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To the Point

FASB — proposed guidance

Boards make more progress on leases project

A final leases standard is not likely before 2015.

What you need to know

- The FASB and the IASB continued discussing ways to clarify and simplify the joint proposal they issued last year to put most leases on the balance sheets of lessees.
- After disagreeing on key elements of the proposal last month, the Boards reached joint decisions on lease modifications, combining certain contracts, in-substance fixed lease payments and the discount rate that would be used to measure lease assets and liabilities.
- The Boards also agreed on how to include index- and rate-based variable lease payments in the initial measurement of lease assets and liabilities but reached different decisions on how such payments would be considered in subsequent measurement of right-of-use assets and lease liabilities.
- The Boards will redeliberate scope and the definition of a lease at their May meeting.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) continued discussing how to clarify and simplify their 2013 proposal[1] to put most leases on lessees' balance sheets because constituents said it would be too complex and costly to apply.

At their last joint meeting in March, the Boards disagreed on fundamental issues such as whether to require a single or dual accounting model for lessees, lessor accounting for selling profit in Type A leases, and a recognition and measurement scope exception for leases of "small-ticket" assets.[2] By reaching a number of converged decisions at this week's joint

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meeting, the Boards signaled that they are continuing to seek ways to minimize any differences between US GAAP and IFRS. What's not yet clear is when or whether the Boards will revisit their fundamental differences on the lessee and lessor accounting models. The latest decisions, like all decisions to date, are tentative.

Key decisions

Lease modifications

The Boards decided that a lease modification would be defined as "any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease."

The Boards decided that lessees and lessors would account for a lease modification as a separate new lease when both of the following conditions are met:

- The modification grants the lessee an additional right-of-use (e.g., an additional underlying asset, the same underlying asset for an additional period of time not contemplated by a renewal option) not included in the original lease.
- The additional right-of-use is priced commensurate with its standalone price.

This type of modification would result in an entity accounting for two separate leases: the unmodified original lease and the new lease.

For a lease modification that does not result in a separate new lease, lessees would generally remeasure the existing lease liability and right-of-use asset without affecting profit or loss. However, for a modification that decreases the scope of a lease (e.g., reducing the square footage of leased space, shortening a lease term), lessees would remeasure the lease liability and recognize a proportionate reduction (e.g., the proportion of the change in the lease liability to the pre-modification lease liability) to the right-of-use asset. Any difference between those adjustments would be recognized in profit or loss.

For lessors, the Boards decided a modification that is not a separate new lease would be accounted for as follows:

- A modification to a Type B lease (generally an operating lease today) would be, in effect, a new lease, the lease payments for which would be equal to the remaining lease payments of the modified lease, adjusted for any prepaid or accrued rent from the original lease.
- A modification to a Type A lease (generally a sales-type or direct financing lease today) would be accounted for in accordance with IFRS 9[3] or ASC 310.[4]

> **How we see it**
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> The Boards' decisions on lease modifications are responsive to comments received from stakeholders, including seeking clarity on what constitutes a lease modification.

Contract combinations

The Boards decided that two or more contracts entered into at or near the same time with the same counterparty (or related party) would be considered a single transaction if either of the following is met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

This decision is intended to address the Boards' concerns that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction. For IFRS reporting entities, SIC 27[5] would be removed upon transition to a final standard.

Index- and rate-based variable lease payments

Consistent with their 2013 proposal, the Boards decided the initial measurement of lease assets and lease liabilities would include index- and rate-based variable lease payments, using the index or rate existing at lease commencement. That is, entities would initially measure lease assets and lease liabilities by assuming no increases or decreases to future lease payments throughout the lease term. In an attempt to further reduce the complexity and costs of application, the Boards also addressed the reassessment of such lease payments but reached different decisions. The FASB decided that lessees would reassess index- and rate-based variable lease payments only when the lease liability is reassessed for other reasons (e.g., a change in the lease term). The IASB decided that lessees would also reassess index- and rate-based variable lease payments (and thus remeasure the lease liability) upon a contractual change in the cash flows (e.g., when a lessee's payments escalate based on the terms of the original lease). Consequently, under the FASB's approach, lessees would recognize changes to index- or rate-based variable lease payments in profit or loss in the period of the change (i.e., similar to other variable lease payments).

The decisions on index- and rate-based variable lease payments would create another difference between US GAAP and IFRS.

Consistent with the Boards' March 2014 tentative decision that lessors would not reassess the lease term, the Boards decided that lessors would not be required to reassess variable lease payments that depend on an index or rate.

In-substance fixed payments

The Boards agreed that variable lease payments that are in-substance fixed payments would be included in the definition of lease payments and thus used to measure entities' lease assets and lease liabilities. They also decided to note in the Basis for Conclusions in a final standard that this decision is expected to align with existing practice. However, the Boards decided not to include any illustrative examples of such in-substance fixed payments in a final standard.

Discount rate

The Boards also reached a number of decisions about the discount rate that would be used to measure lease assets and liabilities.

The 2013 proposal would have required a lessor to use the rate it charges the lessee to discount lease assets. A lessee would have discounted lease liabilities using the rate the lessor charges the lessee when that rate is readily determinable. When that rate is not readily determinable, the proposal would have required a lessee to use its incremental borrowing rate.

The Boards decided that the rate the lessor charges the lessee would be defined as "the rate implicit in the lease." This is similar to the current definition in IFRS[6] and US GAAP.[7] The lessor's initial direct costs would be included in the lease receivable for Type A leases. Importantly, both lessees and lessors would use the revised definition of the "rate implicit in the lease" when accounting for leases. Lessees would still be permitted to use their incremental borrowing rate when the rate implicit in the lease is not readily determinable.

How we see it

For US GAAP lessors, the Boards' decision to define the discount rate as the "rate implicit in the lease" would result in two key changes in practice. The calculation of the rate implicit in the lease using the revised definition would include the lessor's initial direct costs and exclude investment tax credits that the lessor retains and expects to realize.

The Boards also decided on clarifications and additions to the implementation guidance for the lessee's incremental borrowing rate. The Boards asked the staff to conduct additional research into the factors lessees may consider when determining the incremental borrowing rate.

The Boards decided that lessees would reassess the discount rate only upon a lease modification, a change to the lease term or a change to the assessment of whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset. Lessors would not reassess the discount rate.

What's next

In May 2014, the Boards plan to redeliberate the definition of a lease, separating lease and non-lease components, initial direct costs and lease incentives. They are expected to address residual value guarantees, subleases and sale-leaseback accounting at their June meeting. Before issuing a final standard, the Boards will also re-deliberate other topics, including the presentation of leases in financial statements, disclosures and transition. The FASB will separately discuss leveraged leases and private company and not-for-profit issues (e.g., use of a risk-free discount rate as a policy election). In a recent meeting with stakeholders, the FASB staff indicated that a final standard will likely not be released until 2015.[8]

Endnotes:

1. See the Proposed Accounting Standards Update (revised), *Leases (Topic 842)*, on the FASB's website.
2. See our To the Point, *Boards back away from some key aspects of leases proposal* (BB2718).
3. International Financial Reporting Standard (IFRS) 9, *Financial Instruments*.
4. Accounting Standards Codification (ASC) 310, *Receivables*.
5. Standing Interpretations Committee (SIC) Interpretation 27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*, provides guidance for combining two or more transactions involving a lease when the overall economic effects cannot be understood without considering the series of transactions as a whole.
6. International Accounting Standard (IAS) 17, *Leases*.
7. ASC 840, *Leases*.
8. Center for Audit Quality, *Daily Media Briefing* (18 April 2014).

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