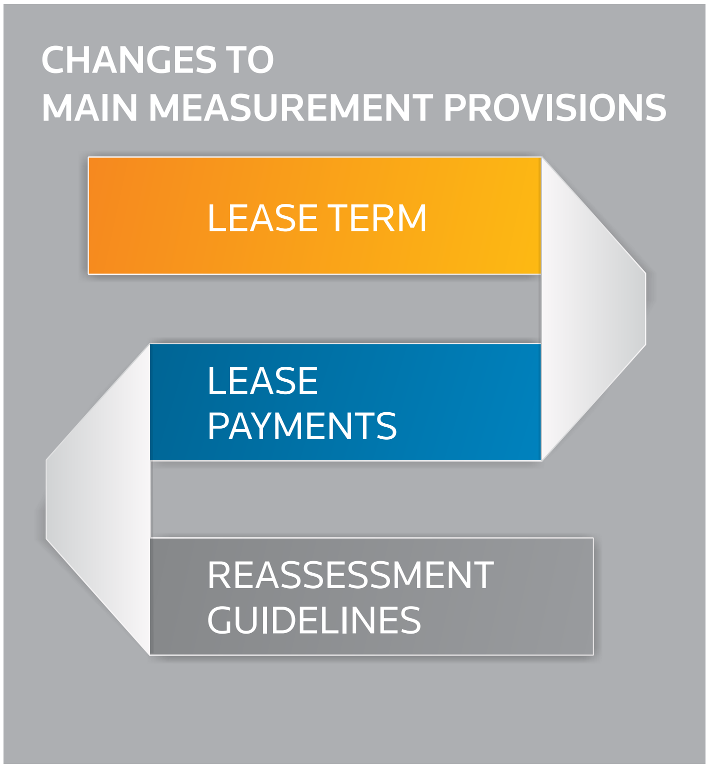
LEASES OF ASSETS OTHER THAN PROPERTY

Unless the lease term represents a small portion of the total economic life of the leased asset or the present value of the lease payments is insignificant as compared to the fair value of the leased asset.

TYPE B LEASES

LEASES OF PROPERTY

Unless the lease term is for a major part of the remaining economic life of the leased asset or the present value of the lease payments substantially equals the fair value of the leased asset.



Proposed new accounting model for lessors

The proposed accounting for lessors also depends on the extent to which the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the leased asset:

- For most leases of assets other than property (referred to as Type A leases in the proposed ASU), the lessor would have to derecognize the leased asset and recognize a lease receivable for the right to receive lease payments from the lessee and a residual asset corresponding to the residual rights that the lessor maintains on the leased asset. The lessor would recognize interest income using the effective interest rate method as the discount on both the lease receivable and the residual asset unwinds. Any profit related to the lease would be booked upfront at inception. Both the lease receivable and the residual asset are subject to impairment tests.

- For property leases (referred to as Type B leases in the proposed ASU), the lessor would keep the leased asset on its balance sheet and would recognize lease income on a straight-line basis over the lease term.

OBSERVATION: The classification of leases between Type A and Type B affects lessors more than lessees, as it also dictates the recognition requirements a lessor has to follow.

Short-term leases

For leases with a maximum term of 12 months or less, the proposed ASU offers the option to exclude them from the model described above. Lessors and lessees could elect to apply simplified requirements very similar to the current guidance for operating leases.

OBSERVATION: Although not clearly stated in the proposed ASU, it seems that short-term leases including an option to renew would not be eligible for this exemption.

Main measurement provisions in the proposed ASU on leases

Proposed ASU No. 2013-270 provides new provisions to initially and subsequently measure the elements of a lease transaction. The key changes involve the following measurement issues:

- Definition of the lease term to use in calculations;
- Identification of items to include in the lease payments; and
- Establishment of reassessment guidelines.

Lease term

In the proposed ASU, the lease term is defined as the noncancellable period during which the lessee has the right to use the leased asset. It must also include:

- Any period covered by an option to extend the lease provided that the lessee has a significant economic incentive to exercise the option; and

- Any period covered by an option to terminate the lease provided that the lessee has a significant economic incentive not to exercise the option.

All available factors (contractual, attached to the asset, to the entity, to the market, such as industry practice or bargain renewal options) must be considered when evaluating whether the lessee has a significant economic incentive to exercise or not to exercise an option.

The lease term is determined at inception and is revisited only in limited circumstances.

OBSERVATION: This represents a change from the initial proposed ASU, whereby lessees and lessors would have been required to estimate the longest possible lease term that was deemed more likely than not considering all extension or termination options. Renewal options would now be excluded from the analysis unless the lessee has a significant economic incentive to exercise the option.

Lease payments

Lease payments are used to measure the right-of-use asset and lease obligation (or, for a lessor, lease receivable and residual asset). According to the proposed ASU, lease payments would include:

a. All fixed payments, reduced by lease incentives granted by the lessor, if any;

b. Variable lease payments, but only if they are linked to an index or a rate. All other variable lease payments (such as those based on the performance of the lessee) would be excluded from the lease payment calculation;

c. Variable lease payments that are in-substance fixed payments (as further described in the proposed implementation guidance);

d. Expected payments due by the lessee because of a residual value guarantee;

e. The payment expected to be due under a purchase option if the lessee has a significant economic incentive to exercise the option; and

f. The payment expected to be due as a penalty to terminate the lease if the lessee has a significant economic incentive to do so (and this is consistent with the lease term).

The variable payments linked to an index or a rate would be measured using the spot rate at the balance sheet date and presumed flat for the entire lease term. In other words, the reporting entity does not have to project what an index or rate may do in the future). These payments are remeasured each period using the new spot rate at the date of the remeasurement (but always assuming the same payment for the remaining lease term).

OBSERVATION: The exclusion from variable lease payments not linked to an index or a rate represents a simplification from the initial ASU. The measurement guidance is still a significant change from current practice.

Reassessment guidelines

Lease payments would have to be reassessed if:

- There is a change in the lease term;
- The lessee no longer has a significant economic incentive to exercise a renewal option or not to exercise a termination option;
- The amounts expected to be due under a residual value guarantee change; or
- Variable lease payments linked to an index or a rate change during a reporting period.

The discount rate to use is the rate a lessor charges the lessee. If that rate is not available to the lessee, the lessee would use its incremental borrowing rate. It would have to be reassessed in the following circumstances (assuming that these were not anticipated when the discount rate was initially set):

- The lease term changes;
- The lessee no longer has a significant economic incentive to exercise a renewal option or not to exercise a termination option; or
- A reference interest rate changes (if variable lease payments are based on that rate).

Presentation and disclosure provisions of the proposed new guidance on leases

Proposed ASU No. 2013-270 would make changes to both the presentation and the disclosure provisions for leases.

Presentation

A general proposition of the new guidance is that it would require that lease-related financial statement items be presented as separate line items (i.e., separately from non-lease items) on the face of the financial statements or in the footnotes in all cases.

Additional notable proposed guidance for lessees is as follows:

- Lessees must consider their right-of-use asset as a nonfinancial asset. A right-of-use asset must be presented separately from other assets on the face of the balance sheet, or must be separately disclosed in the notes to the financial statements. If it is not distinct on the balance sheet, it must be included in the same line item where the leased asset would be presented if it were owned. Right-of-use assets must also be distinguished by lease type (Type A or Type B).
- Lessees must present the following on their statement of other comprehensive income:
  - For Type A leases, the unwinding of the discount on the lease liability independently from the amortization of the right-of-use asset;
  - For Type B leases, the unwinding of the discount on the lease liability and the amortization of the right-of-use asset together on one line item.
- Lessees must present the cash payments for leases on their statement of cash flows as follows:
  - For Type A leases, repayments of the principal portion of the lease liability as cash flows from financing activities and the interest portion as directed by Topic 230, Statement of Cash Flows.
  - For Type B leases, all lease payments are classified as cash flows from operating activities.
  - Payments not included in the lease liability, such as certain variable lease payments and payments on short-term leases, are classified as cash flows from operating activities.

Additional guidance for lessors includes the following:

- Lessors must present their total leased assets (lease receivables plus residual assets) from Type A leases separately on their balance sheet. For Type B leases, the leased asset is presented as it would if it were not leased.
- Income from leases must be clearly presented either in the statement of comprehensive income or in the notes. Day 1 gains on leases must be presented in a manner consistent with the lessor's business model.
- Lessors must present the cash receipts from lease payments as cash flows from operating activities.

Disclosure

The proposed ASU includes disclosure designed to describe how leasing activities might affect the amount, timing, and uncertainty of the future cash flows of the reporting entity. These disclosures include:

- An overall description of the nature of the lease arrangements, including details such as determination of variable lease payments, existence of options to extend or terminate the lease (or purchase the leased asset), residual value guarantees, constraints on dividends or additional debt, and initial direct costs incurred;
- Details concerning the main terms of leases that have not begun if they create significant rights and obligations for the reporting entity;
- Key assumptions and judgments used (e.g., regarding whether the contract contains a lease, whether a contract must be split between lease and non-lease components, the interest rate used to calculate the present value of the lease payments, and, for lessors, the initial measurement of the residual asset);
- Reconciliations of the opening and closing balances of a number of lease items on the balance sheet;
- Variable lease payments not linked to an index or a rate;
- Maturity analyses of a number of lease-related items;
- Related-party information; and
- For lessors, a table with lease income recognized in the reporting period and a description of its risk management for residual assets.

Sale and leaseback transactions

Proposed ASU No. 2013-270 would introduce a new Subtopic discussing sale and leaseback transactions.

In order to determine whether a transaction is a sale, the proposed ASU refers to the requirements of Proposed Accounting Standards Update (ASU) No. 2011-250, Revenue Recognition (Topic 605): Revenue from Contracts with Customers—Proposed Amendments to the FASB Accounting Standards Codification.

If the transaction were deemed to be a sale and the asset were derecognized, it would be replaced on the balance sheet by a right-of-use asset a lease liability. Any gains or losses on the transaction would be recognized on the day of the transaction.

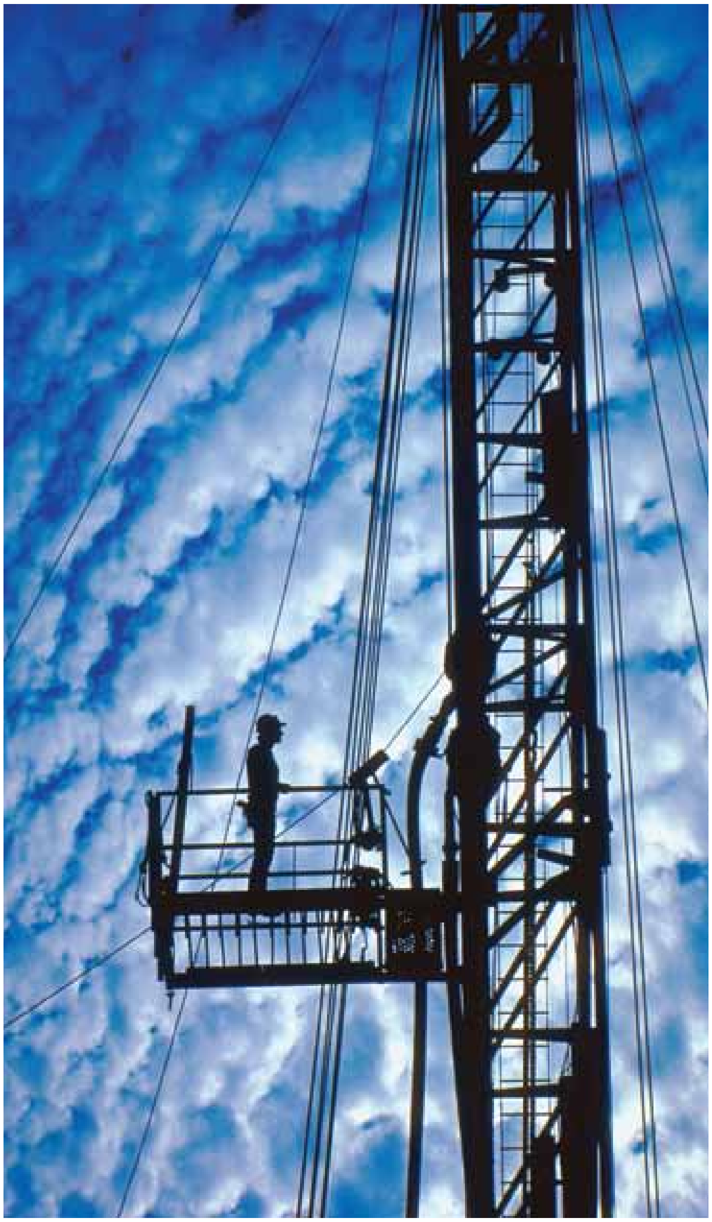
If the transaction were not a sale, then the transferred asset is not derecognized and the transferor and the transferee would recognize a financial liability and a receivable, respectively.

OBSERVATION: This represents a significant change from the current accounting model. Because most leaseback transactions are operating leases, they are often not recognized on the balance sheet of the seller-lessee. In addition, gains on the sale of the asset are currently deferred and amortized over the lease term.

Transition provisions and next steps

The proposed ASU does not include an effective date. It does, however, include proposed transition provisions. The transitional guidance in the proposed ASU would require lessors and lessees to recognize and measure all leases using the new guidance at the beginning of the earliest period presented, either under a full retrospective approach or a modified retrospective approach. Proposed ASU No. 2013-270 does not include grandfathering provisions.

The comment period on Proposed ASU No. 2013-270 ends on September 13, 2013. The FASB has planned substantive outreach activities from May to October 2013, before starting redeliberating in the fourth quarter of 2013. Lessors and lessees are encouraged to participate in the process, as a number of items in the proposed ASU are still debated, as indicated by the close vote on the proposed document.



LEASE ACCOUNTING STANDARDS GUIDANCE AND TRAINING

We're happy to provide comprehensive tools and learning opportunities to help you navigate the complex maze of new regulations and processes.

ACCOUNTING & AUDITING UPDATE SERVICE

This unique service provides you with straightforward analysis and interpretation of new FASB and AICPA pronouncements as they are issued, and includes a detailed technical bulletin on how Proposed Accounting Standards Update (ASU) No. 2013-270, Leases (Topic 840), will dramatically change the way in which both lessees and lessors account for leases.

GAAP REPORTER WITH FASB CODIFICATION

GAAP Reporter is a powerful research resource that makes the FASB Codification easier to understand by providing a concise summary of the key elements of each section of the Codification, and providing professional insights, expertise, and illustrations on how to apply the standards in practice. GAAP Reporter also features timesaving workflow tools and practice aids such as checklists, client letters, and memoranda. It is authored by a full-time staff of experts at the Tax & Accounting business of Thomson Reuters, ensuring that GAAP Reporter is updated in a timely manner.

PPC'S GUIDE TO REAL ESTATE

This Guide thoroughly addresses both the accounting and tax aspects of acquiring, developing, building, leasing, and selling real estate. Accounting topics include revenue recognition, cost allocation, asset impairment,leasing arrangements, joint ventures, and variable interest entities. Practical tax guidance is provided on depreciation, leases, long-term contracts, and more.

Price (single user):$285 / 3 volumes print
(Also available on Checkpoint, call for pricing)

PPC'S PRACTICE AIDS FOR REAL ESTATE

PPC's Practice Aids™ are the perfect companion to your PPC Guides. They are Microsoft® Word and Excel® versions of all of the editable practice aids in the related PPC Guide, and they contain extensive practical considerations and tips to help you conduct your engagements effectively and efficiently.

Price (single user): $145 for current guide owners (single user).
(call for multi-user pricing)

Visit yourcheckpoint.thomsonreuters.com/leaseaccounting to learn more, place an order, or call 800.431.9025

RELATED CPE

Proposed Changes In Accounting For Leases & Other Significant Proposals

Webinar | 2 CPE | $89
June 13 (2:00-4:00 PM CST)

With a focus on the proposed lease accounting rules, this webinar is designed to help you understand the significant current and upcoming exposure drafts from the FASB. This webinar will address the key provisions of current exposure drafts, what we know about planned changes and re-exposure, and a status update on where the leases and other projects are going. This webinar is appropriate for both accountants and auditors who need to understand the impact of changes in lease accounting and other topics.

Accounting for Leases

Online Course | 9 CPE
$126 or FREE for Premier Subscribers*

Leveraged leases, real estate leases, lease classification. No matter what area of lease accounting you are involved with, this course offers expert guidance and instruction. A special section includes detailed presentation of accounting and reporting by lessees and lessors.

* The Checkpoint Learning Premier CPE Package is an annual subscription offering unlimited access to all online courses, to all 1-4 hour webinars, plus CPE tracking and compliance as well as deep discounts on live Gear Up and AuditWatch events. For pricing and details, please visit cl.thomsonreuters.com or call 800.231.1860.

CHECKPOINT LEARNING
cl.thomsonreuters.com
800.231.1860

CONTACT US

Find your local representative on our website at http://ria.thomsonreuters.com/replocator

About Thomson Reuters

Thomson Reuters is the world's leading source of intelligent information for businesses and professionals. We combine industry expertise with innovative technology to deliver critical information to leading decision makers in the financial and risk, legal, tax and accounting, intellectual property and science and media markets, powered by the world's most trusted news organization. With headquarters in New York and major operations in London and Eagan, Minnesota, Thomson Reuters employs approximately 60,000 people and operates in over 100 countries. For more information, go to www.ThomsonReuters.com.

About Thomson Reuters Checkpoint

Thomson Reuters Checkpoint is the industry-leader for online information for tax and accounting professionals.

Checkpoint blends cutting-edge technology, editorial insight, timesaving productivity tools, online learning, and news updates with intelligent linking to related content and software. Thousands of tax and accounting professionals rely on Checkpoint every day to understand complex information, make informed decisions and use knowledge more efficiently.

94 of the Top 100 U.S. Law Firms, 95 of the Fortune 100 and all of the Top 100 U.S. CPA Firms rely on Checkpoint.

THOMSON REUTERS™