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Defining Issues®

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Contents

FASB and IASB Take Divergent Paths on Key Aspects of Lease Accounting

At their March 18-19 meeting to redeliberate the proposals in their 2013 exposure drafts (EDs) on lease accounting, the FASB and the IASB (Boards) could not agree on how lessees and lessors should depict their leasing activities for financial reporting purposes.[1] Because the Boards' redeliberations are not yet complete, their decisions from the meeting could change before a final standard is issued. However, the members of both Boards appeared entrenched in their views.

Key Facts

The Boards made dramatically different decisions about key aspects of their leases project.

Lessee Accounting

- The FASB decided to retain the EDs' proposed dual model for lessee accounting, but to change the lease classification test for all types of underlying assets to be similar to the existing requirements of IAS 17, which are similar to the classification requirements in existing U.S. GAAP but without explicit bright lines.[2] Under U.S. GAAP, most leases would qualify for the EDs' proposed Type B lessee model (which is described in the section on *Lessee Accounting*) with generally straight-line recognition of total non-contingent lease expense as a result.
- The IASB rejected the EDs' proposed dual model approach in favor of a single lessee accounting model based on the EDs' Type A lessee model (which is described in the section on *Lessee Accounting*). As a result, under IFRS, leases would only qualify for straight-line recognition of total non-contingent lease expense if they are eligible for one of the targeted reliefs such as the exceptions for short-term and small-ticket leases.

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[1] FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org. For more information about the Boards' 2013 proposals, see KPMG's Defining Issues No. 13-24, FASB and IASB Issue Revised Exposure Drafts on Lease Accounting, and Issues In-Depth No. 13-3, Implications of the Revised FASB and IASB Exposure Drafts on Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network.

[2] IAS 17, Leases.

Lessor Accounting

- The IASB decided to retain a version of the existing IAS 17 lease classification requirements for lessors for all types of underlying assets, rather than the EDs' proposed lessor lease classification guidance. Under IFRS, most leases would qualify for the EDs' proposed Type B lessor accounting with generally straight-line recognition of total non-contingent lease income as a result, similar to current operating lease accounting.
- The FASB decided to replace the EDs' proposed lessor lease classification guidance for all types of underlying assets with a classification test similar to that in IAS 17 (which is similar to the classification requirements in existing U.S. GAAP but without explicit bright lines), with one important twist. Under U.S. GAAP, recognition of selling profit at lease commencement would be precluded for any lease that meets the criteria for finance lease classification only as a result of involvement by a third party other than the lessee (e.g., a third-party residual value guarantor). The FASB believes this will substantially align the requirements for recognition of up-front profit in a lease with the requirements in the Boards' forthcoming revenue recognition standard.[3]
- Both Boards decided to replace the EDs' proposed Type A lessor receivable and residual accounting model (which is described in the section on *Lessor Accounting*) with the IAS 17 finance lease accounting model.

Targeted Reliefs

- The IASB decided to provide an explicit recognition and measurement exemption for leases of small-ticket items (e.g., office furniture, personal computers, etc.) but the FASB decided not to.
- The Boards agreed that leases could be accounted for on a portfolio basis in limited circumstances.
- The Boards agreed to expand the EDs' proposed short-term lease exemption to leases with a maximum lease term of 12 months for accounting purposes rather than a maximum contractual term of 12 months. This would allow some leases with renewal options to qualify for the short-term lease exemption.

Key Impacts

- Lessees applying IFRS will account for all property leases as Type A leases, which is significantly different than the accounting the EDs proposed.
- Most equipment leases will be accounted for as Type B leases under U.S. GAAP, which is significantly different than the accounting the EDs proposed.
- The decisions on lessee accounting in particular result in non-convergence for a critical aspect of this project.
- Lessor accounting will be similar to current practice in response to feedback from financial statement users indicating that current lessor accounting generally is useful without significant change.

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[3] FASB Proposed Accounting Standards Update, Revenue from Contracts with Customers, November 14, 2011, available at www.fasb.org, and IASB ED/2011/6, Revenue from Contracts with Customers, November 2011, available at www.iasb.org.

- Lessors applying U.S. GAAP will be prohibited from recognizing selling profit at lease commencement in some cases, even if the fair value of the underlying asset exceeds its carrying amount and the criteria for finance lease classification are met at lease commencement.

Background

Since issuing the EDs, the Boards have received over 600 comment letters and have held subsequent outreach meetings to listen to the concerns of investors, analysts, regulators, and preparers. At their November 2013 meeting the Boards discussed plans for future redeliberations that focused on the following significant issues:

- The lessee model, lessor model, lease classification, and scope simplifications;
- Measurement, specifically the lease term, reassessment of variable lease payments, in-substance fixed payments, residual value guarantees, and discount rate;
- Scope, specifically the definition of a lease, separating lease and non-lease components, and scope exclusions;
- Sale and lease-back transactions;
- Presentation and disclosure; and
- Transition.

At the January 2014 meeting, the Boards were presented with alternative ways forward for:

- Lessee accounting;
- Lessor accounting, including lease classification and the lessor accounting model; and
- Small-ticket leases.

At the March 2014 meeting, the Boards made significant decisions on each of these issues. In addition, the Boards considered alternative ways forward for:

- Lease term; and
- Renewal and purchase option reassessments.

This edition of *Defining Issues* provides a summary of the Boards' decisions, including examples of their potential impacts.

Lessee Accounting

The discussions took as a given that leases should be on-balance sheet for lessees. The focus was on whether to retain a dual model for lessee accounting and, if so, the lease classification test.

The EDs proposed a dual model approach for lessee accounting, under which a lessee would classify each lease as either Type A or Type B. The proposed lease classification test was based on the nature of the underlying asset and the extent to which it was consumed during the lease term. Broadly, most leases in which the underlying asset was not property – i.e., not land or a building – would be classified as Type A; most property leases would be classified as Type B.

For all leases other than short-term leases, a lessee would recognize a right-of-use (ROU) asset for its right to use the underlying asset during the lease term and a lease liability for its obligation to make lease payments based on the present value of the lease payments. Subsequently, the lessee would measure the lease liability at amortized cost. However, subsequent accounting for the ROU asset and presentation of lease expense would depend on whether the lease was classified as Type A or Type B.

- For Type A leases, the lessee would measure the ROU asset at amortized cost and would typically amortize the ROU asset on a straight-line basis. The lessee would recognize amortization of the ROU asset and interest expense on the lease liability separately in profit or loss. Overall, the lessee would typically recognize a front-loaded pattern of total non-contingent lease expense.
- For Type B leases, the lessee would recognize total non-contingent lease expense generally on a straight-line basis over the lease term, and present this as a single expense in profit or loss. To achieve this accounting outcome, the lessee would plug the measurement of the ROU asset.

There was no consensus among constituents on the proposed dual model for lessees. Many favored the Type B lease accounting model because they believed that the straight-line profile of lease expense better reflected the economics of some leases – especially property leases. Some supporters of the Type B model wished to apply it to a wider range of leases. Other constituents questioned whether there was any conceptual basis for the Type B model. Many also raised concerns about the costs and complexity of the new proposed classification tests, noting that new accounting systems would be required and that applying the tests would require increased management judgment.

At the March 2014 meeting, the Boards discussed alternative approaches to lessee accounting and ultimately decided not to converge U.S. GAAP and IFRS. The IASB opted for a single model based on the EDs' proposed Type A model, in which lessees would recognize amortization of the ROU asset separately from interest on the lease liability.

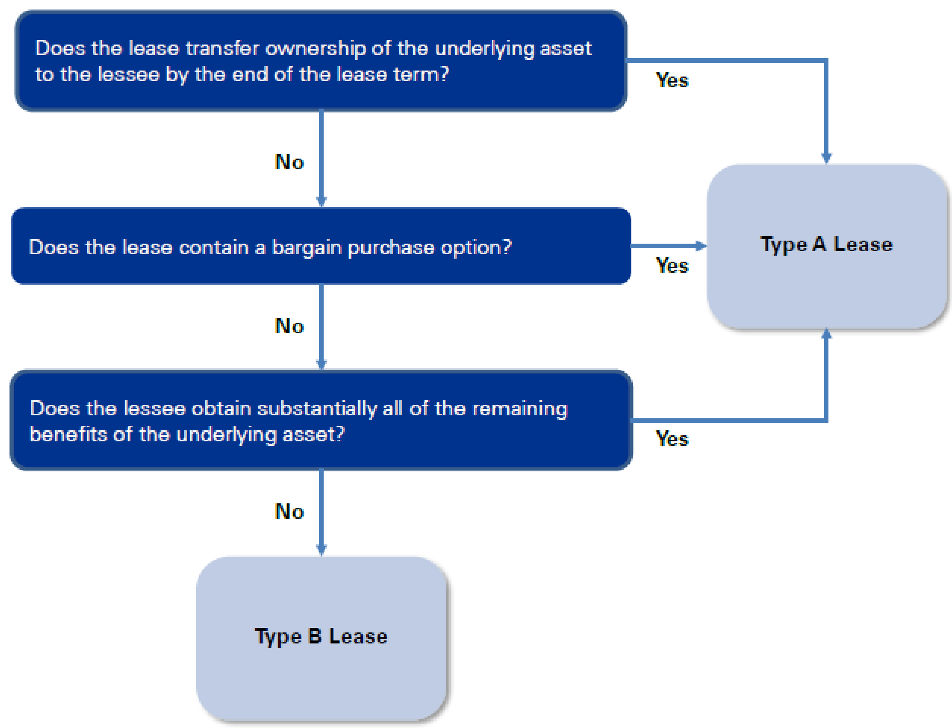
The FASB decided to retain the EDs' proposed dual model. However, the FASB decided to replace the EDs' proposed lease classification approach for all types of underlying assets with a classification test similar to that in IAS 17, which is similar to the classification requirements in existing U.S. GAAP but without explicit bright lines. Specifically, leases would be classified as Type B unless any of the following conditions are met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lessee has a purchase option that is reasonably certain to be exercised based on consideration of economic factors (i.e., a bargain purchase option);
- The lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease.

Factors that may indicate the lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease include:

- A lease term that is for a major part of the remaining economic life of the underlying asset;
- Lease payments with a present value that is substantially all of the fair value of the underlying asset;
- An underlying asset of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

If it is clear that notwithstanding these indicators the lessee would not obtain substantially all of the remaining benefits of the underlying asset as a result of the lease (e.g., because the fair value of the asset is expected to appreciate over the lease term) this criterion would not be met.



Leases that include a land element would require separate classification of the land element unless it is clearly immaterial. Leases not classified as Type B leases would be classified as Type A leases. This approach is similar to determining whether a lease is effectively an installment purchase by the lessee. Under this approach, a lessee applying U.S. GAAP would account for the vast majority of existing capital leases as Type A leases, and the vast majority of existing operating leases as Type B leases.

KPMG Observations

Under both U.S. GAAP and IFRS, the core results of the lessee ROU model – i.e. recognizing all leases on-balance sheet – will represent a consistent change from today's lease accounting. However, the Boards' differing approaches will cause significant differences in the measurement and presentation of lease expense, with consequential impacts on the balance sheet.

The Boards' divergence on fundamental aspects of lessee accounting is unfortunate after nearly 8 years of joint effort on the project. There are no jurisdictional differences in leasing transactions that the Boards have identified to justify differences in lessee accounting. The Boards' staff asserted that for organizations with large revolving portfolios of leases with differing terms, the results of applying the different lessee accounting models may be substantially the same, other than the presentation in the income statement. However, in light of the divergent decisions by the FASB and IASB, it appears that for financial statement users, performing comparisons of companies with significant leasing activities may become a rather messy exercise that is more difficult than it is under current accounting requirements if some of the companies apply U.S. GAAP and others apply IFRS.

The FASB approach would preserve the EDs' proposed straight-line recognition of total lease expense for Type B leases, and expand it to a wider population of leases because classification would not be based on the nature of the underlying asset as proposed in the EDs. Instead, the classification test would be similar to the existing IAS 17 classification tests, which are similar to the classification requirements in existing U.S. GAAP, but without explicit bright lines. This is likely to increase the level of judgment involved in evaluating lease classification as compared to current U.S. GAAP.

The IASB approach would not require the lease classification judgments that would be required under the FASB approach and therefore may be less susceptible to error. However, the IASB approach will not allow for the Type B straight-line recognition of total lease expense that many constituents asserted better reflects the economics of certain leases, notably many real estate leases. IASB members provided an example to FASB members similar to Example 1 in the Appendix illustrating the basis for their view that Type B lease accounting may not faithfully depict the economic result of a leasing transaction, depending on the timing of the rent payments in the lease contract.

Lessor Accounting

Classification Tests. The Boards discussed lease classification and lease accounting by lessors, including whether to retain key aspects of current accounting practice.

The EDs proposed that lessors would apply the same classification requirements as lessees, which would be based on the nature of the underlying asset and the extent to which the asset is consumed over the lease term. For Type A leases, the EDs proposed that the lessor would apply a new, complex model under which it would derecognize the underlying asset and recognize a lease receivable and a residual asset. For Type B leases, the lessor would account for the lease similar to operating lease accounting under current U.S. GAAP or IFRS.[4]

Most constituents, including financial statement users, indicated that they do not consider symmetry between lessee and lessor accounting to be a high priority. Some constituents felt that lessors should classify more leases as Type B – e.g., leases of ships and heavy equipment that would be classified as Type A under the proposals. In general, most users did not support the proposals, as they believed that lessor accounting works well in practice and do not adjust financial statement results for current lessor accounting requirements.

At the March 2014 meeting, the IASB decided on a dual model approach that would determine lessor lease classification (Type A versus Type B) based on whether the lease is effectively a financing or a sale, rather than an operating lease (i.e., an approach that would be generally consistent with the current requirements of IAS 17). A lessor would make that determination by assessing whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset. Specifically, leases would be classified as Type B unless any of the following conditions are met:

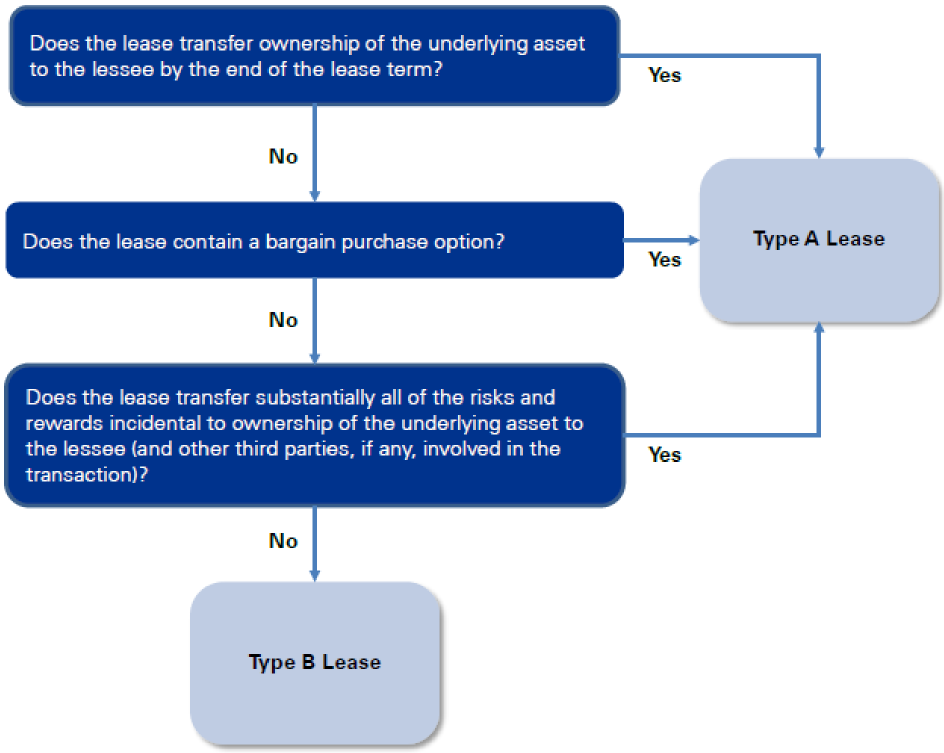
- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lessee has a purchase option that is reasonably certain to be exercised based on consideration of economic factors (i.e., a bargain purchase option);
- The lease otherwise transfers substantially all of the risks and rewards incidental to ownership of the underlying asset to the lessee (and other third parties, if any, involved in the transaction).

Factors that may indicate the lease transfers substantially all of the risks and rewards incidental to ownership of the underlying asset include:

- A lease term that is for a major part of the remaining economic life of the underlying asset;
- Lease payments and third-party residual value guarantees (if any) with a present value that is substantially all of the fair value of the underlying asset;
- An underlying asset of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term (e.g., when the lessor would incur significant economic losses to direct the asset to another use).

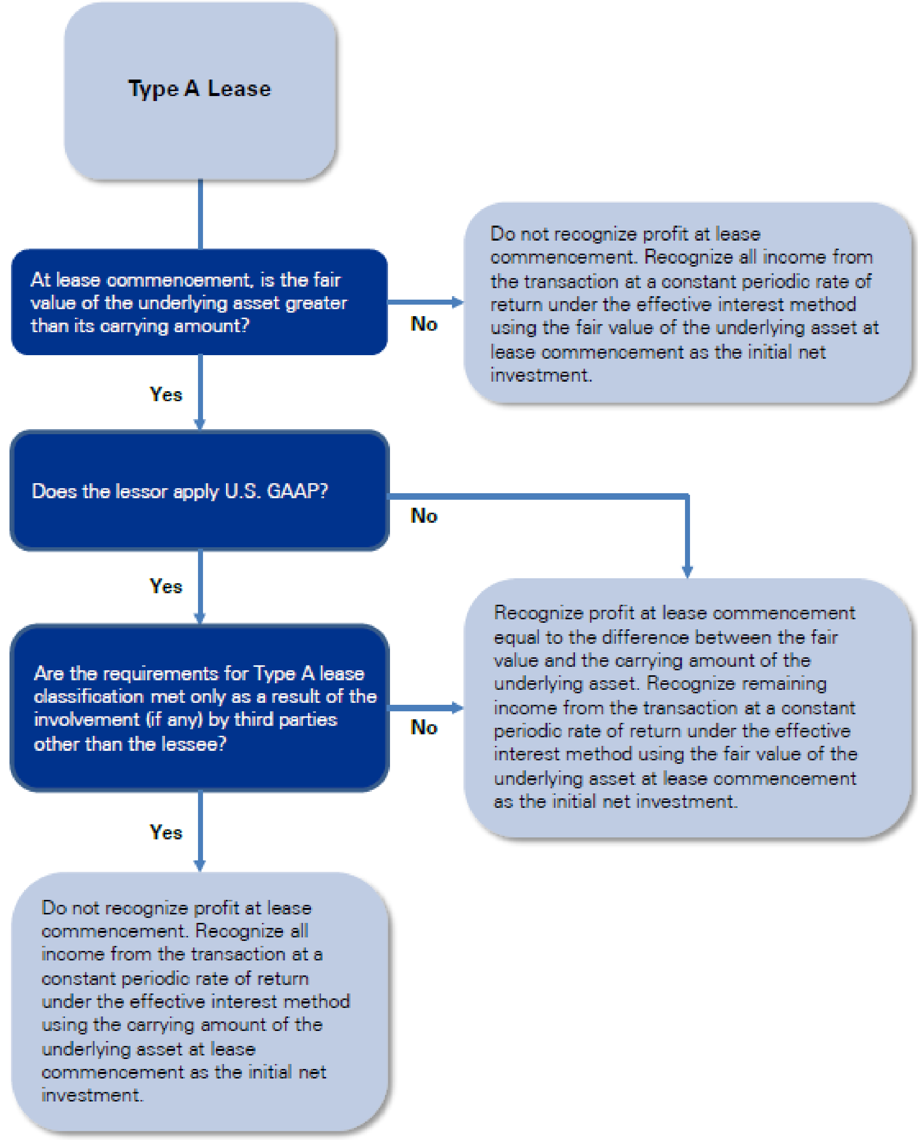
If it is clear that notwithstanding these indicators the lease does not transfer substantially all of the risks and rewards incidental to ownership of the underlying asset (e.g., because the fair value of the asset is expected to appreciate over the lease term) this criterion would not be met.

[4] FASB ASC Topic 840, Leases, available at www.fasb.org, and IAS 17, Leases.



Leases that include a land element would require separate classification of the land element unless it is clearly immaterial. Leases not classified as Type B leases would be classified as Type A leases. Under this approach, a lessor would account for the vast majority of existing finance leases as Type A leases, and the vast majority of existing operating leases as Type B leases.

The FASB decided on a similar approach, except that it decided to preclude recognition of selling profit at lease commencement for any lease that meets the criteria for Type A lease classification only as a result of involvement by a third party other than the lessee. Third-party residual value guarantees, buy-back arrangements, and similar features that result in a reduction of risk to the lessor are examples of features that would be considered for this purpose. This is intended to substantially align the requirements for recognition of up-front profit in a lease with the requirements in the Boards' forthcoming revenue recognition standard. The amount of profit that does not qualify for up-front recognition in such leases would be recognized as additional interest income using a constant effective yield over the lease term as illustrated in Example 2 in the Appendix.



KPMG Observations

The decision to base the lessor lease classification test on an approach generally consistent with the current requirements of IAS 17 will significantly reduce the cost and complexity of applying the proposals for lessors as it will limit the extent of necessary changes to systems and processes required to assess lease classification. In many cases, a lease that is currently classified as a direct financing or sales-type lease under U.S. GAAP (finance lease under IFRS) would be classified as a Type A lease, and a lease that is currently classified as an operating lease would be a Type B lease. However, as the existing classification bright lines in U.S. GAAP will be eliminated, additional judgment will be required to classify a lease and it will be important to assess whether there may be reclassifications on transition. Leveraged lease classification will be eliminated under U.S. GAAP and these leases will likely be classified as Type A leases.

The IASB decision to have a dual model for lessor accounting, but a single model for lessees will result in significant changes to the accounting by intermediate lessors – i.e., entities that lease an asset from a head lessor and lease the same asset to another party under a sublease – and to the accounting for lease-leaseback transactions. It will also increase the complexities associated with intra-group leases, especially when individual entities within a group are required to file separate financial statements and are taxed separately.

Lessor Accounting Model. The EDs proposed that lessors apply a complex new model to Type A leases. Under this model, a lessor would derecognize the underlying asset and recognize a:

- Lease receivable – representing its right to receive lease payments from the lessee; and
- Residual asset – representing its interest in the underlying asset at the end of the lease term.

Many constituents questioned whether a new lessor accounting model was necessary. Some expressed specific concerns about the cost and complexity of applying the proposed Type A model, including the:

- Judgment required to estimate the value of the residual asset and the sensitivity of income recognition to this estimate;
- Complexity involved in accounting for variable lease payments; and
- Different impairment tests for the lease receivable and the residual asset.

At the March 2014 meeting, the Boards decided to replace the EDs' proposed Type A lessor accounting model with the IAS 17 finance lease accounting model (modified for lessors applying U.S. GAAP as indicated in the discussion of lease classification). The Boards expect this will reduce cost and complexity. It also will significantly reduce the extent of change to lessor accounting generally, given the EDs' proposal for lessors to apply a model similar to IAS 17 operating lease accounting for Type B leases.

KPMG Observations

Retention of the IAS 17 lessor accounting model for Type A leases is consistent with the Boards' overall decision not to make significant changes to lessor accounting. Taken together with the Boards' decision that lessors should apply a lease classification test based on current IAS 17, and the similarity of the lessor accounting model for Type B leases to current operating lease accounting, the changes to lessor accounting will be modest. This reflects user feedback that lessor accounting under current GAAP works well in practice.

However, it would be inaccurate to characterize the project as a 'lessee-only' project. There are still various proposals that will affect lessor accounting, including the identification of a lease, sale-leaseback accounting, and disclosure requirements.

Lease Term and Purchase Options

The EDs proposed that the lease term would be the non-cancelable period of the lease, together with:

- The period(s) covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; or
- The period(s) covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

The EDs proposed that when making an assessment of whether the lessee has a significant economic incentive to either exercise an option to extend a lease, or not exercise an option to terminate a lease, an entity would consider contract-based, asset-based, entity-based, and market-based factors. The exercise price of purchase options would be included in lease payments when the lessee has a significant economic incentive to exercise the option based on the same factors that apply to the significant economic incentive for lease term options.

Many constituents noted that substantial judgment and effort would be required to apply the concept of *significant economic incentive*. Lessors were particularly concerned because they would be required to make the assessment from the perspective of the lessee. Constituents suggested that the Boards keep the "reasonably assured" or "reasonably certain" thresholds as currently used in Topic 840 and IAS 17, if the intent is the same.

At the March 2014 meeting, the Boards decided that the lease term should include optional periods when it is reasonably certain that the lessee will exercise its option to lease the asset during those periods based on consideration of the economic factors described in the EDs. The determination of whether to include purchase option exercise prices in lease payments will be evaluated using the same test. The Boards indicated that they will not use the term *significant economic incentive* as they do not intend to change the high threshold in existing U.S. GAAP and IFRS for inclusion of optional periods in the lease term and purchase option strike prices in lease payments. However, they will retain the EDs' clarifying guidance about the economic factors to be considered in evaluating the likelihood that lease term or purchase options will be exercised.

KPMG Observations

The IFRS reasonably certain threshold is applied in practice in a manner that is equivalent to the reasonably assured threshold in U.S. GAAP. Confirmation that the Boards do not intend to change the high threshold in existing GAAP for recognition of renewal and purchase options will reduce the cost and complexity for entities, including on transition. It is also likely to result in more consistent application of the threshold.

Reassessments. The EDs proposed that lessees and lessors would be required to reassess the lease term and likelihood of purchase option exercise if:

- There is a change in relevant factors that affect the assessment of whether the lessee has a significant economic incentive to exercise one or more options in the lease contract; or

- The lessee either (a) elects to exercise a renewal or termination option for which previously it was determined the lessee did not have a significant economic incentive to exercise; or (b) elects *not* to exercise a renewal or termination option for which previously it was determined the lessee had a significant economic incentive to exercise.

At the March 2014 meeting the Boards decided that lessees would be required to reassess the lease term and likelihood of purchase option exercise if there is a significant event or change in circumstances in relation to the lease as a result of actions that are taken by the lessee. Examples of such events or circumstances include:

- Construction of significant leasehold improvements;
- Making significant modifications or customizations of the underlying asset; and
- Subleasing the underlying asset for a period beyond the exercise date of a renewal option in the lease.

The Boards decided that lessors would not be required or permitted to perform reassessments of the likelihood of option exercise.

KPMG Observations

The Boards' decision to limit reassessments to lessee-controlled events will reduce the potentially significant changes in reported profits and losses which could have arisen under the EDs' reassessment proposals. The elimination of these requirements for lessors will further align the lessor proposals with current practice.

Small-Ticket Leases and Short-Term Leases

The Boards discussed a variety of options to simplify the EDs' application to small-ticket leases, ranging from revisions to the proposed exception for short-term leases, to new guidance on materiality and portfolios of leases. The staff described small-ticket leases as those that are small in value or secondary to an entity's business operations.

The EDs proposed that lessees and lessors could elect to apply a simplified approach to short-term leases (i.e., leases with a maximum contractual term, including renewal options, of 12 months or less). Any lease that contains a purchase option would not be a short-term lease. Under this simplified approach, the lessee/lessor would recognize lease payments as expense/ income in profit or loss, similar to current operating lease accounting.

Many constituents welcomed the proposed relief but noted that substantial effort would be required to identify and analyze the key terms of leases to assess whether they qualified for the simplified approach. Many also felt that the simplified approach should be available to a wider range of leases to reduce the costs of implementing the proposals. Constituents suggested a variety of ways to extend the simplified approach to more small-ticket leases. The Boards discussed alternative options for expanding the circumstances in which a lessee could apply the simplified approach to reduce the costs of implementing the proposals.

At the March 2014 meeting, the Boards:

- Agreed to expand the EDs' proposed short-term lease exemption to leases with a maximum lease term (as assessed at lease commencement) of 12 months for accounting purposes rather than a maximum contractual term of 12 months. This would allow leases with renewal options to qualify for the short-term lease exemption provided that:
  - There is not a purchase option that is reasonably certain to be exercised;
  - The minimum contractual lease term is not greater than 12 months; and
  - It is not reasonably certain, based on economic considerations, that the lessee will exercise options to extend the lease term beyond 12 months.
- Agreed that aspects of the proposals could be applied at a portfolio level when there is a reasonable expectation that portfolio-level accounting would not differ materially from applying the standard to individual leases, consistent with the guidance in the forthcoming revenue standard. The IASB decided to include application guidance to that effect in the standard, while the FASB decided to acknowledge it in the basis for conclusions.
- Agreed not to provide specific materiality guidance with respect to leasing transactions in the final standard.

The Boards also discussed whether to provide a scope exclusion for leases of assets with a small value (i.e., small-ticket items). The IASB decided to develop further a scope exception for leases of underlying assets that are individually small in value when new. The IASB indicated that this exception is intended to capture leases such as those of small IT equipment (e.g., laptops, desktops, tablets, mobile phones, individual printers, etc.) and office furniture. The exception would not be intended to capture underlying assets such as automobiles and most photocopiers. The exception would be applied without regard to the materiality – individually or in aggregate – of the leases to the reporting entity.

The FASB decided not to provide a scope exception for small-ticket leases because current guidance on materiality would permit entities to exclude from the scope of the proposed guidance any leases, including leases for small-ticket items, that would not be material to the financial statements. However, the FASB directed its staff to perform further research about the impact of small-ticket leases on reporting entities applying U.S. GAAP.

KPMG Observations

Short-Term Leases

The Boards' decision on the short-term lease exemption will expand the population of leases eligible for the exemption to include month-to-month, evergreen, and other leases for which it is not reasonably certain that the lessee will renew the lease beyond 12 months.

Aligning the definition of a short-term lease to be consistent with the guidance on lease term may increase the sensitivity of the judgment to be made in evaluating the lease term. Whereas the EDs proposed a bright-line test of a maximum contractual term of 12 months for a lease to qualify for the short-term exemption, entities will now need to analyze all relevant economic factors (e.g. contract-based, market-based, asset-based, and entity-based) to determine whether leases are eligible for the short-term exemption. As a result, the revised exemption may attract more structuring efforts.

The new disclosure requirements for short-term leases may reduce some of the benefits associated with the exemption, as entities will still be required to track such leases to compile the disclosures. In addition, due to the level of judgment required in determining the lease term for such leases, they may become subject to the same process and control requirements as all other leases, which may further reduce the benefits of applying the exemption.

The Boards did not discuss the short-term lease exemption for lessors. Many leases that qualify for the exemption for lessees would be classified as Type B leases by lessors, such that lessors would apply similar accounting whether or not they applied the exemption.

Small-Ticket Leases

It is currently unclear what factors an entity applying IFRS would consider to make the determination of whether an item is eligible for the small-ticket exemption, other than an item being "small" in nature – though the IASB does not seem inclined to provide a specific quantitative threshold. There is a risk that the relief may not be applied consistently, and that arrangements may be structured in order to take advantage of the exemption.

Some constituents may be surprised that an entity would not be required to assess whether items eligible for the exemption are material in the aggregate. This could have a significant effect on certain industries – e.g., a telemarketing firm that leases a large number of phones and low value IT equipment. In turn, this may complicate the comparison of financial statements of entities

in such industries reporting under IFRS and U.S. GAAP, given the FASB's decision not to provide the exemption.

Portfolio Approach

The decision to permit a portfolio approach aligns with the Boards' forthcoming revenue standard and may also help to reduce costs. For example, an entity may be able to use the same judgment to determine the discount rate and lease term for all similar items leased under a master lease agreement. However, judgment will be required in order to determine when a portfolio-level approach can be used. One practical question may be what level of analysis is necessary to demonstrate that there is a reasonable expectation that portfolio-level accounting would not differ materially to applying the requirements to individual lease contracts.

Appendix – Examples

Example 1: Simple Equipment Lease

This example reflects the EDs' proposals, updated for the Boards' March 2014 discussions.

Facts

- Lessee and Lessor enter into a transaction to lease an automobile for a non-cancelable 3-year lease term with no renewal options;
- The lease does not contain a purchase option or an automatic transfer of title;
- The automobile has a remaining economic life of 5 years and a fair value of $30,000 at lease commencement;
- The rate Lessor charges Lessee is 5% and can be readily determined by Lessee (if the rate Lessor charges Lessee cannot be readily determined, Lessee would use its incremental borrowing rate);
- There are no initial direct costs incurred by Lessee; and
- The lease payments have a present value of $24,000 when discounted at 5%.

Lease Classification

Under the IASB single-model approach, Lessee would not perform a lease classification test and would account for this lease as a Type A lease.

Under the FASB dual-model approach, Lessee would classify and account for this lease as a Type B lease. This is because there is no transfer of ownership at the end of the lease, there is no purchase option, the lease term is not for a major part of the remaining economic life of the underlying asset, the present value of the lease payments is not substantially all of the fair value of the underlying asset, and the underlying asset is expected to have alternative uses to Lessor at the end of the lease term.

Lessee Accounting – Type A Lease

Lessee would recognize a ROU asset and, if it has an obligation to make future lease payments (i.e., if all payments are not made at lease commencement), a lease liability. Lessee would initially measure the ROU asset at $24,000 (i.e., the present value of the lease payments discounted at 5%). Initial measurement of the lease liability would be equal to the present value of the lease payments (if any) to be made after lease commencement. Lessee would subsequently measure the lease liability (if any) at amortized cost using the effective interest method. Lessee would subsequently amortize the ROU asset each period on a straight-line basis, consistent with the amortization of other non-financial assets. As a result, the pattern of total lease expense would depend on the timing of the lease payments, consistent with the accounting for other non-financial assets that are acquired with the proceeds of debt financing.

Lessee Accounting – Type B Lease

Lessee would recognize a ROU asset and, if it has an obligation to make future lease payments (i.e., if all payments are not made at lease commencement), a lease liability. Lessee would initially measure the ROU asset at $24,000 (i.e., the present value of the lease payments discounted at 5%). Initial measurement of the lease liability would be equal to the present value of the lease payments (if any) to be made after lease commencement. Lessee would subsequently measure the lease liability (if any) at amortized cost using the effective interest method and would recognize total lease expense (including both interest and amortization of the ROU asset) on a straight-line basis in the statement of comprehensive income. Lessee would subsequently measure the amortization of the ROU asset each period as a balancing amount, which would be calculated as the greater of zero or the periodic straight-line lease expense minus interest on the lease liability for the period.

The following tables summarize the amounts arising in Lessee's statement of financial position and statement of comprehensive income under various payment scenarios based on whether the lease is accounted for as a Type A lease (IFRS) or a Type B lease (U.S. GAAP).

Scenario 1 – Lease Payments Fully Prepaid at Lease Commencement

Type A (IFRS)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$ -	$ -	$ -	$ -
1	16,000	-	8,000	-	8,000
2	8,000	-	8,000	-	8,000
3	-	-	8,000	-	8,000
	Totals		**$24,000**	**$ -**	**$24,000**

Type B (U.S. GAAP)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$ -	$ -	$ -	$ -
1	16,000	-	8,000	-	8,000
2	8,000	-	8,000	-	8,000
3	-	-	8,000	-	8,000
Totals			**$24,000**	**$ -**	**$24,000**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

In Scenario 1 the total lease expense for each period is the same under Type A and Type B accounting because the lease payments are fully prepaid.

Scenario 2 – Single Payment at End of Year 2

Type A (IFRS)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,000	25,200	8,000	1,200	9,200
2	8,000	-	8,000	1,260	9,260
3	-	-	8,000	-	8,000
Totals			**$24,000**	**$2,460**	**$26,460**

Type B (U.S. GAAP)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,380	25,200	7,620	1,200	8,820
2	8,820	-	7,560	1,260	8,820
3	-	-	8,820	-	8,820
Totals			**$24,000**	**$2,460**	**$26,460**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

Under Type B lease accounting, the ROU asset would be amortized each period by the straight-line lease expense amount minus interest on the lease liability for the period. For year 1, the amortization of the ROU asset would be calculated as $8,820 – $1,200 = $7,620. The ROU asset would then be adjusted by this amount to calculate the year 1 ROU asset closing balance ($24,000 – $7,620 = $16,380).

In Scenario 2 the periodic amortization expense is the same for Type A accounting as it is under Scenario 1. The additional cost that arises due to the timing of the payment is reported as a periodic expense related to the time value of money under Type A accounting.

Conversely, under Scenario 2, amortization expense for Type B accounting is lower in the first two years of the lease than it is under Scenario 1 and higher in the final year of the lease than it is under Scenario 1 because the total cost of the lease is allocated to the reporting periods on a straight-line basis.

Scenario 3 – Single Payment at End of Lease

Type A (IFRS)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,000	25,200	8,000	1,200	9,200
2	8,000	26,460	8,000	1,260	9,260
3	-	-	8,000	1,323	9,323
Totals			**$24,000**	**$3,783**	**$27,783**

Type B (U.S. GAAP)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$24,000	$ -	$ -	$ -
1	15,939	25,200	8,061	1,200	9,261
2	7,938	26,460	8,001	1,260	9,261
3	-	-	7,938	1,323	9,261
Totals			**$24,000**	**$3,783**	**$27,783**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

In Scenario 3 the periodic amortization expense is the same for Type A accounting as it is under Scenario 1. The additional cost that arises due to the timing of the payment is reported as a periodic expense related to the time value of money under Type A accounting.

Conversely, under Scenario 3, amortization expense for Type B accounting is higher in the first two years of the lease than it is under Scenario 1 and lower in the final year of the lease than it is under Scenario 1 because the total cost of the lease is allocated to the reporting periods on a straight-line basis.

Scenario 4 – Equal Annual Payments at Beginning of Each Year

Type A (IFRS)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,000	16,387	8,000	780	8,780
2	8,000	8,394	8,000	400	8,400
3	-	-	8,000	-	8,000
	Totals		**$24,000**	**$1,180**	**$25,180**

Type B (U.S. GAAP)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,387	16,387	7,613	780	8,393
2	8,394	8,394	7,993	400	8,393
3	-	-	8,394	-	8,394
	Totals		**$24,000**	**$1,180**	**$25,180**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

In Scenario 4 the periodic amortization expense is the same for Type A accounting as it is under Scenario 1. The additional cost that arises due to the timing of the payments is reported as a periodic expense related to the time value of money under Type A accounting.

Conversely, under Scenario 4, amortization expense for Type B accounting is lower in the first two years of the lease than it is under Scenario 1 and higher in the final year of the lease than it is under Scenario 1 because the total cost of the lease is allocated to the reporting periods on a straight-line basis.

IASB members expressed concerns about the results of applying Type B accounting in Scenarios 2–4 because the additional cost that arises due to the timing of the payments is allocated to the reporting periods on a basis that is unrelated to the time value of money. They expressed the view that Type B accounting results in a charge to the income statement that is too small in the first two years of the lease and too large in the final year of the lease under Scenarios 2 and 4, and a charge to the income statement that is too large in the first two years of the lease and too small in the final year of the lease under Scenario 3. Consequently, IASB members argued that the income statement does not faithfully depict the economic result of the lease under Type B accounting in Scenarios 2–4.

Example 2: Type A Lease With Third-Party Residual Value Guarantee

This example reflects the EDs' proposals, updated for the Boards' March 2014 discussions.

Facts

- Lessee and Lessor enter into a transaction to lease equipment for a non-cancelable 3-year lease term with no renewal options;
- The lease does not contain a purchase option;
- The equipment has an estimated remaining economic life of 5 years at lease commencement;
- The equipment has a fair value and a carrying amount of $40,000 and $36,000, respectively, at lease commencement;
- The equipment has an estimated residual value of $12,500;
- The lease payments are $10,500 per year (paid in arrears) and there are no variable lease payments;
- Lessor's implicit rate is 4.289% if the fair value of $40,000 is used as the initial investment and 9.314% if the carrying amount of $36,000 is used as the initial investment;
- Lessor obtains a residual value guarantee (RVG) from a third party with a net present value at lease commencement of $9,200;
- At lease commencement the present value of the lease payments is 95% of the initial fair value of the equipment with the RVG and 72% of the fair value of the equipment without the RVG (note that the full amount of the RVG is used for purposes of determining the present value of the lease payments with the RVG as required by the existing guidance in IAS 17); and

- There are no initial direct costs incurred by Lessor and no prepaid rent.

Lease Classification

Under the revised proposed lease classification tests, the lease would be classified as a Type A lease by Lessor because the present value of the lease payments, including the RVG, represents substantially all of the fair value of the equipment at commencement of the lease.

Lessor Accounting – Type A Lease with Selling Profit (FASB Approach)

In this transaction the fair value of the equipment exceeds its carrying amount at lease commencement. However, because the lease only qualifies for Type A classification as a result of the third-party RVG, any selling profit would be deferred at lease commencement and recognized as income over the lease term in a manner that produces, when combined with the interest income on the net investment in the lease, a constant periodic rate of return on the lease.

Lessor would recognize its net investment in the lease and would derecognize the underlying asset. Lessor would measure the net investment in the lease at the present value of the lease payments plus the present value of the residual value less deferred profit. Lessor also would recognize interest income on the net investment in the lease over the lease term using the effective interest method.

The table below summarizes the amounts arising in Lessor's statement of financial position and statement of comprehensive income under the FASB approach.

	Statement of financial position				**Statement of comprehensive income**			
End of year	Lease receivable	Residual asset	Deferred profit*	Net investment in lease	Interest on receivable†	Residual accretion†	Earned profit‡	Total income‡
0	$28,980	$11,020	$(4,000)	$36,000	$ -	$ -	$ -	$ -
1	19,722	11,493	(2,362)	28,853	1,242	473	1,638	3,353
2	10,068	11,986	(1,014)	21,040	846	493	1,348	2,687
3	-	12,500	-	12,500	432	514	1,014	1,960
Totals					**$2,520**	**$1,480**	**$4,000**	**$8,000**

* Deferred profit is equal to the equipment's fair value minus its carrying amount ($40,000 - $36,000).

† Interest on the receivable and residual accretion are calculated using the rate implicit in the lease that is derived by using the equipment's fair value at lease commencement of $40,000 as the initial investment (i.e., 4.289%).

‡ Total income, including release of deferred profit, is allocated so that it is recognized at a constant rate equal to the rate implicit in the lease that is derived by using the equipment's carrying amount at lease commencement of $36,000 as the initial investment (i.e., 9.314%).

Lessor Accounting – Type A Lease with Selling Profit (IASB Approach)

The IASB approach is the same as the FASB approach except that there would be no deferral of the selling profit. The table below summarizes the amounts arising in Lessor's statement of financial position and statement of comprehensive income under the IASB approach.

	Statement of financial position			Statement of comprehensive income			
End of year	Lease receivable	Residual asset	Net investment in lease	Interest on receivable†	Residual accretion†	Earned profit**	Total income
0	$28,980	$11,020	$40,000	$ -	$ -	$4,000	$4,000
1	19,722	11,493	28,853	1,242	473	-	1,715
2	10,068	11,986	21,040	846	493	-	1,339
3	-	12,500	12,500	432	514	-	946
	Totals			**$2,520**	**$1,480**	**$4,000**	**$8,000**

** Earned profit recognized at lease commencement is equal to the equipment's fair value minus its carrying amount ($40,000 - $36,000).

† Interest on the receivable and residual accretion are calculated using the rate implicit in the lease that is derived by using the equipment's fair value at lease commencement of $40,000 as the initial investment (i.e., 4.289%).

As illustrated by this example, the timing of profit recognition and the periodic rate of return on the lessor's net investment in the lease may be significantly different for some Type A leases under the FASB approach than the IASB approach.

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