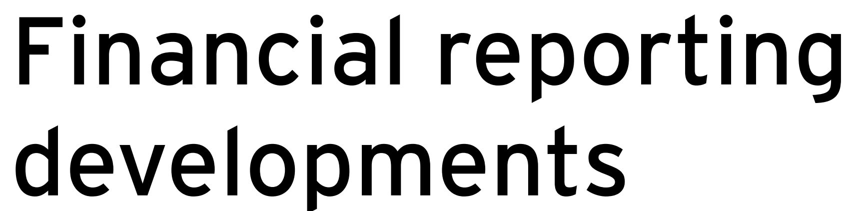

Financial reporting developments

Proposed accounting for leases

September 2010

Ernst & Young
Quality In Everything We Do

To our clients and other friends

The FASB and IASB (the Boards) issued an Exposure Draft (ED) on 17 August 2010 that proposes substantial changes to lease accounting that will affect all lease arrangements. The Boards plan to issue a final standard on leases in 2011. The proposal does not include a proposed effective date. Instead, the effective date will be considered as part of another project on the effective dates for all of the major joint projects currently under way and those expected to be completed in 2011.

The current lease accounting model is often criticized because operating leases are accounted for as off-balance sheet transactions. In addition, the criteria used to determine whether leases are operating or capital is viewed as complex and may result in significantly different accounting results for leases with similar economics. The Boards initiated the joint leases project to develop a new approach to lease accounting to address these criticisms with a particular focus on ensuring that assets and liabilities arising under leases are recognized in the balance sheet.

We have issued this publication to provide an overview of the proposals and highlight some of the more significant implications that we have noted thus far. This publication is intended to facilitate a discussion of the Boards' proposals and aid in gaining a greater understanding of the implications and consequences of the proposals. The discussions within this publication represent preliminary thoughts and additional issues will be identified through continued analysis of the ED and as the elements of the ED change on further deliberation by the Boards.

The issues discussed in this publication are intended to assist companies in formulating feedback to the Boards that can help in the development of a high-quality final standard. The comment letter period ends on 15 December 2010 and the Boards also plan to hold public roundtable meetings following the comment period to gather information and obtain the views of interested parties about the proposed guidance. Interested parties should refer to the ED on either of the Boards' websites for instructions on submitting comment letters and registering for the roundtable events.

Ernst & Young LLP

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Chapter 1: Scope

1.1 Definition of a lease

The ED defines a lease as a contract in which the right to use an **asset** is conveyed, for a period of time, in exchange for consideration. Users typically think of leases as office rentals and certain equipment rentals (e.g., cars) which are labeled as leases within the contract. However, leases cover a wide variety of transactions and, at times, leases are included within a contract which may not be explicitly identified as a lease or may comprise only a portion of the arrangement. The proposed model retains much of the current guidance[1] relative to assessing whether an arrangement is or contains a lease.

1.2 In-scope assets

The proposed guidance would apply to all leases, except for:

- Leases of intangible assets
- Leases to explore for or use natural resources (such as minerals, oil and natural gas)
- Leases of biological assets

Subleases are included within the scope of the ED. See Section 4.2 for further discussion of accounting for subleases.

How we see it

The definition of a lease is generally the same as current US GAAP. Based on the exclusions specified in the proposed guidance and the Boards' deliberations, we believe that this standard will essentially apply to leases of property, plant and equipment. However, as current US GAAP specifies that only leases of property, plant and equipment are subject to lease accounting standards and the proposed standard uses a scope that includes all leases with specific exclusions, certain scope changes could occur. For example, it would appear that, based on the definition and exclusions included in the ED, inventory could be the subject of a lease for accounting purposes. Existing lease accounting guidance does not currently apply to inventory. While we do not believe it was the Boards' intent to expand the contracts considered leases beyond those considered leases under current accounting, companies should assess their arrangements to determine if the change in description of the scope of lease accounting could result in arrangements that were not previously considered leases to be within the scope of the ED.

Note that the scope of the new leases standard is of heightened importance as the accounting for leases will be dramatically different from non-lease executory contracts.

[1] ASC 840-10-15 (formerly EITF 01-8).

1.2.1 Lease criteria

Entities should assess if a contract is or contains a lease at the inception date of the contract (i.e., the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement). The following criterion described in the ED must be met to determine that a contract is or contains a lease.

Excerpt from ED

B1. At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether:

(a) the fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset') (paragraphs B2 and B3); and

(b) the contract conveys the right to control the use of a specified asset for an agreed period of time (paragraph B4).

How we see it

Although the criteria for determining what is or is not a lease is not changing, that determination for many arrangements will take on increased importance. As the current accounting for operating leases and service contracts is often similar, determining that a service arrangement contains a lease classified as an operating lease generally does not result in significantly different accounting for the arrangement. That is, a service arrangement with an embedded operating lease is often accounted for similarly to a service arrangement that does not contain a lease. As such, entities may not have scrutinized the assessment of whether an arrangement contained a lease under the current guidance when it is clear that any potential embedded lease would be classified as an operating lease. Under the proposed guidance, any embedded lease in an arrangement will result in the recognition of lease assets and liabilities. As such, the determination of whether an arrangement contains a lease will have significant accounting implications under the proposed model.

Entities whose contracts involve providing or using fixed assets, even if the assets are used exclusively to provide the services called for in the contract, may have a lease component within their contracts. The lease model requires entities to assess if the contract is or contains a lease first, then determine if there is a separate lease and service component (see Section 1.3 for further information about identifying the lease and service components). If the lease and service component cannot be separated, entities must use the lease accounting model for the entire contract. Companies should carefully assess whether the specified asset and right to use criteria are met for these types of contracts.

Further, certain contracts were grandfathered under EITF 01-8 and therefore current US GAAP guidance is not applied in determining whether a contract is or contains a lease. Under the proposed model, these contracts will need to be assessed upon transition.

1.2.2 Specified asset

In order for a transaction to qualify as a lease, the fulfillment of the contract must be dependent on a specified asset. The asset can be either explicitly or implicitly identified and performance is dependent on the specified asset, as noted in the following excerpts:

Excerpt from ED

B2. In assessing whether fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset') to the lessee, it may be necessary to consider whether the asset or assets are implicitly or explicitly identified. An asset is implicitly 'specified' if it is (a) infeasible or impractical for a lessor to provide alternative assets in place of the underlying asset during the lease term or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice. For example, in a lease of an aircraft, it may not be practical to substitute another aircraft if the lessee has made extensive changes to the underlying asset (the aircraft) to suit the lessee's image, brand and requirements.

B3. A contract that permits an entity to substitute a similar asset for the specified asset after the date of commencement of the lease does not contain a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset. For example, if a supplier of a specified quantity of goods or services has the right and current ability to provide those goods or services using assets not specified in the arrangement, the underlying assets are not specified and the contract does not contain a lease. However, a contract that permits or requires the supplier to substitute other assets only when the specified asset is not operating properly may be a lease. In addition, a contractual provision (contingent or otherwise) that permits or requires a supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

If the asset is not explicitly identified in the contract and it is economically feasible for the seller to perform its obligation independent of the operation of a particular asset, such a contract would not contain a lease. If it is not economically feasible for the seller to perform its obligation using alternative assets, then the asset is implicitly specified in an arrangement and could be the subject of a lease.

The following two examples help illustrate this concept.

Example 1 — specified asset

- In the case of a power purchase contract, if the seller of the power is a single-purpose entity (SPE) that owns a single power plant, that power plant is implicitly specified in the contract because it is unlikely that the SPE could obtain replacement power to fulfill its obligations under the contract because a SPE generally has limited capital resources.
- In the case of a throughput contract (i.e., an agreement that provides for a processor to pay specified amounts to a processing facility in return for the processing of a product), the seller may have only a single pipeline and the prospect of obtaining access to a second pipeline may not be economically feasible. In that case, the seller's pipeline is implicitly specified in the contract.

If the asset is explicitly specified, but the contract permits an entity to substitute a similar asset for the specified asset after the date of commencement and it is economically feasible and practicable to do so, the contract is not a lease because, in substance, the underlying asset is not specified. However, entities should closely assess the contractual rights and obligations and overall substance of the contract to make this assessment. If a contract permits a supplier to substitute another asset for an identified asset, the use of an alternative asset to fulfill the contract must be economically feasible and practicable for that substitution right to be substantive. Otherwise, the identified asset would be a specified asset.

1.2.3 Right to use

The ED provides the following guidance to determine if a contract conveys the right to use the underlying asset:

Excerpt from ED

B4. A contract conveys the right to use an asset if it conveys to an entity the right to control the use of the underlying asset during the lease term. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

[Note that (a) and (b) are not used]

(c) The entity has the ability or right to operate the asset or direct others to operate the asset in a manner that it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(d) The entity has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(e) The entity will obtain all but an insignificant amount of the output or other utility of the asset during the term of the lease, and the price that the entity will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. If the price that the entity will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of the output, then the entity is paying for a product or service rather than paying for the right to use the underlying asset.

The proposed guidance is substantially the same as current guidance under US GAAP. Under current US GAAP, numerous questions have arisen regarding the "fixed per unit of output" and "market price per unit" discussion in ASC 840-10-15-6(c) (which is the equivalent to paragraph B4 (e) above). In the current application of US GAAP, we believe these were intended to be extremely limited exceptions that were meant to be taken literally. The fixed price criteria means absolutely fixed, with no variance per unit based on underlying costs or volumes (either discounts or step pricing), no matter how minor. Market is intended to address those items for which there is a readily available, actively traded market (e.g., electricity). In addition, market price per unit means the cost is solely a market cost without other pricing factors (e.g., market price per kwh plus percent change in price of natural gas would not be market).

Example 2 — identifying a lease within a contract

A manufacturing company (supplier) enters into a contract to provide certain component parts and has the following facts:

- The supplier's plant is explicitly identified in the contract and the supplier does not have another plant that can be used to fulfill the contract.
- The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed amount for the stated minimum quantity, even if the actual quantity taken is less.
- The designed capacity of the plant exceeds the purchaser's current needs and the supplier maintains ownership and control over all significant aspects of the plant.
- The supplier has the right to sell the component parts to other customers and has a history of doing so such that it is expected that parties other than the purchaser will take more than an insignificant amount of the output produced at the plant.

Based on the facts provided, the contract is not a lease. Fulfillment of the contract depends on a specified asset (the plant), but the right of use of the asset is not conveyed.

If the facts above were changed such that the purchases under the contract were expected to require all but an insignificant amount of the output of the plant, then the contract would be a lease, as fulfillment of the contract depends on a specified asset (the plant) and the contract conveys the right to control the use of the asset (i.e., condition in B4(e) is met).

How we see it

While the right to use criteria are not changing from current US GAAP, further application guidance and clarity of criteria would be beneficial in ensuring appropriate and consistent application of the criteria. Different interpretations of the current guidance exist today and with the increased significance of determining whether or not an arrangement is or contains a lease, differences in interpretation could result in drastically different accounting for similar arrangements.

In addition, current US GAAP requires reassessment of whether an arrangement contains a lease if certain conditions exist (e.g., a change in contractual terms, renewal or extension, changes to specific assets). The ED states that the assessment of a contract should be performed at the inception of the contract, but does not address if or when reassessment is required.

1.3 Leases and services arrangements

Certain contracts contain both lease and service components. For example, a company can lease a piece of equipment to and provide maintenance services for a customer. Another example is a service contract which includes embedded lease components for equipment required to fulfill the contract. Once an entity determines that a contract contains a lease, the entity should determine if the contract contains separate performance obligations for service components and lease components. Both lessors and lessees will use revenue recognition principles (as articulated in the Boards' revenue recognition exposure draft) to identify the separate components of such arrangements and allocate payments between the service and lease components. Contracts negotiated concurrently should be assessed together. The ED states how service and lease components are accounted for in paragraph B5.

Excerpt from ED

B5. An entity shall apply the proposals in the boards' exposure draft on revenue from contracts with customers to identify separate performance obligations within a contract that contains both service components and lease components. An entity shall account for each component as follows:

(a) If the service component is distinct (see paragraphs B6 and B7), the entity allocates the payments required by the contract between the service components and lease components using the principles proposed in paragraphs 50-52 in the exposure draft on revenue from contracts with customers. However, if a lessee or a lessor is unable to allocate the payments, the lessee or lessor applies this guidance to the whole contract.

(b) If the service component is not distinct, a lessee and a lessor shall account for the whole of the contract as a lease.

(c) [This paragraph in the IASB exposure draft is not used in the FASB exposure draft.]

B6. An entity shall determine whether a service component is distinct at the date of inception of the lease considering all concurrently negotiated contracts with another party.

To identify all separately accounted for service components within a lease, entities will perform the following three-step process at inception of the contract:

Step 1: Identify performance obligations

The revenue recognition exposure draft defines a performance obligation as "an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer." The concept of identifying separate performance obligations is similar to identifying a deliverable or element under current US GAAP.

Step 2: Determine if the service is distinct

The leases ED specifies that services must be distinct in order for the service component to be accounted for separately from the lease. If the service is not distinct, then the entire contract is accounted for following the lease model.

Excerpt from ED

B7. A service component is distinct if either:

(a) the entity, or another entity, sells an identical or similar service separately; or

(b) the entity could sell the service separately because the service meets both of the following conditions:

(i) It has a distinct function — a service has a distinct function if it has a utility either (1) on its own or (2) together with other non-leasing goods and services that the lessee has acquired from the lessor or is provided separately by the lessor or by another entity.

(ii) It has a distinct profit margin — a service has a distinct profit margin if it is subject to distinct risks and the lessor can separately identify the resources needed to provide the service.

How we see it

The determination of whether a service is distinct may in many cases be subjective and require the application of considerable professional judgment. The best evidence that a service is distinct is when the entity or any other market participant sells the service separately. However, in the absence of standalone sales, the entity may still determine that the service is distinct by showing that the service, while not currently sold separately, could be sold separately. The Boards provide two criteria that must be met to support that assertion: 1) the service has a distinct function and 2) the service has a distinct profit margin. Requiring that a service have a distinct function is consistent with the current guidance for multiple-element arrangements in ASC 605-25, which requires that a deliverable have value to the customer on a standalone basis. That is, for a service to have a distinct function (i.e., the service has utility on its own or when combined with another asset), the service is essentially required to be an asset that generates some economic benefit (i.e., value) to the customer.

The criterion in the proposed guidance that the service has to have a distinct profit margin, however, is not one that exists currently in US GAAP revenue guidance. While not included in ASC 605-25, this concept is similar to the guidance on construction-type contracts in ASC 605-35 that requires an element to have a different rate of profitability to be accounted for separate from other elements. When a standalone selling price is known, the profit margin is readily determinable in most cases. However, demonstrating a distinct profit margin when a selling price is not observable (because the service is not sold separately) is difficult. In deliberating the revenue recognition exposure draft, the Boards concluded that in the absence of an observable selling price, the entity would have sufficient basis for estimating the selling price only when the service is subject to distinct risks and the entity can identify the distinguishable resources needed to provide the service.

Step 3: Allocate the payments between the lease and service components

If separate distinct services are identified, then entities allocate the payments between the distinct components using the principles proposed in the following paragraphs from the revenue recognition exposure draft.

Excerpt from the revenue recognition exposure draft

50. An entity shall allocate the transaction price to all separate performance obligations in proportion to the standalone selling price of the good or service underlying each of those performance obligations at contract inception (that is, on a relative standalone selling price basis).

51. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately. A contractually stated price or a list price for a good or service shall not be presumed to represent the standalone selling price of that good or service. If a standalone selling price is not directly observable, an entity shall estimate it.

52. When estimating standalone selling prices, an entity shall maximize the use of observable inputs and shall apply estimation methods consistently for goods or services and customers with similar characteristics. Suitable estimation methods include the following:

(a) expected cost plus a margin approach — an entity could forecast its expected costs of satisfying a performance obligation and then add the margin that the entity would require for that good or service; and

(b) adjusted market assessment approach — an entity could evaluate the market in which it sells goods or services and estimate the price that customers in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity’s competitors for similar goods or services and adjusting those prices as necessary to reflect the entity’s costs and margins.

How we see it

The cited paragraphs from the revenue recognition exposure draft discuss allocating the "transaction price" whereas the leases ED discusses allocating the "payments required by the contract." The transaction price is described in the revenue recognition exposure draft as the amount that an entity expects to receive from a customer in exchange for transferring goods or services. The leases ED does not explicitly define or state how to determine the "payments required by the contract." The leases ED does define lease payments; however, the definition of lease payments in the leases ED is not the same as the definition of transaction price in the revenue recognition exposure draft. For instance, lease payments are based on the longest possible lease term more likely than not to occur whereas the transaction price would not typically include amounts for optional purchases of goods or services. For certain contracts, the payments determination may be simple (e.g., monthly rent of $100 for one year for use of office space and $10 for advertising services). However, for contracts with variable payments (e.g., contingent rent and services based on usage), the allocation of payments required by the contract may be more difficult. It is not clear if entities are to look to the guidance in the revenue recognition exposure draft for determining the transaction price in a contract when uncertainty exists related to payments required by the contract.

The principles proposed in the revenue recognition exposure draft require allocation of consideration to the components of a contract in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). Any discount within the contract is allocated proportionally to all of the separate components in the contract.

The standalone selling prices should represent the prices an entity would lease the asset and buy/sell the service for on a standalone basis at contract inception. When available, the observable price of the lease of the asset and the service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In such situations, the entity may be able to estimate the amount for which it would purchase/sell each component on a standalone basis.

The referenced paragraphs from the revenue recognition exposure draft indicate that an entity should not presume that a contractually stated price or a list price for a lease or service is representative of the standalone selling price. In order to allocate the payments required by the contract appropriately, the entity will have to determine the standalone selling prices for each of the performance obligations (i.e., each of the lease and service components) and not simply use the rates stated in the contract.

Once the payments are allocated to each lease and service component, then entities should follow the respective model (i.e., lease component would be accounted for using the guidance specified in the leases ED and service components would be accounted for using the guidance in the revenue recognition exposure draft or other applicable guidance for services).

Example 3 — allocation of payments between the lease and service components

A vendor enters into a contract with a customer to provide the customer the right to use a piece of equipment, routine maintenance service for the leased equipment and consulting services unrelated to the leased equipment. The contract requires the customer to make fixed monthly payments of $150 and indicates that $90 of that amount is for the equipment rental, $60 is for the consulting services and that the maintenance services are free. The vendor concludes that both the maintenance and consulting services are distinct services, determines standalone selling prices for each of the components of the contract and calculates the amount allocated to each component as follows:

	Standalone selling price	% allocation	payment	Monthly allocation
Equipment lease	$ 100	50%	$ 150	$ 75
Consulting services	80	40	150	60
Maintenance services	20	10	150	15
	$ 200	100%		$ 150

Lessor/Vendor

For this contract, the vendor would allocate $75 of the monthly payments to the lease of the equipment, $60 to the consulting services, and $15 to the maintenance services. The lease of the equipment would be recognized and measured following the proposed lease accounting guidance whereas the revenue for the consulting and maintenance services would be recognized and measured following the proposed revenue recognition guidance.

Lessee/Customer

Assuming the customer was also able to determine that the consulting and maintenance services were distinct and used consistent standalone selling prices, the customer would perform the same allocation of the payments. The customer would allocate $75 of the monthly payments to the equipment lease and recognize and measure the assets and liabilities related to the equipment lease using the proposed lease accounting guidance. The payments allocated to the services (both consulting and maintenance) would be accounted for under the guidance for other executory arrangements.

When observable prices are unavailable, the proposed revenue recognition guidance describes the following two possible approaches to estimating standalone selling price:

- **Expected cost plus a margin approach** — an entity will use its expected costs of satisfying the performance obligation and add a margin that the entity typically requires on similar leases or for the provision of similar services.
- **Adjusted market assessment approach** — an entity can examine the market in which it regularly provides the distinct components (e.g., leases the assets or buys/sells the services) and estimate the price that customers would be willing to pay. This approach may also include referring to quoted prices from the seller's competitors, adjusted as appropriate to reflect the seller's own costs and margins.

The approaches discussed in the cited paragraphs from the revenue recognition exposure draft are not the only estimation methods permitted. The revenue recognition exposure draft does not preclude nor prescribe any particular method for estimating standalone selling prices. Any reasonable estimation method is permitted, as long as it is consistent with the basis of a standalone selling price, maximizes the use of observable inputs and is applied on a consistent basis for similar leased assets and services and customers. That being said, the ED does provide an accounting model for when payments cannot be separated presuming there will be such instances.

How we see it

In most instances, entities will be able to make estimates of standalone selling prices that represent management's best estimate considering observable inputs. However, there may be occasions when it is difficult for entities to determine a standalone selling price, particularly as it relates to the selling price for leases or services that are never sold independently by the entity or others. While the revenue recognition exposure draft requires entities to make an estimate of the standalone selling price in revenue contracts, the leases ED indicates that if the lessee or lessor is unable to allocate the payments between the lease and service components, the entity applies the lease guidance to the whole contract. That is, the entity would treat the entire consideration as lease payments. However, the Boards stated in the basis for conclusions for the leases ED that they expect that it would be rare that an entity would be able to identify a distinct service component and yet not be able to allocate the payments between the components.

In addition, while the proposed guidance seems to indicate that an entity can use either an expected cost plus a margin approach or an adjusted market approach, we believe that an entity actually will have to consider both of these approaches in coming up with their estimate of a standalone selling price. That is, an entity could not determine that the expected cost plus a margin represents a reasonable standalone selling price if the market would not support the amount of margin used by the entity.

Please see our Financial Reporting Developments publication titled *The road to convergence: the revenue recognition proposal* (20 August 2010, SCORE No. BB1991) for additional information regarding the revenue recognition principles that are applicable to the leasing project.

1.3.1 Changes to payments

The payments required by the contract may change throughout the contract term. If this occurs, the ED states the following:

Excerpt from ED

B8. If the payments required by a contract that contains both lease and service components change after the commencement of the lease, an entity shall determine the change attributable to the lease and service components. If the amount of the change attributable to each component cannot be determined, the entity shall allocate the change to the service components and lease components in the same proportion as determined at the date of commencement of the contract.

The ED does not provide any guidance for how an entity will determine if a change in the payments required by a contract is attributable to the lease or service components. In some contracts, it may be clear that a change in the payments relates to the lease or the service. For instance, a contract may provide for the right to use an asset and unrelated services based on an estimate of the hours required to perform those services and call for additional payments at an agreed hourly rate for services provided in excess of that estimated number of hours. If the payments under the contract change as additional fees are due for additional services that are provided, that change would be attributable to the service component. In other contracts, it may be difficult to discern if a change in payments is related to the service or lease components. For example, a change in payment that is based on a change in the consumer price index (CPI) may be difficult to attribute to a certain component. If an entity cannot determine the amount of the change attributable to each component, the change should be allocated in the same proportion determined at the commencement of the contract.

How we see it

While the ED provides guidance to separate and allocate lease and service components, the ED does not address how to separate and allocate payments among contracts to lease more than one asset. We believe that, consistent with current practice and the principles used for allocated payments between lease and service components, consideration in a contract that provides for more than one lease (i.e., leases of multiple specified assets) should be allocated on a relative selling price basis.

1.4 Purchases/sales exclusion

In a significant change from current practice, contracts that are considered a purchase or sale of the underlying asset are excluded from the scope of the ED.

Excerpt from ED

8. An entity shall not apply this guidance to the following contracts, which represent a purchase or sale of an *underlying asset*:

   (a) a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity (see paragraphs B9 and B10); and

   (b) a lease after the lessee has exercised a purchase option specified in the lease. A contract ceases to be a lease when such an option is exercised and becomes a purchase (by the lessee) or sale (by the lessor).

B9. An entity shall not apply this guidance to contracts that meet the criteria for classification as a purchase or sale of an underlying asset. A contract represents a purchase or sale of an underlying asset if, at the end of the contract, an entity transfers to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset. That determination is made at inception and is not subsequently reassessed.

B10. An entity shall consider all relevant facts and circumstances when determining whether control of the underlying asset is transferred at the end of the contract. A contract normally transfers control of an underlying asset when the contract:

   (a) automatically transfers title to the underlying asset to the transferee at the end of the contract term; or

   (b) includes a bargain purchase option. A bargain purchase option is an option to purchase the asset at a price that is expected to be significantly lower than the fair value of the asset at the date that the option becomes exercisable. If the exercise price is significantly lower than fair value, it would be reasonably certain at the inception of the lease that such options will be exercised. An entity that has a bargain purchase option is in an economically similar position to an entity that will automatically obtain title to the underlying asset at the end of the lease term. By exercising its bargain purchase option, the transferee would be able to direct the use of, and receive the benefits from, the whole of the underlying asset for the whole of its life.

To assess whether a contract is a purchase or sale of an underlying asset, entities should consider all relevant facts and circumstances. The evaluation is performed at inception of the contract and reassessment is not allowed. The determination should be made based on the economic substance of the contract, which may or may not be the same as the terminology used in the contract (e.g., purchase agreement, lease agreement). The ED states that leases

that provide for the automatic transfer of title to the underlying asset to the lessee and those that contain bargain purchase options normally transfer control of the underlying asset and would therefore be considered purchases/sales of the underlying asset (i.e., excluded from the scope of the proposed leases standard).

How we see it

The use of judgment will be required in determining if both control and all but a trivial amount of the risks and benefits associated with the underlying asset are transferred. The ED does not provide guidance for making this determination other than noting that leases that automatically transfer title to the underlying asset or contain a bargain purchase option would normally meet the criteria.

In addition, the ED describes a bargain purchase option as an option to purchase the asset at a price that is expected to be significantly lower than the fair value of the asset at the date that the option becomes exercisable. Current accounting practice also considers if an economic penalty creates a bargain purchase option. For example under current practice a lease of a specialized asset with no suitable alternative that contains a purchase option may be deemed to be a bargain purchase option even if the option is at a price that approximates fair value. As drafted, it would not appear that similar consideration of economic factors would be appropriate.

Once a purchase option (i.e., one that was not determined to be a bargain) in a lease is exercised, the contract is no longer a lease and is accounted for as a purchase/sale. See Sections 2.2.1 and 2.2.2 for additional information on accounting considerations prior to exercise.

The ED states that entities should not apply the leasing guidance to contracts that meet the purchase/sale exclusion. The Boards indicate in the basis for conclusions of the ED that entities should look to other accounting guidance, particularly revenue recognition guidance, to determine how to account for these "in-substance" purchases/sales.

How we see it

Under current US GAAP, leases that automatically transfer title of the underlying asset or contain a bargain purchase option are accounted for as leases. However, these contracts will be outside of the scope of the proposed lease standard. It is not clear how these arrangements will be accounted for if determined to be outside the scope of the ED. Additionally, the ED does not discuss transition provisions for contracts that are leases under existing standards but excluded from the proposed new standard as they represent purchases/sales. While we expect these arrangements to be accounted for as a financed purchase of an asset by the purchaser (lessee), further guidance may address this issue.

1.5 Short-term lease simplified model

A simplified form of lease accounting for short-term leases (i.e., leases with a maximum possible lease term of 12 months or less) will be permitted. Under the simplified accounting for short-term leases, the accounting treatment is the following:

- Lessees will measure the right-of-use asset and the liability to make lease payments at the undiscounted amount of the lease payments. Other measurement and accounting treatment is the same as long-term leases.
- Lessors will recognize lease payments in income over the lease term (i.e., similar to current operating lease accounting) and will not recognize lease assets or lease liabilities or derecognize any portion of the underlying leased asset.

Entities will make the election to use the short-term lease exemption on a lease-by-lease basis at the date of inception of the lease.

How we see it

Companies should carefully validate that the short-term lease exemption applies. The exemption applies to leases with a **maximum** possible lease term of 12 months or less. Therefore, evergreen agreements or daily leases with no set termination date would not meet the short-term lease exemption criterion. The lessee's intentions are not considered in this determination as it is based on the maximum possible lease term.

1.6 Exclusions considered and rejected

The Boards deliberated certain additional scope exclusions, including exclusions for leases of non-core assets and long-term leases of land, but ultimately rejected them.

1.6.1 Non-core assets

Some constituents viewed assets that are not essential to the operations of an entity (non-core assets) as being of little interest to users of an entity's financial statements because such assets do not relate to the entity's operations. These constituents did not believe that the benefits provided outweighed the cost of accounting for these assets. The Boards concluded that these assets were relevant to the users of the financial statements because:

- US GAAP does not distinguish between core and non-core purchased assets for the purposes of recognition and the Boards did not believe they could justify a different conclusion for right-of use assets.
- Leases of non-core assets may give rise to significant assets and liabilities.

1.6.2 Long-term leases of land

Certain entities enter into long-term leases of land (e.g., 99-year leases). Some view long-term leases of land as economically similar to the purchase or sale of land and therefore believe that long-term leases of land should be excluded from the scope of the ED. However, the Boards concluded that long-term leases of land are within the scope of the proposed guidance because:

- The lessor retains title to the land during the lease term and regains possession of the land at the end of the lease term. Because the value of land generally does not decline, the title to the land will likely have significant value at the end of the lease term.
- There is no conceptual basis for differentiating long-term leases of land from other leases. Any definition of a long-term lease of land would be arbitrary.

1.7 Investment property

Under IFRS, certain real estate properties held to earn rentals or for capital appreciation (investment property) can be measured at either amortized cost or fair value. The IASB decided to exclude investment property measured at fair value from the scope of the proposed model for leases. That is, lessors would not apply the proposed model to leases of investment property. No special accounting for investment property exists under US GAAP. However, the FASB is working on a project to consider providing special accounting for such assets and has tentatively concluded to require fair value accounting for investment property. See our Hot Topic, *Changes to be proposed for investment property* (23 July 2010, SCORE No. BB1977), for further details on this project.

How we see it

If the FASB requires fair value accounting for investment property, the accounting model for lessors of investment property will change significantly and the proposed guidance for lessor accounting would not be applied by lessors to the leases of these properties. Based on the definition of investment property under IFRS and the preliminary decisions made to date by the FASB in its project on investment properties, many entities, including those outside of the real estate industry, would be affected. Entities should closely monitor the progress on the project.

Chapter 2: Lessee accounting

2.1 Overview of lessee accounting

Under the right-of-use accounting model proposed in the ED, all leases will be recorded on the balance sheet at the lease commencement date. The Boards believe that the proposed model will better reflect the assets and liabilities arising in lease contracts. Additionally, the Boards believe that the proposed accounting model is beneficial as it will improve comparability since lessees will apply the same accounting to most lease contracts, the model can be applied to a wide range of leasing arrangements and the model is consistent with the Board's conceptual framework and other recently issued standards.

While leases currently accounted for as operating leases will be most affected, the accounting for present day capital leases will also change, primarily due to differences in the determination of the lease term, the measurement of lease payments, and the requirement to reassess estimates and judgments throughout the life of the lease. In addition, as discussed in Section 1.4, certain contracts currently accounted for as capital leases will be outside of the scope of the new leases standard.

2.1.1 Right-of-use asset and liability to make lease payments

Under the proposed model, lessees will be required to record an asset representing the right to use the leased item for the lease term (the right-of-use asset) and a liability to make lease payments. The asset and liability will be initially recognized by a lessee at the commencement of the lease (i.e., the date on which the lessor makes the underlying asset available for use by the lessee). The recorded asset and liability incorporate the rights (including renewal options) and obligations (including contingent payments, termination payments and residual value guarantees) arising under the lease and are based on the lessee's assessment of the expected payments to be made over the lease term. Importantly, the proposed model requires measuring the amounts recorded at the present value of future payments and not at fair value. Measurement of the expected payments will require estimates and judgments about uncertain future events and conditions including consideration of renewal options and contingent payments to be made over the lease term. The more complex a lease is (e.g., variability in terms of length or payment amounts), the more complicated the accounting will be.

Example 4 — right-of-use and liability summary

Lessee A rents a crane from Lessor B for a three-month period. The lease requires Lessee A to make fixed monthly payments which are due at the end of each month. Under current accounting, this lease would likely be classified as an operating lease and Lessee A would not typically record any amounts on its balance sheet related to the lease. In contrast, the proposed model will require Lessee A to recognize a right-of-use asset and a liability to make lease payments.

2.2 Key concepts

There are several key concepts that have a pervasive effect on accounting for leases under the proposed model. These are:

- Lease term
- Lease payments
- Discount rate

Each of these concepts is discussed below.

> **How we see it**
>
> While many of the terms used in the ED are the same as those used in current lease accounting standards, the application can be quite different (e.g., lease term and lease payments). Companies should obtain an understanding of the new definitions and associated application to properly capture the impact of the proposed standard.

2.2.1 Lease term

Under the proposed model, the lease term for accounting purposes is the longest possible lease term that is more likely than not to occur. In other words, the lease term is the longest term with a greater than 50% probability of occurring. Determining the lease term involves a two-step process:

Step 1: Identify each possible lease term taking into account the effect of any options to extend or terminate the lease

In assessing the lease term, an entity should consider all explicit and implicit options included in the contract. For example, a lease with a five-year non-cancelable lease term and a two-year renewal option has possible lease terms of five or seven years. A seven-year lease with an option to terminate the lease after five years would also have possible lease terms of five or seven years. Options to renew a lease that are priced at market value at the date of renewal would be considered when determining the possible lease terms. In addition, an entity must also consider options given effect by the operation of statutory law. For instance, in certain jurisdictions a tenant in a lease of real estate (e.g., lessee of a retail store location) may have, under applicable statutes, a legal right to renew their lease. That is, the landlord (lessor) is obligated to continue to lease that space to the tenant at fair value rentals. Although a lease contract in such jurisdictions may not explicitly state that a renewal option exists, the operation of statutory law provides for such an option and that option would be considered in the determination of the lease term.

Purchase options (that are not bargain purchase options) are only accounted for when they are exercised. The Boards concluded that when a lessee exercises a purchase option, it terminates the lease and purchases the underlying asset. Thus, purchase options do not

represent lease term extensions and are not considered as part of the assessment of possible lease terms. As discussed in Section 1.4, arrangements that include bargain purchase options or arrangements that automatically transfer the asset to the lessee are outside the scope of the proposed leases standard.

Step 2: Estimate the probability of occurrence of each possible lease term

After identifying all of the possible lease terms, an entity must determine which one of those possible lease terms is the longest lease term that is more likely than not to occur. In order to do so, an entity must estimate the probability of each possible lease term taking into consideration:

- Contractual factors
- Non-contractual factors
- Business factors
- Other lessee-specific factors

The ED provides further description of each of these considerations as follows:

Excerpt from the ED

B18. An entity considers the following factors in assessing the probability of each possible term:

(a) contractual factors, which are the explicit contractual terms that could affect whether the lessee extends or terminates the lease. Examples of contractual factors are the level of lease payments in any secondary period (bargain, discounted, market or fixed rate), the existence and amount of any contingent rentals or other contingent payments such as payments under term option penalties and residual value guarantees, the existence and terms of any renewal options and costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.

(b) non-contractual factors, such as statutory law or the financial consequences of a decision to extend or terminate the lease that the contract does not explicitly state. Examples of non-contractual features are local regulations that affect the lease term, the existence of significant leasehold improvements that would be forgone if the lease were terminated or not extended, non-contractual relocation costs, costs of lost production, tax consequences and costs associated with sourcing an alternative item.

(c) business factors, such as whether the underlying asset is crucial to the lessee's operations, or whether the underlying asset is a specialized asset or the location of the asset.

(d) other lessee-specific factors, such as lessee's intentions and past practice.

Using the factors described above, an entity will determine the probability of occurrence for each possible lease term. For leases with multiple options, this may require assigning individual probabilities to each possible lease term and calculating the cumulative probability of occurrence in order to determine the longest possible lease term that is more likely than not to occur.

How we see it

The assessment of the lease term under the proposed model is significantly different from current accounting. Under current lease accounting standards, optional renewal periods are only included in the lease term if the exercise of the renewal is reasonably assured (a high threshold) as of the inception of the lease.

The model proposed in the ED will result in longer lease terms for accounting purposes which will not only affect the accounting for the amounts recorded under the model but could also affect other items, such as the amortization period used for leasehold improvements. In addition, the lease term will be reassessed periodically.

The following example illustrates how an entity will determine the lease term for a lease:

Example 5 — lease term

A manufacturing company enters into a lease for equipment with a five-year non-cancelable lease term and two five-year optional renewal periods. The possible lease terms are 5 years (exercise no renewals), 10 years (exercise first renewal only) and 15 years (exercise both renewals).

The manufacturing company estimates the probability of occurrence for each possible lease term considering the following:

- Contractual factors — There are no residual value guarantees and management believes that the renewal terms are slightly discounted.
- Non-contractual factors — The manufacturing company incurred significant freight costs and initial inspection costs which would be incurred again if the company chose to enter into a new equipment lease.
- Business factors — The economic outlook for the manufacturing company's products is uncertain with potential technological changes in the long-term (e.g., after 10 years), which could cause the equipment to be obsolete.
- Lessee-specific factors — The manufacturing company has historically extended the lease terms beyond five years for this type of equipment.

In evaluating the facts and circumstances, the lessee determines the individual probability of occurrence for each possible lease term and determines the cumulative probability of occurrence for each possible lease term as illustrated below.

Possible lease terms	Individual probability of occurring (%)	Cumulative probability of occurring (%)
15 years	20%	20%
10 years	40%	60%
5 years	40%	100%

The lease term for this lease will be 10 years because this is the longest possible lease term more likely than not to occur (cumulative probability in excess of 50%).

How we see it

Under current accounting, cancelable (at the lessee's option), evergreen (i.e., automatically renewed) or "daily" (where the lessee has an option to continually renew) leases would rarely require capital lease consideration. Conversely, under the proposed guidance these lease terms do not preclude the lease from being recorded on the balance sheet. An entity would need to determine the longest possible lease term that is more likely than not to occur considering all possible lease terms under the contract, which could result in a lengthy lease term based on consideration of the relevant factors described above.

While identifying the possible lease terms will be relatively simple for most contracts, estimating the probability associated with these options will likely require the use of judgment and will involve assessing expectations regarding future business operations, expected market conditions and the value of the leased asset in future years, as well as other factors. Verifying the completeness and accuracy of the best information available through coordination with the appropriate functions (e.g., operating and marketing personnel) and developing appropriate controls will be key to performing this assessment.

The Boards believe that defining the lease term as the longest possible lease term that is more likely than not to occur is the best practical approach to capturing the impact of options in that the right-of-use asset represents an entity's reasonable expectation of what the lease term will be.

2.2.2 Lease payments

The ED defines lease payments as "payments arising under a lease including fixed rentals and rentals subject to uncertainty, including, but not limited to, contingent rentals, and amounts payable by the lessee under residual value guarantees and term option penalties." In some leases, the amount of the lease payment is not fixed (i.e., uncertain payments) due to the existence of contingent rentals, residual value guarantees or term option penalties (i.e., termination penalties). The Boards concluded that the uncertain payments should be included in the amounts recognized on the balance sheet based on the premise that these items, by falling within the lease term, met the definition of a liability at the date of inception of the lease and that only the measurement of the amount to be paid is uncertain. As noted earlier, purchase options are not considered extensions of a lease, but rather when a lessee exercises a purchase option, the lease is terminated. Similarly, the exercise price of a purchase option included in a lease is not a lease payment. While the Boards acknowledged differences in the proposed model with current US GAAP for contingencies, the Boards concluded that not including contingent components of the contract would understate the right-of-use asset and liability to make lease payments and would also decrease comparability and introduce structuring opportunities.

How we see it

A purchase option that is considered a bargain purchase option at the inception of a contract will typically result in that contract being excluded from the scope of the ED (i.e., not accounted for as a lease). However, a lease contract that contains a purchase option that is not considered a bargain purchase option would be within the scope of the ED. Subsequent to the inception of the contracts, there is no reassessment of whether or not a purchase option is a bargain. That is, there is no accounting for a purchase option not considered a bargain at lease inception that becomes reasonably assured of exercise during the lease term until that option is exercised.

The lease payment amounts should be measured using an expected outcome technique, which is a method that estimates the probability-weighted average of the present values of the cash outflows for a reasonable number of outcomes. Estimating the expected outcome involves the following four-step process:

Step 1: Identifying each reasonably possible outcome

The Boards considered the cost impact to applying this method and concluded that an entity need not assess every possible outcome using complex models and techniques. The Boards indicate that it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows. However, by indicating that each reasonably possible outcome should be identified, it could be argued that all possible outcomes other than those with a remote probability of occurring should be included which by definition is fairly expansive. However, none of the possible outcomes would include the exercise of a purchase option (see Section 2.2.2.1).

Step 2: Estimating the amount and timing of the cash flows for each reasonably possible outcome

An entity will need to consider all relevant information in determining the lease payments required during the lease term. Significant assumptions may be required, including:

- An estimate of contingent rentals payable, which can be driven by:
  - The lessee's use of the underlying asset (e.g., miles flown or hours used)
  - The lessee's performance (e.g., percentage of sales in a leased store)
  - Other factors (e.g., indexed for inflation, adjustment to market rates)
- An estimate of the underlying asset value at the end of the lease for residual value guarantees to determine the amount payable
- An estimate of expected payments to the lessor for termination penalties

If contingent rentals depend on an index or rate (e.g., CPI or Libor), an entity should determine the expected lease payments using readily available forward rates and if forward rates are not readily available, an entity should use the prevailing rate. Residual value guarantees provided by a third party do not form part of the lease arrangement and are not considered lease payments by the lessee or lessor. The ED does not address situations in which the lessee pays an unrelated third party to guarantee the residual value for the benefit of the lessor.

Step 3: Determining the present value of those cash flows

An entity would calculate the present value of each of the cash flows using the applicable discount rate. See Section 2.2.3 for further discussion of discount rate.

Step 4: Estimating the probability of each outcome

Considering all relevant factors, an entity would then estimate the probability of occurrence of each outcome. That is, for each of the outcomes identified in Step 1 and measured in Steps 2 and 3, an entity would determine the likelihood of occurrence. The entity would use these probabilities to "probability-weight" the reasonably possible outcomes and calculate the amount of lease payments.

The following example illustrates how an entity will determine lease payments for contingent rents:

Example 6 — contingent rents

A retailer is a lessee in a one-year store lease that includes a contingent rental arrangement whereby the lessee pays an additional $10,000 of rent for each $1 million of sales in the leased location up to a maximum of $30,000. The lessee's incremental borrowing rate is 11%. The lessee determines the probability of the sales for the leased store generating each of the various contingent rental amounts as follows:

Sales	Contingent rents	Present value	Probability	Probability-weighted amount
Less than $1 million	$ 0	$ 0	35%	$ 0
> $1million and < $2 million	$ 10,000	$ 9,000	50%	4,500
> $2 million and < $3 million	$ 20,000	$ 18,000	10%	1,800
> $3 million	$ 30,000	$ 27,000	5%	1,350
				$ 7,650

Contingent rent of $7,650 would be included in lease payments.

How we see it

The expected outcome technique is also used in accounting for asset retirement obligations and is proposed to be used in the revenue recognition exposure draft. While the example above was straightforward based on the limited number of possible outcomes, the estimation of the contingent amounts looks to be one of the more challenging aspects of the proposed model as it may require companies to forecast activities in periods beyond their normal planning or budgeting cycle. The expected outcome calculation can become very complex based on the nature of contingent payments, contractual features (e.g., variability in timing or the absence of limits on uncertain amounts) and the number of reasonably possible scenarios. To perform this analysis for each lease could be a very time consuming and costly process. This process will be made even more complex by the requirement to reassess these probability-weighted estimates when facts or circumstances change.

For example, consider a contingent rent based on a percentage of sales. The possible outcomes would include a wide range of projected sales. Companies would need to develop outcomes that would consider various scenarios that are reasonably possible by taking into account macroeconomic and industry trends as well as entity-specific facts and circumstances. Determining the number of reasonably possible outcomes as well as the timing and the probability of each outcome would require a significant amount of estimation and potentially complex calculations.

2.2.2.1 Purchase options

As noted above, the Boards decided that the exercise price of a purchase option is not a lease payment and that purchase options should not be accounted for until they are exercised. The Boards provided the following explanation for their decision.

Excerpt from ED

BC63 The boards considered whether a purchase option is:

(a) a term of the lease that should be accounted for as if it were an option to extend the lease term; or

(b) a means of terminating the lease that should be accounted for only when it is exercised.

BC64 The boards concluded that when a lessee exercises a purchase option, it terminates the lease and purchases the underlying asset. Thus, the exercise price of the option is not a lease payment and should not be included in the measurement of assets and liabilities arising from a lease. Accordingly, the boards propose that purchase options should not be accounted for until they are exercised. However, bargain purchase options are considered when determining if a transaction is a lease or a purchase or sale.

The accounting for purchase options under the ED is significantly different from the approach previously proposed by the Boards in the discussion paper on leases issued in March 2009. In the earlier document, purchase options were considered extensions of the lease term and treated on a basis consistent with lease renewal options.

How we see it

A number of questions arise related to the application of the proposed model due to the exclusion of the exercise price of purchase options from lease payments. Many leases provide lessees the ability to terminate a contract on the condition that the lessee purchases the underlying leased asset at a contractually agreed amount. Also, many leases contain purchase options that are interrelated with residual value guarantees provided by the lessee. It is unclear how these arrangements would be assessed under the proposed model and whether or not arrangements structured to include purchase options either in place of or in combination with termination penalties or residual value guarantees would be afforded different accounting.

Take for instance a lease with a 10-year lease term that provides the lessee with a purchase option at the end of five years and assume that the purchase option is not considered a bargain purchase option at the inception of the lease. Is such a lease considered cancellable at the end of five years (i.e., is one of the possible lease terms five years)? If the lessee expects to exercise the purchase option at the end of 5 years (i.e., the exercise is considered more likely than not), is the lease term only five years, even though that term can only occur under the contract if the lessee exercised the purchase option?

2.2.3 Discount rate

The discount rate used by the lessee to determine the present value of lease payments is either:

1) The lessee's incremental borrowing rate, or

2) The rate that the lessor charges the lessee (if it can be readily determined)

Whichever rate is used, the discount rate is determined as of the inception of the lease. The lessee's incremental borrowing rate is the rate of interest that the lessee would have to pay to borrow over a similar term (i.e., the lease term), and with a similar security, the funds necessary to purchase a similar underlying asset. The rate the lessor charges the lessee could be based on the lessee's incremental borrowing rate, the implicit rate of the lease (i.e., the discount rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to be the equal to the fair value of the underlying asset) or some other appropriate approach (see Section 3.4.3 for further discussion of the rate the lessor charges the lessee). In most cases, we expect lessees will use their incremental borrowing rate.

In their deliberations, the Boards considered requiring only one method to determine the appropriate discount rate but ultimately concluded that allowing companies the option of either rate would provide flexibility for companies to determine the appropriate rate based on specific circumstances.

How we see it

While the term "incremental borrowing rate" is the same term used in current accounting guidance, there appear to be some potential differences in application based on the guidance in the ED. The Boards concluded that the lessee's incremental borrowing rate would reflect the nature of the transaction and specific terms of the lease, such as lease payments, lease term, expected uncertain payments as well as security attached to the underlying asset. Companies will therefore need to determine the discount rate for each lease. The definition of the incremental borrowing rate in the ED specifically requires that the rate reflect a secured borrowing rate. While current US GAAP indicates that a lessee's use of a secured borrowing rate is allowed if that rate is determinable, reasonable and consistent with the financing that would have been used in the particular circumstance, it does not require a lessee to use a secured borrowing rate. While it would be unusual to obtain non-recourse financing for the entire value of the underlying asset, we believe that it would be appropriate to use a secured borrowing rate that reflects the aggregate interest rate obtained using a combination of recourse and non-recourse financing. In addition, the ED notes that the lessee's incremental borrowing rate on a lease that includes optional renewals would incorporate such optionality in a manner similar to the rate on loan commitment facilities that permit extensions.

2.3 Initial measurement

The ED provides the following description of how an entity will measure amounts initially recognized on its balance sheet for a lease:

Excerpt from ED

12. At the date of inception of the lease, a lessee shall measure:

    (a) the liability to make lease payments at the present value of the lease payments (see paragraphs 13-15), discounted using the *lessee's incremental borrowing rate* or, if it can be readily determined, the *rate the lessor charges the lessee* (see paragraph B11).

    (b) the right-of-use asset at the amount of the liability to make lease payments, plus any *initial direct costs* incurred by the lessee (see paragraphs B14 and B15).

13. A lessee shall determine the *lease term* by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease (see paragraphs B16—B20).

14. A lessee shall determine, using all relevant information, the present value of lease payments payable during the lease term determined in accordance with paragraph 13 on the basis of expected outcome. The expected outcome is the present value of the probability-weighted average of the cash flow for a reasonable number of outcomes (see paragraph B21). In determining the present value of the lease payments payable, a lessee shall include:

    (a) an estimate of contingent rentals payable. If the contingent rentals depend on an index or a rate, the lessee shall determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessee shall use the prevailing rates or indices.

    (b) an estimate of amounts payable to the lessor under residual value guarantees. Residual value guarantees that are provided by an unrelated third party are not lease payments.

    (c) an estimate of expected payments to the lessor under term option penalties.

15. The exercise price of a purchase option included in a lease is not a lease payment and the purchase option is not included in determining the present value of lease payments payable.

While the lessee does not recognize the right-of-use asset and liability to make lease payments until the lease commencement date (i.e., the date on which the lessor makes the underlying asset available for use by the lessee), the lessee performs its initial measurement at the date of inception (i.e., the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement). Initial measurement of the lease is based on the inception date estimates to best reflect the contract pricing with the counterparty and to perform a reasonable approximation of fair value. The Boards concluded that using a present value model would be more comparable with the measurement applied to other non-financial assets and normally would be less complex and less costly than requiring a fair value measurement model.

How we see it

Many times the date of inception and commencement date are almost simultaneous. However, in some leases there is a significant delay between the two dates (e.g., build-to-suit assets). The Boards concluded that before the date of commencement of the lease, the lease is executory. That is, it depends on future action by both parties and, therefore, lessees should not recognize the lease between the date of inception and commencement; however, certain disclosures may be required (see Section 5.1). The ED does not address accounting for any transactions prior to the commencement date or the effect of changes that could occur between the inception and commencement of a lease. Examples of transactions or changes include up-front cash payments, changes in currency exchange rates and changes in present values due to the passage of time.

At the inception date, the liability to make lease payments is measured at the present value of the lease payments using an applicable discount rate. Calculating the present value of the lease payments involves the following steps:

1. Establishing the lease term (see Section 2.2.1)
2. Determining the number and amount of the lease payments required during the term of the lease (see Section 2.2.2)
3. Discounting the amount of lease payments to the present value of lease payments (see Section 2.2.3)

The right-of-use asset is measured initially at cost and would include the amount of the liability to make lease payments plus any initial direct costs incurred by the lessee. Initial direct costs are defined in the ED as recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made. Therefore, initial direct costs need to be direct and incremental to the lease transaction. Examples include costs incurred by the lessee (either internally or externally) for:

- Commissions
- Legal fees

- Negotiating lease terms
- Preparing and processing legal documents
- Closing the transaction

As discussed at Section 1.5, lessees applying the short-term lease exemption will measure the right-of-use asset and the liability to make lease payments using the undiscounted amount of the lease payments. Other measurement and accounting treatment is the same as long-term leases.

How we see it

A lease contract with a new lessor may include incentives for the lessee to enter into the lease, such as an up-front cash payment to the lessee, payment of certain costs for the lessee (such as moving expenses or leasehold improvements), or the assumption by the lessor of the lessee's preexisting lease with a third party. The ED does not address accounting for lease incentives. In light of the significant scrutiny applied to lessee accounting for lease incentives in certain industries, we expect many lessees to request clear guidance from the Boards on how to account for lease incentives under the right-of-use model. That is, should the incentive be treated as a separate element embedded in the lease, such as a loan?

2.4 Subsequent measurement

2.4.1 Amortized cost approach

After the date of commencement of the lease, the lessee will measure the right-of-use asset and liability to make lease payments using the amortized cost approach by performing the following:

- Amortize the right-of-use asset on a systematic basis (generally straight-line) over the shorter of the lease term or economic life of the leased asset
- Recognize interest expense on the liability to make lease payments using the interest method (i.e., the method used to arrive at a periodic interest cost that will represent a level effective rate on the liability and expense at the beginning of each period) and reduce the liability for any lease payments

Example 7 — amortized cost approach

Company A leases a truck under a three-year lease (with no renewal options) for annual payments of $3,620 due at the end of each year. Company A's incremental borrowing rate is 10%. The present value of lease payments at the beginning of the lease is $9,000 and that amount is recognized as a right-of-use asset and a liability to make lease payments at the commencement of the lease. The useful life of the truck is five years and Company A uses a straight-line amortization method.

During the first year of the lease, Company A records the following:

- Recognizes amortization expense and a reduction in the right-of-use asset of $3,000 ($9,000/3 years)
- Recognizes interest expense and an increase to the liability to make lease payments of $900 ($9,000 x 10%)
- Reduces the liability to make lease payments by $3,620 for the amount paid

At the end of the first year of the lease, the carrying amount of the right-of-use asset is $6,000 ($9,000 initial amount less $3,000 amortization) and the carrying amount of the liability to make lease payments is $6,280 ($9,000 initial amount plus $900 interest accrued less $3,620 payment made).

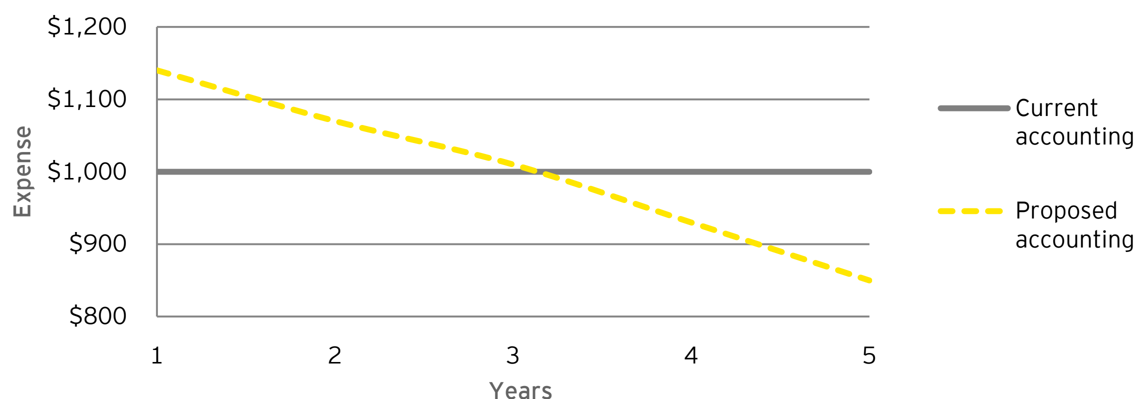
How we see it

Recognizing interest expense on all leases will affect the timing and pattern of expense recognition for lessees that currently classify leases as operating leases. For many leases, the total expense recognized (i.e., the sum of amortization and interest expense) will be higher in earlier periods of a lease and lower in later periods of a lease. The following example illustrates this difference in timing of expense recognition between an operating lease under the current accounting model and the same lease under the proposed ED.

Example 8 — expense recognition

A lessee enters into a lease to rent office space for $1,000 per year for five years. Payments are due at the beginning of each year. The lessee's incremental borrowing rate is 8.5%.

Assuming the lease is classified as an operating lease under the current accounting model, the lessee would not initially recognize any amounts on its balance sheet for the lease and would recognize rent expense on a straight-line basis (i.e., $1,000 per year). Under the proposed model, the lessee would recognize both an asset and a liability for the present value of lease payments over the lease term (approximately $4,250 in this example). In addition, the lessee would recognize both amortization expense (presumably on a straight-line basis) and interest expense. As illustrated below, the proposed model will result in an acceleration of expense when compared to the current accounting model.



2.4.2 Impairment of the right-of-use asset

Right-of-use assets will be subject to the impairment guidance for amortizing intangible assets. That guidance (ASC 350, *Intangibles – Goodwill and Other*) requires the following three-step process to identify, recognize and measure the impairment at each reporting period:

1) Indicators of impairment — Consider whether indicators of impairment are present.

2) Test for recoverability — If indicators are present, perform a recoverability test by comparing the sum of the estimated undiscounted future cash flows attributable to the asset(s) in question to their carrying amounts.

3) Measurement of an impairment — If the undiscounted cash flows used in the test for recoverability are less than the carrying amount of the asset(s), determine the fair value of the asset(s) and recognize an impairment loss if the carrying amount of the asset(s) exceeds its fair value.

Note that the right-of-use asset will often be part of an asset group and it is the asset group that is tested for recoverability and measured for impairment. That is, a right-of-use asset will be grouped with other assets at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities of the lessee. After an impairment loss is recognized, the adjusted carrying amount of the right-of-use asset will be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

How we see it

Under current US GAAP, impairment analyses for capital leases are required, but lessees do not recognize losses on lease contracts accounted for as operating leases unless and until the lessee permanently ceases use of the leased asset or terminates the lease. The proposed model therefore represents a significant change and could significantly affect the timing of expense recognition.

2.4.3 Reassessment of key considerations

Excerpt from ED

17. After the date of commencement of the lease, the lessee shall reassess the carrying amount of the liability to make lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period. When such indications exist, a lessee shall:

    (a) reassess the length of the lease term in accordance with paragraph 13 and adjust the right-of-use asset to reflect any change to the liability to make lease payments arising from changes to the lease term.

    (b) reassess the expected amount of any contingent rentals and expected payments under term option penalties and residual value guarantees in accordance with paragraph 14. A lessee shall recognize any resulting changes to the liability to make lease payments in accordance with paragraph 18.

One of the most significant changes in the proposed standard is the requirement to reassess certain key considerations throughout the life of the lease contract. At each reporting date, the lessee will reassess the carrying amount of its liability to make lease payments if new facts or circumstances indicate that a significant change occurred in the liability since the previous reporting period. Features that could drive a change include options to extend or terminate the lease, contingent rental arrangements and residual value guarantees. The discount rate used is **not** revised unless the lease terms specify that contingent rentals are contingent on variable reference interest rates (e.g., Libor). When contingent rentals are based on reference interest rates, a lessee will change the rate used to discount the lease payments to reflect changes in those reference interest rates and recognize the change to the liability to make lease payments due to changes in the discount rate in net income.

A purchase option which subsequently becomes a "bargain" is not revisited and the accounting treatment (i.e., no accounting for the purchase option) remains the same as assessed at inception.

How we see it

The Boards concluded that reassessment of the liability to make lease payments at each reporting date was required in order to properly reflect current market conditions and provide more relevant information to the users of the financial statements. To address concerns about the cost-benefit of performing these analyses, the Boards added the significant change criteria (i.e., only required to reassess if facts or circumstances indicate that there would be a significant change).

While entities would not be required to perform a detailed analysis of all lease contracts each reporting period, processes would need to be established to identify changes in facts or circumstances that may affect the estimates and judgments used to determine the liability to make lease payments. Verifying the completeness and accuracy of the best information available through coordination with the appropriate functions (e.g., operating and marketing personnel) and developing appropriate controls will be key to performing this review.

It is possible that changes could occur over time that accumulates to a significant change to the liability. For example, a lessee could have a steady decrease in its sales for leases with contingent rents based on sales. The review for significant changes process may have to be considered cumulatively rather than over a relatively short period in order to identify such changes on a timely basis.

Change in lease term

If a change in facts or circumstances has occurred related to the lease term, the lessee performs the same assessment to determine the longest possible lease term more likely than not to occur as described earlier (see Section 2.2.1). If the reassessment changes the lease term conclusion, the lessee recalculates the liability to make lease payments using the revised lease term. Any change in the liability to make lease payments because of a change in the lease term is recorded as an adjustment to the right-of-use asset. Therefore, in the period in which a change in lease term is determined, the change affects the balance sheet only and affects the income statement (amortization expense) in subsequent periods.

Example 9 — change in lease term

Consistent with example 5, a manufacturing company enters into a lease for equipment with a five-year non-cancelable base term and two five-year optional renewal periods. At inception of the lease, the manufacturing company determined that the lease term (i.e., the longest possible lease term more likely than not to occur) was 10 years. At the end of year 2, due to higher than expected volume of sales and improved business outlook, Lessee A reassesses the lease term and determines that it is more likely than not that both the first and second renewal period will be exercised and as a result, the lease term is 15 years.

At the end of year 2, the manufacturing company will calculate the present value (using the original discount rate even though it is now a 13-year lease term not the original 10-year term) of the lease obligation inclusive of the estimated lease payments for years 11 through 15 and compare the updated present value to the carrying amount of the liability to make lease payments. The difference between the newly calculated present value of the lease obligation and the carrying amount of the liability to make lease payments will be recognized as an increase to both the right-of-use asset and the liability to make lease payments.

How we see it

Under the proposed model, accounting for a contractual renewal will be different than accounting for a newly negotiated lease. In other words, the asset and liability recognized for a lease renewal will be measured differently than the asset and liability that would have been recognized had a new lease with the same terms been executed. This represents a change from current accounting whereby the exercise of a lease renewal that was not included in the original lease term is treated as a new lease and measured on a basis consistent with a newly entered into lease with those same terms.

Also, the ED does not indicate how a lessee should account for a reduction in the liability to make lease payments that exceeds the carrying amount of the right-of-use asset. The right-of-use asset and the liability to make lease payments are initially recognized at the present value of lease payments. The carrying amount of the right-of-use asset declines due to amortization while interest accretes on the liability to make lease payments. As such, a reduction in the liability to make lease payments due to a decrease in the lease term could exceed the carrying amount of the right-of-use asset (particularly in a lease with increasing lease payments). We believe that any amount of the reduction in the liability to make lease payments in excess of the carrying amount of the right-of-use asset should be recognized in net income.

Change in uncertain payments

If a change in facts or circumstances related to the uncertain payments (contingent rentals, payments under residual value guarantees or termination penalties) occurs, the lessee updates its expected outcome calculation and assesses if the change relates to prior, current or future periods. If the change in the liability to make lease payments relates to:

- Prior or current periods, then the lessee recognizes the change in net income
- Future periods, then the lessee adjusts the right-of-use asset

How we see it

Currently, it is unclear if changes to the expected amount payable to the lessor for residual value guarantees would be considered changes that relate to the current period or future periods. One view would be that the change in value was realized in the current period (i.e., the period in which the expected value of the underlying asset declined) whereas the contrary view is that the amount payable is not determined until the end of the lease term and therefore pertains to a future period. While we would lean toward the later view, it is unclear in the proposed standard.

If the change in uncertain payments relates to both current or prior periods and future periods, the lessee should quantify the amounts separately. The following example illustrates the accounting treatment for a change impacting both current and future periods.

Example 10 — change in contingent rent

Company X leases equipment for $4,000 annual rent plus $1 for each mile driven each year for a term of five years. Upon initial measurement Company X estimated the present value of the contingent rent would be $500 in year one using the expected outcome technique. During year one, Company X drove 200 miles so the actual contingent rent was $200. To record the impact of the change in liability to make lease payments, Company X records the difference in the amount expected and the actual amount ($500-$200) as a reduction to lease expense in year one.

Company X determines that a material change in facts or circumstances (diminished business outlook which would lead to decreased use of the equipment) has occurred and updates the expected outcome technique calculation for contingent rent payments. The revised estimates indicate that the present value of lease payments for the remaining term of the lease (years 2-5) is $800 lower than the carrying amount of the liability to make lease payments. Because this change relates to future years, Company X would record an $800 decrease to both the liability to make lease payments and the right-of-use asset.

Note that the diminished business outlook could be an indicator of impairment of the right-of-use asset.

Although the Boards did not provide a specific example within the ED, we believe the following example illustrates the accounting treatment for leases with contingent rent based on an index.

Example 11 — contingent rent based on an index

Company A rents office space for a five-year term with no renewal options. The annual rent, due at the end of each year, is $1,000 for the first year. For years two through five, the amount of rent adjusts from the amount of the rent in the prior year by the change in the Consumer Price Index (CPI) as determined at the beginning of each year. The CPI at the beginning of the first year is 200. Company A's incremental borrowing rate is 5%.

In determining lease payments, Company A assumes the CPI prevailing rate of 200 will remain (i.e., annual rent will be $1,000/year) as there is no readily available forward rate for the relevant CPI. At the date of commencement, Company A recognizes a liability to make lease payments and a corresponding right-of-use asset at $4,330.

During the first year of the lease, Company A recognizes amortization expense of $866 and interest expense of $216 and makes a payment of $1,000. The carrying amount of the liability to make lease payments at the end of year one is $3,546 ($4,330 initial amount plus $216 of interest accrued less the $1,000 payment made).

At the end of year one, the CPI is 205. Since 205 is the new prevailing CPI rate, Company A updates its liability to make lease payments to reflect the 2.5% ((205-200)/200) increase in expected lease payments for the remaining years (keeping the discount rate at 5%). The new expected annual lease payment is $1,025 and the updated present value of the liability to make lease payments is $3,635. The $89 increase to the liability to make lease payments represents a change in estimated contingent payments related to future periods so Company A recognizes the change as an adjustment to the right-of-use asset. The adjusted carrying amount of the right-of-use asset of $3,553 ($4,330 initial amount less $866 amortization plus the adjustment for contingent rent of $89), would be amortized over the remaining lease term.

In summary, any change related to the current and prior periods is recorded to net income since the amounts are realized. Changes driven by adjustments of future uncertain payments are recorded to the balance sheet in the year of the change and would affect amortization in subsequent periods. If a change in lease term occurred at the same time as a change in uncertain payments, each change should be separately assessed. The quantification of the change in lease term would include both certain and uncertain payments for the affected periods. The quantification of the change in uncertain payments would only reflect changes in uncertain payments for periods included in both the revised lease term and the lease term prior to revision.

How we see it

This overall reassessment accounting treatment approach is conceptually consistent with accounting for changes in estimates (ASC 250-10-45-17), which requires changes in estimates to be accounted for in the period that is affected by the change (currently or prospectively). Note however that in situations in which changes in the lease obligation occur, the carrying amount of the right-of-use asset and the timing of the expense recognition will not be equivalent to what they would have been had the original estimates reflected the revisions.

Change in lease contract

Parties to lease contracts may enter into a variety of lease modifications or changes to lease contracts (e.g., rent reduction, additional option renewal rights). Current lease accounting standards include guidance for assessing whether modifications or changes to a lease contract are accounted for as part of the original lease or constitute a new lease for accounting purposes. The ED does not include equivalent guidance. As such, it is unclear how entities will determine when a lease modification/change constitutes a new lease or how to account for such a modification.

2.5 Comprehensive example

The following example illustrates application of the right-of-use model for lessee accounting:

Example 12 — multi-year example: lessee right-of-use model

Lessee A, a retail company, enters into a lease for a new store location with a five-year non-cancelable base term and two five-year optional renewal periods. Rents under the lease consist of fixed annual base rent and contingent rent based on sales from the leased store location as follows:

Base term (years 1–5):	$1,000 + 1% of sales
First renewal period (years 6–10):	$1,200 + 1% of sales
Second renewal period (years 11–15):	$1,400 + 1% of sales

At inception of the lease, Lessee A determines that the longest possible lease term that is more likely than not to occur is 10 years (i.e., lease term includes the first renewal period only). Lessee A performs a probability-weighted assessment of contingent rents based on projections of sales for the leased store location over the 10-year period. Lessee A estimates that the contingent rent will be $100 for the first year and will increase modestly each year as sales from the store increase. Lessee A’s incremental borrowing rate as of the inception of the lease is 8.5%.

Lessee A determines that the present value of the lease payments (i.e., both base and contingent rents for years 1 through 10) at the inception of the lease is $8,000. The following journal entry would be recorded at commencement of the lease:

Right-of-use asset	8,000	
Liability to make lease payments		8,000

To initially record the asset and liability arising under the lease (present value of lease payments)

Year one

In the first year of the lease, the leased store location performs consistent with Lessee A's original expectations and there are no changes in facts or circumstances that affect Lessee A's expectations regarding renewal options or contingent rents for future periods. The following journal entries would be recorded:

Amortization expense	800	
Right-of-use asset		800

To record amortization of the right-of-use asset

Interest expense	680	
Liability to make lease payments		680

To record interest expense on the liability to make lease payments using the interest method

Liability to make lease payments	1,100	
Cash		1,100

To record cash paid for rents (base rent of $1,000 and contingent rent of $100)

Year two

In the second year of the lease, sales at the leased store location were significantly higher than originally estimated. As a result, actual contingent rents for year two of the lease were greater than originally projected (i.e., estimated contingent rent was $110 and actual contingent rent was $150). At the end of year two, Lessee A adjusts forecasted sales for future years from the leased store location to reflect the higher than previously anticipated sales that they now expect to continue. In addition, based on the expected continuation of the higher sales at the leased store location, Lessee A determines (at the end of year two for simplicity purposes) that it is now more likely to exercise the second renewal option and that the longest possible lease term that is more likely than not to occur is 15 years (i.e., lease term includes both renewal periods).

Lessee A would record the following entries to amortize the right-of-use asset and recognize interest expense in year two:

Amortization expense	800	
Right-of-use asset		800
Interest expense	644	
Liability to make lease payments		644

Lessee A would record the excess contingent rent incurred for year two as an expense in year two:

Contingent rent expense	40	
Liability to make lease payments		40

To record change in the liability to make lease payments for changes in contingent rents related to the current period

Total cash payment made for year two would reduce the obligation:

Liability to make lease payments	1,150	
Cash		1,150

To record cash paid for rents (base rent of $1,000 and contingent rent of $150)

Lessee A reassessed the liability to make lease payments (both base and contingent rents) over the revised lease term and adjusts the liability to make lease payments to the revised amount using the original discount rate (i.e., the incremental borrowing rate at the inception of the lease). The following entry is recorded:

Right-of-use asset	4,300	
Liability to make lease payments		4,300

To record change in the liability to make lease payments due to change in lease term and for changes in contingent rents related to future periods

Year three

In the third year of the lease, the leased store location performs consistent with Lessee A's revised expectations and there are no changes in facts or circumstances that affect Lessee A's expectations regarding renewal options or contingent rents. The following journal entries are recorded:

Amortization expense	823	
Right-of-use asset		823

To record amortization of the right-of-use asset (based on adjusted right-of-use asset and revised lease term)

Interest expense	970	
Liability to make lease payments		970

To record interest expense on the liability to make lease payments (based on adjusted obligation and original discount rate)

Liability to make lease payments	1,170	
Cash		1,170

To record cash paid for rents (base rent of $1,000 and contingent rent of $170 — consistent with revised estimates)

The following table summarizes the cash payments made and expense recognized in each of the first three years of the lease and demonstrates the effect that a longer lease term and increased contingent payments can have on the periodic expense recorded under the proposed model.

	Year 1	Year 2	Year 3
Cash payments:			
Base rent	1,000	1,000	1,000
Contingent rent	100	150	170
	1,100	1,150	1,170
Expense:			
Amortization expense	800	800	823
Interest expense	680	644	970
Excess contingent rent expense	–	40	–
	1,480	1,484	1,793

Note that under current operating lease accounting, periodic rent expense for each of the first three years will likely be equivalent to the cash payment amounts.

2.6 Presentation

The following table summarizes how amounts related to leases will be presented on the financial statements of lessees:

Financial statement	Lessee presentation
Statement of financial position	▶ Right-of-use asset presented within property, plant and equipment but separately from assets that the lessee does not lease ▶ Liabilities to make lease payments presented separately from other financial liabilities
Income statement (or disclosed in notes)	▶ Lease related amortization and interest expense presented separately from other amortization expense and other interest expense
Statement of cash flows	▶ Cash payments for leases classified as financing activities and shown separately

The right-of-use asset is presented with property, plant and equipment, but separately from other assets that are not leased. Although the right-of-use asset could be viewed as an intangible asset, the Boards concluded that presentation with property, plant and equipment would provide better information about how the lessee uses the underlying asset and the productive capacity of its business. The right-of-use asset is presented separately from owned assets because there are important differences between right-of-use assets and owned assets, including financial flexibility and different risks.

The liability to make lease payments is presented separately from other financial liabilities as the liability to make lease payments is a unique class of liability that is linked to a corresponding asset and may have features such as options and contingent rentals that differ from other financial liabilities.

Presentation of amortization expense and interest expense on the income statement or disclosed in the notes is determined based on the relevance to the company's financial performance.

In a significant change from current practice, cash payments for all leases will be classified as financing activities. Currently cash flows from operating leases are presented as an operating cash outflow by lessees.

How we see it

Changes to the liability to make lease payments resulting from remeasurement of the expected amount of uncertain payments related to current or prior periods should be recognized in net income. Additionally, right-of-use assets are subject to potential impairment which would be recognized in net income. However, the ED is unclear as to the presentation of these amounts on the income statement.

2.7 Summary of differences

2.7.1 Proposed model compared to current US GAAP

Under the proposed model, the operating lease classification is no longer allowed. All leases must now follow the same model and will be recorded on the balance sheet. While not as significant as the changes to operating leases, leases currently accounted for as capital leases also will be impacted. The following is a summary of the more significant differences for lessee accounting between the proposed model and current US GAAP.

Topic	Proposed model	Current US GAAP
Recognition	► All leases required to be recognized on the balance sheet (a right-of-use asset and a liability to make lease payments)	► Four part bright-line test which specifies whether accounted for as a capital lease (i.e., recognized on balance sheet) or operating lease
Measurement	► Lease term is the longest possible lease term more likely than not to occur and therefore includes renewal periods that are likely to be exercised ► Measurement of lease payments uses an expected outcome (weighted average) technique and includes uncertain payments (e.g., contingent rent) ► Index-based contingent rent measured using readily available forward rate or prevailing rate (if no forward rate available) ► Consideration of the guaranteed residual value within the measurement of the liability is based on the expected amount that the lessee will pay (the calculated difference between the total residual value guarantee and actual value at the end of the term)	► Lease term only includes non-cancelable lease term and renewal periods that are reasonably assured of exercise (e.g., bargain renewals) ► Measurement of amounts recognized as assets and liabilities for capital leases based on minimum lease payments only (contingent rent is excluded) ► Index-based contingent rent included in minimum lease payments based on index rate existing at lease inception ► Consideration of the guaranteed residual value within the minimum lease liability is based on the amount of the guaranteed residual value

Topic	Proposed model	Current US GAAP
Reassessment of liability	► Requires ongoing reassessment for new facts or circumstances which would affect the lease term and lease payment estimates	► Generally no reassessments
Impairment analysis	► Right-of-use assets assessed for impairment using impairment guidance for amortizing intangible assets (long-lived asset model)	► Assets under capital lease require ongoing impairment analysis using impairment guidance for fixed assets (long-lived assets model) ► Liability for costs to be incurred under an operating lease without economic benefit to the lessee recognized and measured at fair value as of the cease-use or termination date
Presentation	► Right-of-use asset presented separately from owned assets within property, plant and equipment ► All leases give rise to amortization expense and interest expense (unless the short-term lease simplified method applies) ► Cash payments for leases classified as financing activities and shown separately	► Assets under capital lease may be combined with property, plant and equipment ► If accounted for as an operating lease, lease expense included as rent expense within the appropriate classification (e.g., operating expense, SG&A) ► Cash payments for operating leases are included within operating activities

How we see it

The leases project is just one of many projects that the Boards intend to complete in the near future. This project is therefore influenced by and linked to other projects such that decisions made in other projects, such as the Boards' projects on revenue recognition and financial statement presentation, could affect the final leases standard. For example, the proposals for presentation of leases by the lessee do not consider the proposals in the Boards' ongoing project on financial statement presentation. Companies should monitor these projects and related conclusions as they consider lessee accounting treatment and presentation.

2.8 Transition

2.8.1 Summary

Due to the long-term nature of many leases and the significance of the accounting changes proposed as well as to help ensure comparability, the Boards have proposed what they refer to as a simplified retrospective approach for transition to the new leases standard and existing leases will not be grandfathered. While the specific transition date has not yet been set, the Boards have concluded that lessees should recognize and measure all outstanding leases as of the date of initial application, which is defined as the beginning of the first comparative period presented in the first financial statements in which the entity applies the proposed guidance. For example, if the leases standard is effective for calendar year 2015, then the date of initial application for a calendar year company that prepares a three-year comparative income statement is 1 January 2013.

2.8.2 Measurement at the date of initial application

As of the date of initial application (e.g., three years prior to the date of adoption for a SEC filer), lessees would determine the lease term as well as contingent rents and expected payments under termination penalties and residual value guarantees. The liability to make lease payments will be measured at the present value of the lease payments discounted using the lessee's incremental borrowing rate at the date of initial application. Lessees will determine the lease term by assessing the longest possible lease term more likely than not to occur and measure the lease payments following the expected outcome technique, as described earlier (see Section 2.2.2). The right-of-use asset will be measured on the same basis as the liability, subject to any adjustments for impairment. Additional adjustments may be required for prepaid or accrued lease payments.

The initial recognition provisions described above are modified in the following situations:

- Simple capital leases — Simple capital leases will not be affected significantly by the proposed leases model. That is, the measurement of the right-of-use asset and liability to make lease payments for capital leases without options, contingent rentals and (or) residual value guarantees generally will not result in measurements that are significantly

different from current accounting for capital leases. Therefore, the right-of-use asset and the liability to make lease payments at transition for simple capital leases will be the carrying amount of the lease asset and liability under the current accounting model.

- Short-term leases — If a lessee elects to use the short-term lease simplified model (see Section 1.5), short-term leases (12 months or less in maximum lease term) at the date of application would be recognized by recording a gross right-of-use asset and liability to make lease payments measured at the undiscounted amount of the remaining lease payments (lessee does not need to discount).

As discussed earlier, leases with an automatic transfer of title or bargain purchase option normally would be considered in-substance purchases and excluded from the scope of the proposed new leases standard; therefore, some capital leases under current US GAAP may not be in scope. It is not clear how such arrangements will be accounted for or what the transition provisions (if any) will be for such arrangements; however, at this time we expect them to be accounted for as a financed purchase of an asset.

Entities will need to record a cumulative effect of a change in accounting to each affected component of equity as of the date of initial application to the extent that the amounts recognized under the ED differ from the amounts previously recognized.

How we see it

Under current US GAAP, operating leases require no ongoing analysis for impairment or loss contracts and losses are only recorded if the lessee ceases to use the lease asset; however, the proposed model would require right-of-use assets to be subject to potential impairments even if the lessee is still using the underlying leased asset. Companies will need to assess if, based on the proposed guidance, right-of-use assets are impaired on the date of initial application. The right-of-use asset would be recorded at the post-impairment value and any adjustment would be part of the cumulative effect adjustment to equity.

2.8.3 Subsequent to the date of initial application

Subsequent to the date of initial application, lessees should perform the following:

- For leases recognized at the date of initial application, the same accounting treatment described at Section 2.4 for subsequent measurement will apply, including amortizing the right-of-use asset, recognizing interest expense, reassessing the liability and performing impairment analysis as necessary.
- Any new leases that commence after the date of initial application will be recognized on the balance sheet at the commencement date of the lease and lessees will apply the accounting treatment described at Section 2.3.

Example 13 — transition

Company A is a calendar year public company required to apply the new leases standard in its annual financial statements for periods beginning on or after 15 December 2016. The date of initial adoption for Company A is 1 January 2015 (the beginning of the first comparative period presented in its 2017 annual financial statements). To record its initial adoption, the company compiles a list of all leases outstanding as of 1 January 2015.

One of the leases identified is a lease of equipment with a five-year term and one two-year renewal option, annual payments of $1,000 due at the beginning of each year and a commencement date of 1 January 2014.

The company determines the following as of 1 January 2015 (even though likely performed in 2016 or 2017):

- Company A's incremental borrowing rate is 7.5%
- The longest possible remaining lease term more likely than not to occur is four years
- Lease payments will be $1,000 annually (no contingent payments)

The present value of the liability to make lease payments as of 1 January 2015 is $3,600. The company determines that no impairment indicators exist for this lease as of the date of initial adoption so the company records a comparable right-of-use asset for $3,600. Since no amount was prepaid or accrued as of 1 January 2015, no additional adjustment is required.

While the opening balance sheet is not presented in the 2017 financial statements, Company A presents the 2015 income statement affect based on the 1 January 2015 measurement as follows:

- Recognizes amortization expense of $900 ($3,600/4 years)
- Recognizes interest expense on the liability to make lease payments of $195 ($2,600 x 7.5%)

How we see it

Depending on when the proposed leases standard is finalized and the required effective date, the date of initial application for some entities may precede the finalization of the new standard. The retrospective determination of estimates as of the date of initial application will be difficult if these amounts are not captured contemporaneously. The transition method may require retrospective determination of estimates, something which potentially could be considered impracticable under ASC 250.

Chapter 3: Lessor accounting

3.1 Overview of lessor accounting

Over the life of the leases project, there has been debate as to whether or not lessor accounting should be modified as part of the initial leases project or whether it could wait until a later time. The Boards ultimately decided to change lessor accounting to make it consistent with the proposed accounting for leases by lessees. As a result, lessors will be required to account for the assets and liabilities arising from lease contracts under the right-of-use model. The Boards also intend for lessor accounting under the right-of-use model to be conceptually consistent with the Boards' joint project on revenue recognition.

As discussed in Section 1.4, the ED proposed that contracts that represent the sale (or purchase) of the underlying asset be excluded from lease accounting. As such, arrangements currently considered leases, for example leases that include a bargain purchase option or automatically transfer title of the underlying asset to the lessee, would no longer be considered leases and would not be accounted for under the proposed guidance described herein.

As discussed in Section 1.5, lessors in qualifying short-term leases will be allowed to elect to use a simplified form of lease accounting whereby the lessor will recognize lease payments in income over the lease term (i.e., similar to current operating lease accounting, albeit without straight-lining) and will not recognize lease assets or lease liabilities or derecognize any portion of the underlying leased asset. That is, lessors will be able to elect to not apply the accounting described in this chapter to qualifying short-term leases.

The FASB's current project on investment properties (as described further in Section 1.7) may have a significant effect on lessors of investment property. If the FASB requires investment property to be measured at fair value, lessors of investment property likely will be excluded from the scope of the proposed leases model consistent with the preliminary decisions made by the IASB for lessors of investment property measured at fair value.

3.2 Leveraged leases

Leveraged leases are a unique class of leases that are financed by lessors using nonrecourse debt and meet certain specified criteria. Current US GAAP requires a lessor in a leveraged lease to apply special accounting that affects the pattern of income recognition, the presentation of the net investment in the lease and the related nonrecourse debt, and the measurement of income tax related amounts. While the FASB considered retaining the specialized accounting for leveraged leases, they ultimately decided not to retain it. As such, the assets and liabilities that arise in leveraged leases will be accounted for under the lessor accounting model described below and the debt, interest and income tax related amounts will be subject to other applicable accounting guidance (e.g., ASC 470, *Debt*, ASC 740, *Income Taxes*).

How we see it

Leveraged leases are used principally in the financial services industry. Removal of the specialized accounting for these leases will result in a significant change in how these transactions are reported in the balance sheet and the income statement. On the balance sheet, the amounts for lease receivable and debt will be grossed up. The income statement will be affected in terms of both timing and presentation as lease income and interest income on the lease receivable, interest expense on the debt and income tax related amounts will no longer be determined under the "investment with separate phases method," but rather determined and presented based on the applicable guidance for each component.

3.3 Proposed approaches

To account for leases under the right-of-use model, lessors will apply one of two approaches to each lease based on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. Lessors will determine which approach to apply at the inception of the lease and the determined approach will not change over the lease term. The performance obligation approach will be applied when the lessor has retained exposure to significant risks or benefits associated with the underlying asset. When the lessor does not retain exposure to significant risks or benefits associated with the underlying asset, it will apply the derecognition approach.

3.3.1 Exposure to significant risks or benefits

The proposed guidance will require lessors to evaluate each lease to determine whether they retain exposure to significant risks or benefits associated with the underlying asset either during the expected term of the lease or after the expected term of the lease. Paragraphs B22 and B24 provide factors that lessors should consider in making this assessment.

Excerpt from the ED

B22. A lessor shall consider the following factors in assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the current lease:

(a) significant contingent rentals during the lease term that are based on the use or performance of the underlying asset.

(b) options to extend or terminate the lease.

(c) material non-distinct services provided under the current lease.

B24. A lessor shall consider the following factors when determining whether it retains exposure to significant risks or benefits associated with the underlying asset after the expected term of the current lease:

(a) whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset.

(b) whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making that assessment, the lessor shall consider:

(i) the present value of the underlying asset at the end of the lease term, and

(ii) the effect that any residual value guarantees (including those provided by an unrelated third party) may have on the lessor's exposure to risks or benefits

The ED provides factors to consider when assessing whether or not a lessor has retained exposure to significant risks or benefits associated with the underlying asset during the lease term. A lessor will evaluate the terms and conditions of each lease to determine the exposure to significant risks or benefits associated with the underlying asset. The ED specifies that this analysis should exclude the risks associated with the counterparty credit risk of the lessee. That is, the assessment focuses on the lessor's exposure to the risks and benefits associated with the underlying asset and not the risk of the lessee failing to pay. Lease contracts that include significant contingent rentals based on the use or performance of the underlying asset can result in a lessor retaining exposure to the underlying asset. For example, if a significant amount of lease payments in a lease of an automobile are based upon the number of miles driven by the lessee, the lessor has retained exposure to the risks and benefits associated with the automobile. Lessee optionality can also result in the lessor retaining exposure to the risks or benefits related to the underlying asset. For instance, if a lease contract provides the lessee the right to cancel the lease, the lessor could be exposed to the risks or benefits associated with the leased asset as the lessee could terminate the lease requiring the lessor to re-lease, sell or use the asset. Also, if a lease contract includes material non-distinct services, that is, the lease of the asset is combined with other integrated services that do not meet the criteria to be considered distinct (see Section 1.3 for further discussion of distinct services), a lessor could retain exposure to the risks or benefits associated with the underlying asset.

The ED also provides factors to consider when assessing whether or not a lessor has retained exposure to significant risks or benefits associated with the underlying asset after the lease term. A lessor will evaluate whether it has the expectation or the ability to generate significant returns by re-leasing or selling the underlying asset subsequent to the expected term of the lease. A lease that is relatively short in comparison to the underlying asset's remaining useful life generally will expose a lessor to significant risks and benefits associated with the underlying asset as the lessor will need to either re-lease the asset, sell the asset or use the asset at the end of the expected lease term. For example, a lessor that leases a new commercial airplane to a lessee under a five-year lease would retain exposure to significant

risks and benefits associated with the airplane as the useful life of the airplane is significantly longer than five years and the lessor will need to either lease, sell or use the airplane after the end of the lease. Another factor to consider is the lessor's exposure to significant changes in value of the underlying asset at the end of the expected term of the lease. To assess this exposure, a lessor should consider both the present value of the underlying asset at the end of the lease term and the effect of any residual value guarantees. Third-party residual value guarantees should be included in this assessment even though third-party residual value guarantees are not considered a part of the lease under the ED. A residual value guarantee generally will reduce a lessor's exposure to decreases in the value of the underlying asset, but may give a lessor the potential to benefit from increases in the expected value of the underlying asset at the end of the lease. A lessor must consider its exposure to both the risks and benefits associated with the underlying asset.

In certain leases, the lessor's business model may give some indication of the approach that is likely to apply. The derecognition approach often will be appropriate when an entity's business model is to provide financing without assuming asset risk because the profit of that business is derived from interest income and lessors operating under this model generally try to minimize asset risk. The performance obligation approach often will be appropriate in those circumstances where the business model is characterized by asset risk. For example, entities whose primary business model is to actively manage the underlying assets to generate a return either from leasing those assets to multiple lessees during their life or from the use or sale of those assets at the end of the lease. Another example of where the performance obligation approach often would be applied is a business model where a lessor primarily generates a variable return during the term of the lease by accepting payments that are contingent on the usage or performance of the underlying asset.

How we see it

The proposed guidance will require lessors to exercise significant judgment in their assessment of whether they retain exposure to significant risks or benefits associated with the underlying asset. The ED does not define the term significant and provides no bright lines to use in determining the approach to use for each lease. As proposed, the lessor accounting contains many attributes of current finance versus operating lease determinations without the bright lines. In this regard, the proposed guidance is more like the current guidance in IAS 17, *Leases*.

The proposed guidance provides that the existence of one or more indicators is not conclusive in making this assessment. As such, lessors should carefully evaluate the factors provided in the ED and other relevant facts and circumstances to determine which approach to use for each lease. Lessors will also need to develop policies to ensure that individual leases are assessed on a consistent basis.

3.4 Lease receivable

Under both the performance obligation approach and the derecognition approach, lessors will recognize an asset for their right to receive lease payments (i.e., a lease receivable) at the commencement of the lease. The amount of the receivable will not be affected by which approach to lessor accounting applies. The receivable recognized by the lessor for the right to receive lease payments is measured (i.e., lease term and payments) in much the same way as the liability to make lease payments is measured by the lessee. The lease receivable will be initially measured at the inception of the lease based on the present value of the lease payments expected to be received over the lease term and any initial direct costs incurred by the lessor. The ED provides the following description of how a lessor will measure the present value of lease payments:

Excerpt from the ED

34. A lessor shall determine the lease term by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease (see paragraphs B16-B20).

35. A lessor shall determine, using all relevant information, the present value of the lease payments receivable during the lease term determined in accordance with paragraph 34 on the basis of expected outcome. The expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes (see paragraph B21). In determining the present value of lease payments receivable, a lessor shall include:

    (a) an estimate of contingent rentals receivable that the lessor can reliably measure. If the contingent rentals depend on an index or a rate, the lessor shall determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessor shall use the prevailing rates or indices.

    (b) an estimate of amounts receivable from the lessee under residual value guarantees that the lessor can reliably measure. Residual value guarantees that are provided by an unrelated third party are not lease payments.

    (c) an estimate of expected payments from the lessee under term option penalties.

36. The exercise price of a purchase option included in a lease is not a lease payment and the purchase option is not included in determining the present value of lease payments receivable.

The Boards believe that the lease receivable meets the definition of a financial asset. Financial assets generally are measured at fair value. However, the Boards think that the right to receive lease payments has features unique to leases such as options and contingent rentals. As a result, the Boards concluded that lessors should not account for lease assets in the same way as other financial assets (e.g., there is no fair value option) unless the receivable is impaired, transferred or derecognized.

3.4.1 Lease term

The recognized lease term will be the longest possible lease term that is more likely than not to occur. In determining the lease term, the lessor will evaluate the probability of occurrence for each possible lease term considering the effects of any options to extend or terminate the lease. Both lessees and lessors will use the same approach to determine the lease term. For a further discussion and illustration of the lease term determination, see Section 2.2.1.

How we see it

While the approach to determine the lease term is the same for lessors and lessees, the different estimates and judgments involved can result in lessees and lessors using different lease terms for the same lease arrangement. For example, a lessee that has an option to renew a lease is in control of the exercise of the option and has a more complete understanding of its own plans than the lessor. The lessee may determine that a renewal option is more likely than not of being exercised, while the lessor may not have adequate insight to reach that same conclusion.

3.4.2 Lease payments

Lease payments include fixed rentals and rentals subject to uncertainty, such as contingent rents and amounts payable by the lessee under residual value guarantees and termination penalties. A lessor will determine lease payments using an expected outcome technique similar to the approach used by a lessee. See Section 2.2.2 for further discussion and illustration of the expected outcome technique.

Lease payments will include the amounts that a lessor expects to receive for contingent rents and lessee residual value guarantees only to the extent that the lessor can reliably measure those amounts. Certain amounts of contingent rents will be difficult to measure since they depend on the actions of lessees. However, the proposed model assumes that entities negotiate leases with contingent rental arrangements with some level of understanding about the likely amount of payments. To the extent these amounts are not reliably measurable, they would not be included.

How we see it

A lessor's determination of the lease payments used to measure the lease receivable may be different than a lessee's determination of lease payments used to measure its liability to make lease payments because of the different estimates and judgments used by lessors and lessees in determining the present value of lease payments. Additionally, while the amounts for contingent rents and residual value guarantees are only included in lease payments by lessors to the extent those amounts can be measured reliably, lessees include estimates of such amounts without any restriction.

In deciding that estimated contingent rents and amounts receivable under residual value guarantees only be included in lease payments to the extent a lessor can reliably measure those amounts, the Boards indicated that doing so would achieve consistency with the proposals being jointly developed by the Boards as part of their revenue recognition project. Interestingly, the revenue recognition exposure draft requires that variable consideration be "reasonably estimated" in order to be included in the measurement of consideration and provides that in order to be reasonably estimated, the following conditions that must be met:

(a) the entity has experience with similar types of contracts (or access to the experience of other entities if it has no experience of its own); and

(b) the entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.

It is unclear if the requirement that a lessor can "reliably measure" uncertain lease payments is intended to be the same as the "reasonably estimated" criteria in the revenue recognition exposure draft.

Also, it is important to note that a similar constraint does not exist related to the lessor's determination of the lease term. That is, the ED does not require that a lessor be able to "reliably measure" or "reasonably estimate" the probability of renewals occurring in order to include renewal periods in the lease term.

Lessors should exclude purchase options from expected lease payments (see Section 2.2.2.1 for further discussion of purchase options). Additionally, while third-party residual value guarantees are included in the evaluation of whether a lessor retains exposure to significant risks or benefits associated with the underlying asset, they are not considered payments to be received from the lessee and should be excluded from the expected lease payments.

3.4.3 Discount rate

The discount rate used by the lessor to determine the present value of lease payments is the rate the lessor charges the lessee. The rate the lessor charges the lessee is defined as "a discount rate that takes into account the nature of the transaction as well as the specific terms of the lease such as lease payments, lease term and contingent rentals." The ED describes the rate the lessor charges the lessee as follows:

Excerpt from the ED

B12. The discount rate used to determine the present value of lease payments for lessors is the rate that the lessor charges the lessee. The rate the lessor charges the lessee could be, for example, the lessee's incremental borrowing rate, the rate implicit in the lease (that is, the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset) or, for property leases, the yield on the property.

The rate the lessor charges the lessee is a new concept that is not used in current lease accounting. The definition and description above tend to indicate that a great deal of latitude will be allowed in determining the appropriate discount rate to use. Under current US GAAP, the term "interest rate implicit in the lease" is defined differently than the description of the "rate implicit in the lease" above as the current use of that term is in the context of an accounting model based on minimum lease payments. Note that a lessee may also use the rate the lessor charges the lessee as the discount rate in determining the present value of lease payments if the lessee can readily determine that rate (see Section 2.2.3).

How we see it

Although the ED provides a number of possible rates that could constitute the rate the lessor charges the lessee (e.g., lessee's incremental borrowing rate, rate implicit in the lease, yield on property being leased), the rate the lessor charges the lessee is not meant to be the stated interest rate on a lease. That is, neither a lessee nor a lessor can simply look to the contractually stated interest rate on a lease to determine the rate the lessor charges the lessee. For example, a lease that states the lessor is charging the lessee 0% interest rate would not result in a 0% discount rate.

3.4.4 Initial direct costs

Any initial direct costs incurred by the lessor are included in the right to receive lease payments. Initial direct costs are defined as recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made. The ED does not address situations in which a lessee pays initial direct costs that are attributable to the lessor. As such, it would appear that when a lessee pays for a lessor's initial direct costs, those amounts would not be included in the lessor's lease receivable. The ED provides examples of initial direct costs and examples of costs that are not initial direct costs.

Excerpt from the ED

B14. Initial direct costs result directly from, and are essential to, acquiring or originating a lease and would not have been incurred had the lease transaction not been made. They may include:

(a) commissions

(b) legal fees

(c) evaluation of the prospective lessee's financial condition

(d) evaluating and recording guarantees, collateral and other security arrangements

(e) negotiating lease terms

(f) preparing and processing lease documents

(g) closing the transaction

(h) other costs that are incremental and directly attributable to negotiating and arranging the lease

B15. The following items are not initial direct costs:

(a) general overheads, such as rent, depreciation, occupancy and equipment costs, unsuccessful origination efforts and idle time.

(b) costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases or other ancillary activities.

How we see it

In addition to the potential differences in lease term and lease payments determined by the lessor in comparison to those determined by the lessee discussed earlier, the initial direct costs incurred by the lessor would be included in the lessor's lease receivable but are not included in the lessee's liability. As such, the lessor's receivable will not necessarily mirror the lessee's liability.

3.4.5 Subsequent measurements

After the date of commencement of the lease, the lessor will measure the lease receivable at amortized cost using the interest method. The lessor will recognize interest income over the lease term and lease payments will reduce the lease receivable. The lessor will evaluate the lease receivable for impairment each reporting period using the guidance in ASC 310, *Receivables*.

3.4.6 Reassessment requirements

Lessors will be required to reassess the judgments and estimates used to determine the lease term and the present value of lease payments as facts or circumstances indicate that there could be a significant change in the right to receive lease payments since the previous reporting period. The right to receive lease payments (i.e., the lease receivable) will be reassessed each reporting period and will be adjusted to reflect changes in facts or circumstances, similar to how lessees reassess their liability to make lease payments. For example, a lessor's receivable would be reassessed if any new facts or circumstances indicate that there is a material change in estimates or judgments regarding contingent rents or residual value guarantees or adjustments to the lease term. The discount rate used is **not** revised unless the lease terms specify that contingent rentals are contingent on variable reference interest rates (e.g., Libor). When contingent rentals are based on reference interest rates, a lessor will change the rate used to discount the lease payments to reflect changes in those reference interest rates and recognize the change to the lease receivable due to changes in the discount rate in net income.

3.5 Performance obligation approach

Under the performance obligation approach, the underlying leased asset is considered to remain the lessor's economic resource, and the lessor is committed to allow the lessee to use the underlying leased asset during the term of the lease. At the lease commencement date (i.e., the date on which the lessor makes the underlying asset available for use by the lessee) the lessor will recognize a lease receivable and a lease liability (performance obligation) for its obligation to permit the lessee to use the leased asset. Lessors will retain the leased asset on the balance sheet and will continue to depreciate the leased asset and evaluate it for impairment when necessary.

3.5.1 Measurement of the lease liability

Lessors will measure the lease liability at the inception of the lease (i.e., the earlier of the date of the lease agreement or the date of commitment by the parties to the lease agreement) at the present value of the expected lease payments. In other words, the measurement of the lease liability will be the same amount as the measurement for the lease receivable less any initial direct costs incurred by the lessor.

3.5.2 Recognition of lease income

Under the performance obligation approach the lease liability recognized is a performance obligation of the lessor. The lessor satisfies the performance obligation by permitting the lessee to use the underlying asset continuously during the lease term. The lessor will recognize income as the lease liability is satisfied over the term of the lease. Income is recognized by the lessor as the lease liability is reduced in a systematic and rational manner based on the pattern of use of the underlying asset by the lessee (e.g., over time, based on hours of use). A lessor will not recognize any income at the commencement of the lease (i.e., upon delivery of the

leased asset) under this approach. Under the performance obligation approach, lessors generally will recognize lease income on a straight-line basis similar to the accounting for operating leases under the current accounting standards.

Example 14 — performance obligation approach

Lessor A leases an apartment to Lessee B for monthly rent of $1,000 under a three-year non-cancelable lease that does not contain any renewal options or uncertain payments. Lessor A would recognize a lease liability for the present value of the lease payments (i.e., the 36 monthly payments of $1,000) discounted using the rate Lessor A is charging Lessee B in the lease and a lease receivable for the amount of the lease liability and any initial direct costs incurred by Lessor A. Lessor A would recognize lease income and reduce the lease liability on a straight-line basis over the lease term. Note that Lessor A would also recognize interest income on the lease receivable and continue to depreciate the underlying asset.

3.5.3 Reassessment of the lease receivable

Adjustments to the lease receivable for changes in the estimated lease term will be recorded as an adjustment to the lease liability.

Adjustments to the lease receivable for changes in expected lease payments for contingent rents or expected payments under termination penalties and residual value guarantees will be treated as adjustments to the original transaction price. If a change relates to a satisfied obligation, the change will be recognized in net income. If a change relates to an unsatisfied obligation, the lease liability will be adjusted.

Example 15 — reassessment under the performance obligation approach

Lessor in a five-year lease that includes a lessee residual value guarantee estimates the reliably measureable amount receivable from the lessee under the residual value guarantee using an expected outcome approach as of the inception of the lease. The lease liability is reduced on a straight-line basis over the lease term. At the end of two years (3 years left), facts and circumstances indicate that the expected payments from the lessee under the residual value guarantee will be higher than originally expected. Lessor would adjust the amount of the receivable to reflect the higher amount (i.e., the present value of the expected payments) and recognize 40% of the adjustment as revenue and 60% as an adjustment to the lease liability as the lessor has satisfied 40% (2 years out of 5 years) of its performance obligation.

Note that if a change in the lease receivable that is required to be recognized as a reduction to the lease liability based on the guidance described above exceeds the carrying amount of the lease liability, any excess amount will be recognized in net income. That is, if a reduction in the lease receivable is greater than the lease liability, a loss will be recognized.

3.5.4 Performance obligation approach example

The following example illustrates the application of the performance obligation approach:

Example 16 — Performance obligation approach

Lessor A leases equipment to Lessee B. The equipment has a cost basis of $360,000 and a useful life of 15 years. The lease has a two-year non-cancelable lease term and no renewal options. The annual rent is $50,000 due at the end of each year. Lessor A is charging Lessee B interest (as determined in accordance with the ED) at 11%.

At lease commencement, Lessor A would record a receivable and lease liability:

Lease receivable	85,000	
Lease liability		85,000

To initially record the liability and asset arising under the lease (present value of lease payments)

In the first year of the lease, Lessor A would continue to depreciate the asset, recognize revenue as it satisfies its performance obligation and record interest on the receivable:

Depreciation expense	24,000	
Accumulated depreciation		24,000

To record depreciation of the underlying asset ($360,000 cost basis/15-year useful life)

Lease liability	42,500	
Revenue		42,500

To record the reduction of the lease liability and recognize revenue a straight-line basis ($85,000/2-year lease term)

Lease receivable	9,350	
Interest income		9,350

To recognize interest income using the interest method

Cash	50,000	
Lease receivable		50,000

To record cash received for lease payments

How we see it

In many ways the accounting for leases under the performance obligation approach will be similar to accounting for leases as operating leases under current accounting standards (e.g., underlying asset remains on the balance sheet and is depreciated, lease income is recognized over the lease term). However, there are important differences (e.g., lease receivable and lease liability are recognized on the balance sheet, interest income is recognized). While many contracts classified as operating leases will be accounted for under the performance obligation approach, care must be taken by lessors to assess their exposure to significant risks or benefits related to the underlying asset. Every lease currently classified as an operating lease will not meet the requirements to apply the performance obligation approach (i.e., some will be accounted for under the derecognition approach).

3.5.5 Presentation

The following table summarizes how amounts related to leases accounted for under the performance obligation approach will be presented on the financial statements of lessors:

Financial statement	Lessor presentation
Statement of financial position	▶ Leased assets, lease receivables and lease liabilities presented separately and totaling to a net lease asset or a net lease liability
Income statement	▶ Lease income, interest income and depreciation expense presented separately and totaling to a net lease income or a net lease expense
Statement of cash flows	▶ Cash receipts from lease payments classified as operating activities

Lessors will be required to present gross amounts in the balance sheet for the leased assets, lease receivables and lease liabilities. The gross amounts will be shown separately from other assets and liabilities and the net of these amounts will be presented as a net lease asset or net lease liability. The Boards acknowledge that the criteria for offsetting the lease receivable and the lease liability are not met, thereby requiring gross presentation; however, the grouped presentation is provided because it:

- Reflects the interdependency of these amounts (i.e., the leased asset, the lease receivable and lease liability)
- Reflects that the lessor continues to own the leased asset
- Alleviates the concern that presenting these items separately inappropriately overstates both total assets and total liabilities in the balance sheet

The following illustrates the grouped presentation:

Lessor balance sheet presentation (performance obligation approach)		
Cash		X
Property, plant and equipment		X
Assets leased to others	X	
Lease receivables	X	
Lease liabilities	(X)	
Net lease asset		X
Total assets		X

How we see it

The ED requires that the information discussed above be presented in the balance sheet; however, it does not provide specific guidance on how to present it. For example, the proposed model does not provide guidance for whether entities with classified balance sheets will be required to separately present current and non-current net lease assets and net lease liabilities. Also, there is no guidance provided in the ED on the appropriate aggregation of leases for presentation purposes (e.g., whether or not net lease assets should be combined with net lease liabilities).

Similar to the balance sheet presentation, a lessor will present on a gross basis the interest income on a right to receive lease payments, lease income (i.e., income generated from the satisfaction of a lease liability) and depreciation expense on an underlying asset separately, totaling to a net lease income or net lease expense.

The following illustrates the grouped presentation:

Lessor income statement presentation (performance obligation approach)		
Interest income from lease receivables	X	
Lease income	X	
Depreciation expense	(X)	
Net lease income		X

The FASB's proposed income statement presentation does not match the proposed presentation by the IASB. The IASB's proposed guidance does not require the presentation of a total net lease income or net lease expense, but requires that interest income, lease income and depreciation expense should be presented as separate components of the income statement on a basis consistent with other interest income, and income and depreciation arising from non-leased assets.

Cash receipts from lease payments will be presented as operating activities in the statement of cash flows. Those entities applying the indirect method will present the changes in the right to receive lease payments separately from changes in other operating receivables. Those entities applying the direct method (as currently proposed in the FASB's Financial Statement Presentation project) will present the cash flows from lease payments separately from other cash flows from operating activities.

3.6 Derecognition approach

Under the derecognition approach, some of the economic benefits associated with the underlying leased asset are considered to transfer to the lessee at the commencement of the lease in exchange for an unconditional right to receive lease payments. At the date of commencement of the lease, the lessor will recognize a lease receivable and derecognize the portion of the underlying asset representing the economic benefits that were transferred to the lessee. Any remaining economic benefits not transferred to the lessee (i.e., the lessor's residual interest in the asset) will be recognized in the balance sheet as a residual asset. Lessors applying the derecognition approach will recognize some measure of profit or loss at the date of the lease commencement.

3.6.1 Residual asset

Under the derecognition approach the lessor is viewed to have sold a right-of-use asset to the lessee. That is, the lessor has sold a portion of the underlying asset and retained a portion (i.e., the residual asset). Lessors will be required to determine the amount of the carrying value of the underlying asset to derecognize and the initial carrying amount of the residual asset at the inception of the lease. The ED indicates that the lessor will determine the amount to derecognize and the amount of the residual as follows:

Excerpt from ED

50. A lessor shall determine the amount derecognized and the initial carrying amount of the residual asset by allocating the carrying amount of the underlying asset at the date of inception of the lease in proportion to the fair value of the rights that have been transferred and the fair value of the rights that have been retained by the lessor. Therefore, the amount derecognized by the lessor is the carrying amount of the underlying asset multiplied by the fair value of the right to receive lease payments divided by the fair value of the underlying asset (all determined at the date of inception of the lease).

As indicated above, the allocation of the carrying amount of the underlying asset to the amount to be derecognized and the residual asset will be performed on a relative fair value basis at the inception of the lease. Using the fair value of the right to receive lease payments and the fair value of the underlying asset at the inception date, the lessor would determine the portion of the carrying amount of the underlying asset to derecognize.

The amount to derecognize can be expressed as follow:

Amount to derecognize = (a) x (b)/(c)

(a) = carrying value of the underlying asset at lease inception

(b) = fair value of the right to receive lease payments at lease inception

(c) = fair value of the underlying asset at lease inception

The remaining carrying value of the underlying asset will be the amount of the residual asset.

Interestingly, the term "fair value" is used to describe the amount of the right to receive lease payments used in this calculation; however, under the ED the right to receive lease payments is not measured at fair value (see Section 3.4). In the illustrative examples included in the ED, the Boards have used the amount of the right to receive lease payments measured under the ED as the "fair value" of the right to receive lease payments in performing the allocation of the carrying amount of the underlying asset. It remains to be seen whether these examples are meant to indicate that in the Boards' view the amount of the receivable approximates fair value for purposes of the allocation of the carrying amount of the underlying asset to the amount to derecognize and the residual asset.

How we see it

Lessors will need to refer to the guidance in ASC 820, *Fair Value Measurements and Disclosures*, to determine the fair value of the underlying asset. However, it is unclear if the fair value of the right to receive lease payments will also need to be determined in accordance with the measurement principles in ASC 820 or if the amount determined using the initial measurement provisions in the ED should be used. The initial measurement of the lease receivable will not necessarily be equivalent to the fair value of the right to receive lease payments as the lease receivable is measured based on the present value of lease payments (see Section 3.4) not fair value under ASC 820. For instance, the lease receivable only includes cash flows expected to occur during the lease term (i.e., the longest possible lease term more likely than not to occur), whereas a fair value measurement would likely include all possible lease terms and consider the uncertainty of payments in the optional periods. It would be helpful if the guidance included in the ED were clarified to indicate whether or not a separate determination of the fair value of the right to receive lease payments as of the inception of the lease is required.

The residual asset will not be subsequently remeasured except for impairment or when reassessment of the lease receivable results in a change to the residual asset. The residual asset will be subject to the impairment guidance applicable to the underlying asset (i.e., ASC 350, *Intangibles — Goodwill and Other*, for subleases and ASC 360, *Property, Plant, and Equipment*, for all other leases).

3.6.2 Recognition of lease income

Under the derecognition approach, lesssors will recognize any lease income (or loss) not attributable to the financing component of the lease at the commencement of the lease. That is, upon making the underlying asset available for use by the lessee, the lessor will recognize any profit associated with the sale of the right-of-use asset and only amounts related to financing that sale will be subsequently recognized over the lease term. Lessors will recognize lease income at the present value of the expected lease payments and lease expense for the portion of the underlying asset that is derecognized. To the extent that the present value of the lease payments exceeds the amount derecognized, net income will result. Note that some leases (e.g., leases that are considered direct financing leases under current accounting standards) may result in little or no lease income to be recognize at the inception of the lease to the extent that there is little or no profit on the sale of the right-of-use asset. However, it is important to note that financial lessors (i.e., lessors that are not manufacturers or dealers) would be required to recognize any lease income on the transaction at the commencement of the lease. Under current lease accounting guidance, these financial lessors typically account for such arrangements as direct financing leases and recognize all profit on the lease transactions as finance income over the term of the leases (unless it is a lease of a pre-existing asset).

How we see it

In many ways the accounting for leases under the derecognition approach will be similar to the accounting for sale-type leases under current accounting standards (e.g., a lease receivable is recognized, the underlying asset is removed from the balance sheet, lease income is recognized at lease commencement and interest income is recognized over the lease term). However, there are important differences, such as:

- a separate residual asset is recognized,
- the initial and subsequent measurement of that residual asset is different than the accounting for the residual value included in the net investment in the lease under current accounting, and
- amounts expected to be received from third-party residual value guarantees are not included in lease assets.

While many contracts classified as finance leases (i.e., sales-type, direct financing and leveraged leases) will be accounted for under the derecognition approach, care must be taken by lessors to assess their exposure to significant risks or benefits related to the underlying asset. Every lease currently classified as a finance lease will not meet the requirements to apply the derecognition approach (i.e., some will be accounted for under the performance obligation approach).

3.6.3 Non-distinct services

As discussed in Section 1.3, a lessor will separately account for service and lease components in contracts that contain distinct services. For leases subject to the derecognition approach, the failure to identify distinct services at the inception of a contract can result in overstatement of income at lease commencement as payments required by the contract that relate to an unidentified service component would inappropriately be considered in the lease income recognized.

However, if a service component included in a lease contract is not distinct, the lessor will account for the whole of the contract as a lease. As such, under the derecognition approach, lease income recognized at lease commencement is not adjusted for undelivered non-distinct services. The FASB indicates in its basis for conclusions that a lessor should not separate non-distinct service components of a contract because to do so would be inconsistent with the proposals in the revenue recognition exposure draft. Note that the existence of material non-distinct services is an indicator that the lessor retains exposure to risks or benefits associated with the underlying asset and therefore should apply the performance obligation approach (see Section 3.5).

In one of the few instances of disagreement between the Boards, the IASB has proposed that lessors applying the derecognition approach separate **all** service components (i.e., distinct and non-distinct service components) from the lease to preclude recognition of income from a service before the service is delivered.

3.6.4 Reassessment of the lease receivable

Change in lease term

Changes to the lease receivable arising from a reassessment of the lease term will result in an adjustment of the residual asset. That is, the carrying amount of the residual asset will be adjusted to reflect the change in lease term. If the lease term is increased, the residual asset will be adjusted downward to reflect the decrease in the lessor's rights to the economic benefits associated with the underlying asset. In other words, more of the economic benefits have been sold to the lessee and therefore less have been retained by the lessor. Conversely, if the lease term is decreased, the residual asset will be adjusted upward to reflect the increase in the lessor's rights to the economic benefits associated with the underlying asset.

The ED indicates that the adjustment to the carrying amount of the residual asset should be measured on a relative fair value basis consistent with the allocation of the carrying amount of the underlying asset described in Section 3.6.1.

How we see it

The ED indicates that changes to the residual asset resulting from a reassessment of the lease term should be determined based on the relative fair value of the rights transferred (i.e., the right to receive lease payments) and the rights retained (i.e., the residual asset). That is, on a basis consistent with the method used to allocate the carrying amount of the underlying asset to the amount derecognized and the residual asset described in Section 3.6.1. However, it is not clear from the ED exactly how the adjustment to the residual asset should be measured.

The application guidance in the ED provides examples illustrating reassessments of the lease term that result in an increase and a decrease in the residual asset. The examples in the ED determine the change in the residual asset by multiplying the carrying value of the residual asset by the ratio of the change in the present value of the remaining lease payments over the fair value of the underlying asset measured as of the date of reassessment. This calculation is unclear and appears to be inconsistent with the relative fair value calculation as of the lease inception used to allocate the carrying value of the underlying asset to the amount derecognized and the residual asset.

Change in lease payments

Changes to the lease receivable arising from a reassessment of the expected lease payments for contingent rents, residual value guarantees or termination penalties will be recognized in net income. No adjustment to the residual asset will be made. The Boards determined that changes in contingent rents and expected payments under residual value guarantees and termination penalties represent changes in total consideration that the lessor expects to receive for transferring the right-of-use asset to the lessee and not a change in the lessor's remaining rights relating to the underlying asset. However, as discussed in Section 3.3.1, many of the elements in a lease that could lead to changes in lease payments (e.g., contingent rentals based on use or performance, termination provisions) would be indicators that a lessor retains exposure to significant risks or benefits associated with the underlying asset. Leases containing such features are more likely to be appropriately accounted for under the performance obligation approach.

3.6.5 Derecognition approach example

The following example illustrates the application of the derecognition approach:

Example 17 — Derecognition approach

Lessor A enters into lease with Lessee B for a computer. The computer has a fair value of $3,300, a carrying amount of $2,500 and a useful life of four years. The lease has a three-year non-cancelable term and a one-year renewal option. Annual rent is $1,200 due at the end of each year. Lessor A is charging Lessee B 10% interest (as determined in accordance with the ED) in the lease.

Lessor A determines that the longest possible lease term that is more likely than not to occur as of the inception of the lease is three years (i.e., the renewal option is not more likely than not to be exercised). The present value of three $1,200 annual payments discounted at 10% is $3,000.

Lessor A would allocate the carrying amount of the computer to the amount to be derecognized as follows:

$$\$2{,}500 \text{ (carrying amount)} \times \left(\frac{\$3{,}000 \text{ (fair value of right to receive lease payments)}}{\$3{,}300 \text{ (fair value of underlying asset)}} \right) = \$2{,}275$$

Lessor A would allocate the remainder of the carrying amount of the computer to the residual asset (residual asset = $225).

At lease commencement, Lessor A would record a receivable and derecognize the asset. The carrying amount of the asset would be allocated to residual asset and cost of sales. A net profit of $725 would be recognized:

	Debit	Credit
Lease receivable	3,000	
Revenue		3,000
To initially record the lease receivable and recognize revenue at the present value of the expected lease payments at lease inception		
Cost of sales	2,275	
Residual asset	225	
Inventory		2,500
To reclassify a portion of the carrying amount of the underlying asset to the residual asset and derecognize the remaining portion as cost of sales		

In the first year of the lease, Lessor A would recognize interest income on the receivable and record receipt of lease payments as follows:

	Debit	Credit
Lease receivable	300	
Interest income		300
To recognize interest income under the effective interest method		
Cash	1,200	
Lease receivable		1,200
To record cash received for lease payments		

Year two

At the end of year 2, due to changes in facts and circumstances, Lessor A determines that the renewal option is more likely than not to be exercised. Lessor A would record an increase in the lease receivable for the present value of the lease payment for year 4, derecognize the remaining residual asset (assuming that the computer has no residual value at the end of its economic life) and recognize profit for the difference. The present value as of the end of year 2 of the $1,200 lease payment for year 4 is $980.

Lessor A would account for this reassessment of the lease term as follows:		
Lease receivable	980	
Revenue		980
To record the lease receivable and recognize revenue at the present value of the reassessed expected lease payments		
Cost of sales	225	
Residual asset		225
To derecognize the residual asset		

3.6.6 Presentation

The following table summarizes how amounts related to leases accounted for under the derecognition approach will be presented on the financial statements of lessors:

Financial statement	Lessor presentation
Statement of financial position	► Lease receivables presented separately ► Residual assets presented separately within property, plant and equipment
Income statement	► Lease income and lease expense presented either gross or net based on lessor's business model ► Interest income on lease receivable presented separately from other interest income
Statement of cash flows	► Cash receipts from lease payments classified as operating activities

Lessors will be required to present lease receivables separately from other financial assets and residual assets separately from other assets within property, plant and equipment.

A lessor will present lease income and lease expense in the income statement in separate line items or net in a single line item depending upon the lessor's business model. Manufacturers and dealers, and others who use leases as an alternative means of realizing value from the goods they would otherwise sell, should present lease income and lease expense in separate line items. If the lessor's business model primarily uses leases to provide financing, the lessor would present lease income and lease expense net in a single line item. Additionally, interest income from rights to receive lease payments will be presented separately from other interest income.

Cash receipts from lease payments will be presented as operating activities in the statement of cash flows. Those entities applying the indirect method will present the changes in the right to receive lease payments separately from changes in other operating receivables. Those entities applying the direct method will present the cash flows from lease payments separately from other cash flows from operating activities.

3.7 Transition

Consistent with the requirements for lessees, the Boards have proposed a simplified retrospective approach for transition to the new leases standard for lessors and existing leases will not be grandfathered. While the specific transition date has not yet been set, the Boards have concluded that the lessor should recognize and measure all outstanding leases as of the date of initial application, which is defined as the beginning of the first comparative period presented in the first financial statements in which the entity applies the proposed guidance. For example, if the effective date for the standard is calendar year 2015, then the date of initial application for a calendar year company that prepares a three-year comparative income statement is 1 January 2013.

3.7.1 Measurement at date of initial application

Lessors will need to recognize lease receivables for all outstanding leases as of the date of initial application using a simplified retrospective approach. Lessors will determine the lease term as well as contingent rents and expected payments under termination penalties and residual value guarantees as of the date of initial application. The lease receivable will be measured at the present value of the lease payments discounted using the rate charged in the lease, determined at the inception of the lease, subject to any adjustments required to reflect impairment.

For leases under the performance obligation approach, lessors will recognize a lease liability and reinstate any previously derecognized leased assets. The lease liability will be measured on the same basis as the receivable. Previously derecognized assets will be measured at depreciated cost, adjusted for impairment as of the date of initial application.

For leases under the derecognition approach, lessors will recognize a residual asset and derecognize any underlying assets that remain on the balance sheet. The residual asset will be measured at fair value as of the date of initial application. Lessors will be required to apply the accounting guidance in ASC 820, *Fair Value Measurements and Disclosures*, when determining the fair value of the residual asset.

As no special accounting is provided for leveraged leases under the proposed standard (see Section 3.2), lessors in existing leveraged leases at the date of initial application will need to recognize the assets and liabilities related to leases using the transition provisions described above. The other components of a leveraged lease (e.g., non-recourse debt, deferred income taxes) should be recognized and measured using other appropriate accounting guidance (ASC 470, *Debt* and ASC 740, *Income Taxes*).

Entities will need to record a cumulative effect of a change in accounting to each affected component of equity as of the date of initial application to the extent that the amounts recognized under the ED differ from the amounts previously recognized.

How we see it

The ED does not provide any guidance as to the lessor's assessment of leases outstanding at the date of initial application. That is, it is unclear whether a lessor should determine the appropriate approach (i.e., performance obligation or derecognition) as of the date of initial application or the date of inception of the lease. Performing an assessment of a lease at two different points in time may result in different conclusions as to the most appropriate method to apply. For instance, consider a 20-year lease of equipment with an estimated useful life of 21 years. An assessment performed at the inception of the lease may indicate that the lessor does not retain exposure to significant risks or benefits associated with the underlying asset. However, an assessment of that same lease in its 19th year (i.e., with one year remaining) may indicate that the lessor does retain exposure to significant risks or benefits associated with the underlying asset.

In addition, lessors in certain leases (e.g., long-term leases of real estate or equipment) may not be able to reasonably determine the original rate that the lessor charged in the lease as of the inception of the lease.

3.7.2 Subsequent to the date of initial application

Subsequent to the date of initial application, lessors should perform the following:

- For leases recognized at the date of initial application, the same accounting treatment described earlier for subsequent measurement will apply, including recognizing lease income for reductions in the lease liability, recognizing interest income, reassessing the right to receive lease payments and performing impairment analysis as necessary.
- Any new leases that commence after the date of initial application will be recognized on the balance sheet at the commencement date of the lease and lessors will apply the accounting treatment described earlier.

Chapter 4: Other lease accounting matters

4.1 Sale and leaseback transactions

A sale-leaseback transaction involves the sale of an asset and leaseback of the same asset by the seller. The party that initially owns the asset, sells the asset to a counterparty and leases the asset back from the counterparty is referred to as the seller-lessee. The party that purchases the asset and acts as a lessor in leasing the asset back to the seller-lessee is referred to as the buyer-lessor. Under current accounting standards, sale-leaseback transactions can provide a form of off-balance sheet financing to the extent that the seller-lessee is able to achieve sale accounting and classifies the leaseback as an operating lease. Current accounting standards include a number of complicated rules and requirements related to the accounting for sale-leaseback transactions by the seller-lessee, particularly for those involving real estate. In most sale-leaseback transactions, profit or loss on the sale is deferred and amortized prospectively over the term of the lease in proportion to the leased asset, if a capital lease, or in proportion to the related gross rental charged to expense of an operating lease. The accounting requirements for sale-leasebacks involving real estate assets are even more complicated and often require that sale-leaseback transactions be treated as financing transactions by the seller-lessee. The current sale-leaseback rules do not affect the buyer-lessor's accounting for the transaction. A buyer-lessor involved in a sale-leaseback transaction accounts for the transaction as the acquisition of an asset and a corresponding finance or operating lease out.

That being said, the proposed model in the ED would still drastically alter the landscape of accounting for sale-leasebacks. Most importantly, sale-leaseback transactions will no longer provide off-balance sheet financing as all leases would be recorded on the balance sheet. In addition, the ED establishes criteria that must be met in order for the parties in a sale and leaseback transaction to apply sale-leaseback accounting (i.e., separately account for both the sale/purchase of the asset and the lease). The criteria would be applicable to **both** the seller-lessee and the buyer-lessor. The ED also includes application guidance that sets a high hurdle for transactions to qualify as sale-leasebacks. A transaction that does not meet the criteria to apply sale-leaseback accounting would be accounted for as a financing transaction by both the seller-lessee and the buyer-lessor.

How we see it

In a significant change, the sale-leaseback guidance in the ED extends continuing involvement criteria for sale to all assets (not just real estate). In addition, the model applies equally to buyer-lessors and seller-lessees. That is, a buyer-lessor in a sale and leaseback transaction will be required to assess whether or not it has purchased the asset in the same way a seller-lessee assesses if it has sold the asset. The application to buyer-lessors could be particularly troublesome in transition.

4.1.1 Criteria for sale-leaseback transactions

To qualify for sale-leaseback accounting under the proposed model, the underlying asset must be deemed to have been sold based on an assessment that at the end of the contract, both control of the asset and all but a trivial amount of the risks and benefits associated with the asset have been transferred to the buyer-lessor. That is, the "sale" in the sale-leaseback has to meet the criteria for the purchases/sales exclusion (see Section 1.4 for further discussion of purchases/sales). However, because the sale in a sale-leaseback is part of an integrated transaction, the ED provides additional application guidance to consider when determining whether or not the seller-lessee retains more than a trivial amount of the risks or benefits associated with the underlying asset (i.e., whether or not the "sale" is a sale). And, these criteria apply equally to the buyer-lessor.

Excerpt from Exposure Draft

B31. An entity considers the effect of the transfer contract and the lease contract together to assess whether the transferred asset has been purchased or sold in accordance with paragraphs B9 and B10. Additionally, such sale and leaseback contracts may have conditions that generally do not arise in other transactions and may result in the transfer not meeting the conditions for a purchase or sale. For example, the following conditions normally preclude the seller/lessee from transferring more than a trivial amount of the risks and benefits associated with the transferred asset at the end of the contract and do not result in a purchase or sale:

(a) The seller/lessee has an obligation or an option to repurchase the asset at an amount that is not fair value at the time of repurchase, or the buyer/lessor can compel the seller/lessee to repurchase the asset.

(b) The seller/lessee guarantees the buyer/lessor's investment or a return on that investment.

(c) The seller/lessee provides the buyer/lessor with a residual value guarantee.

(d) The seller/lessee provides non-recourse financing to the buyer/lessor.

(e) The seller/lessee retains an obligation to service any existing debt related to the asset.

(f) The seller/lessee provides collateral on behalf of the buyer/lessor (other than the transferred asset) or guarantees the buyer/lessor's debt.

(g) The seller/lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer/lessor.

(h) The seller/lessee enters into a sale and leaseback transaction involving asset enhancements without leasing the transferred asset from the buyer/lessor.

(i) The buyer/lessor is obliged to share a significant portion of the appreciation of the asset with the seller/lessee.

(j) Any other provisions or circumstances exist that allow the seller/lessee to participate in any future profits of the buyer/lessor or the appreciation of the transferred asset, for example, a situation in which the seller/lessee owns or has an option to acquire a significant interest in the buyer/lessor.

Terms and conditions found in many typical lease contracts would disqualify a sale and leaseback transaction from applying sale-leaseback accounting. For example, the existence of a fixed price purchase option or a residual value guarantee would result in the seller-lessee retaining more than a trivial amount of the risks and benefits associated with the underlying asset. These criteria set a very high threshold for transactions to qualify for sale-leaseback accounting.

How we see it

If the conditions listed in the application guidance appear familiar, it is because they are strikingly similar to the stringent criteria that currently exist for sale-leasebacks of real estate. In practice, many sale-leasebacks of real estate fail to meet the criteria to qualify for sale-leaseback accounting and are accounted for as financing transactions by seller-lessees. However, under the proposed guidance, these criteria will be applicable for all sale-leasebacks (e.g., sale-leaseback of an airplane). The sale-leaseback criteria in the ED are more restrictive than the revenue recognition criteria proposed in the revenue recognition exposure draft. That is, terms that would not typically preclude the recognition of revenue for a sale may result in a sale and leaseback not qualifying for sale-leaseback accounting. The criteria included in the ED could result in many more transactions being accounted for as financings than under current practice.

While the criteria in the ED are similar to current requirements for real estate sale-leasebacks, some items that would preclude real estate sale-leaseback treatment under current rules (e.g., an option or requirement to reacquire the asset at fair value) are not included in the ED and therefore would no longer prevent sale-leaseback accounting on sale and leasebacks of real estate (or any other asset).

The seller-lessee will recognize gains or losses on sales transactions that qualify as sale-leasebacks.

4.1.2 Accounting for qualifying sale-leaseback transactions

If a transaction meets the criteria to qualify for sale-leaseback accounting under the proposed model, both the seller-lessee and the buyer-lessor will separately account for both the sale/purchase and the lease. That is, the sale of the underlying asset by the seller-lessee would be accounted for using whatever guidance is applicable for the sale of that type of asset and the lease would be accounted for using the proposed right-of-use model for lessees (see Section 2 for further discussion of right-of-use model for lessee accounting). A seller-lessee would likely look to the guidance that eventually results from the Boards' joint project on revenue recognition to determine the accounting for the sale. From the perspective of the

buyer-lessor, the purchase of the underlying asset would be accounted for using whatever guidance is applicable for the acquisition of such an asset and the lease will be accounted for using the performance obligation approach (see Section 3.5 for further discussion of the performance obligation approach). A buyer-lessor in a sale and leaseback transaction that qualifies for sale-leaseback accounting is required to use the performance obligation approach to lessor accounting to account for the lease as the buyer-lessor must retain exposure to the risks and benefits associated with the underlying asset in order for the sale-leaseback to qualify as a sale. As such, a buyer-lessor in a sale-leaseback transaction would have to recognize the underlying asset on its balance sheet.

How we see it

The requirement that a buyer-lessor apply the performance obligation approach raises some interesting questions about the assessment of whether or not a sale and leaseback transaction meets the criteria put forth in the ED to qualify for sale-leaseback accounting. For instance, a buyer-lessor in a sale and leaseback transaction may obtain a third-party residual value guarantee such that the buyer-lessor does not retain exposure to significant risks or benefits associated with the underlying asset. In assessing whether or not a lessor should apply the performance obligation approach or the derecognition approach, a third-party residual value guarantee would typically be considered (see Section 3.3.1) and the lessor would apply the derecognition approach when the lessor does not retain exposure to significant risks or benefits associated with the underlying asset. It is unclear if the Boards' intent in requiring buyer-lessors to apply the performance obligation approach is to indicate that the existence of a third-party residual guarantee would disqualify a sale and leaseback transaction from sale-leaseback accounting (i.e., require the seller-lessee and the buyer-lessor to account for the transaction as a financing) or result in the buyer-lessor applying the performance obligation to a lease that would otherwise have been accounted for under the derecognition approach.

4.1.3 Accounting for sale and leaseback transactions that do not qualify for sale-leaseback accounting

If a transaction does not meet the criteria to qualify for sale-leaseback accounting under the proposed model, both the seller-lessee and the buyer-lessor will be required to account for the transaction as a financing transaction.

When a sale-leaseback is treated as a financing by the seller-lessee, the asset subject to the sale-leaseback remains on the balance sheet of the seller-lessee and sale proceeds (consideration received) will be recognized as a financial liability. Consistent with current practice for applying the financing method to sale and leaseback transactions that do not meet the criteria to be accounted for as sale-leasebacks, we would expect the seller-lessee to continue to depreciate the asset and recognize interest expense on the financial liability. Lease payments made less the portion considered to be interest expense will decrease the financial liability.

A buyer-lessor in a sale and leaseback transaction that does not qualify for sale-leaseback accounting would not record the "purchased" asset, but rather, recognize a receivable for any amounts paid to the seller-lessee. We would expect the buyer-lessor to recognize interest income on the receivable. Lease payments received less the portion considered to be interest income will decrease the receivable.

How we see it

The requirement that buyer-lessors assess whether or not a transaction to purchase an asset from an entity and lease that same asset back to the same entity qualifies as a purchase and lease is a significant change from existing practice. Under current accounting standards, the buyer-lessor accounts for the purchase and leaseback regardless of whether or not the sale and leaseback results in a "failed sale-leaseback" by the seller-lessee.

4.1.4 Transition

The ED does not provide any transition guidance relative to sale-leaseback transactions. It is unclear how leases that are in place at the date of initial application that relate to underlying assets that were previously owned by the lessee will be treated. That is, would the lessee and lesssor in such a lease need to assess whether or not the original sale and leaseback transaction met the new requirements to qualify for sale-leaseback accounting? Note that under current accounting standards certain existing transactions did not meet the existing requirements and are accounted for by seller-lessees as financing (or possibly using the deposit method). The ED does not address whether those previous "failed sale-leasebacks" would be reassessed at transition.

How we see it

A particularly complex area of current lease accounting involves transactions in which a lessee is involved in the construction of the asset to be leased. Current accounting standards require an assessment of the nature of the lessee's involvement and risks borne by the lessee during construction and may result in a lessee being considered the owner of the asset during construction. In such situations the lessee records the asset on its balance sheet during the construction period and the transaction is subject to sale and leaseback accounting requirements. While we expect this current accounting treatment to be discontinued under the proposed accounting model for leases, the ED is silent as to how entities that currently recognize such assets and related financing liabilities will be affected upon transition. Also, the guidance included in current lease accounting was established to provide consistency in the financial reporting for entities engaged in certain transactions (i.e., at what point lessee involvement represents ownership). It remains to be seen whether the Boards will look to include guidance in the leases standard to address these arrangements.

4.2 Subleases

In a sublease arrangement, one party (the intermediate lessor) will act as both the lessor and lessee of the same asset. That is, one party will obtain the right to use the underlying asset under the head lease, and it will act as the lessor in the sublease whereby it conveys the right to use the underlying asset to a different party for the same or a shorter term. The ED does not provide different measurement guidance for the assets and liabilities that arise in a sublease. The lessee accounting model will be applied to the assets and liabilities that arise in the head lease, and the lessor accounting model will be applied to the assets and liabilities that arise in the sublease.

As such, the intermediate lessor in a sublease could recognize on its balance sheet a right-of-use asset and a liability to make lease payments, as well as a lease receivable and a lease liability (assuming the sublease is accounted for under the performance obligation approach to lessor accounting — see Section 3.5), all related to the same underlying asset.

Example 18 — sublease

Entity A leases office space that it no longer needs and decides to sublease that office space to Entity B. Entity A would include the following on its balance sheet:

- Right-of-use asset for the head lease
- Lease receivable from Entity B for the sublease
- Lease liability to allow Entity B to use the underlying asset under the sublease
- Liability to make lease payments under the head lease

The ED requires that the assets and liabilities that arise under a sublease be presented separately from assets and liabilities that arise in other leases. Intermediate lessors applying the performance obligation approach to the sublease will present the underlying asset, the right to receive lease payments and lease liabilities together in the balance sheet along with a sub-total net lease asset or net lease liability. The ED requires that intermediate lessors present the liability to make lease payments under the head lease separately from the other balances in the leasing arrangements. The intermediate lessor's underlying asset is the same as its right-of-use asset under the head lease.

Example 19 — intermediate lessor presentation

Cash		X
Property, plant and equipment		X
Right-of-use asset	X	
Lease receivable	X	
Lease liability	(X)	
Net sublease asset		X
Total assets		X
Trade and other payables		X
Liability to make lease payments		X
Total liabilities		X

In a sublease that is accounted for by the intermediate lessor under the derecognition approach to lessor accounting (see Section 3.6), a portion of the right-of-use asset obtained in the head lease would be derecognized and the remainder would be reclassified as a residual asset. Intermediate lessors applying the derecognition approach to the sublease will distinguish in the balance sheet rights to receive lease payments and residual assets that arise under a sublease from those that arise from other leases.

For intermediate lessors, the income statement and statement of cash flows presentation of the head lease and sublease will be separately presented and entities should apply the lessee and lessor presentation requirements as described in Sections 2.6, 3.5.5 (performance obligation approach) and 3.6.6 (derecognition approach).

The accounting for lessee and lessor components could result in different measurements (e.g., different discount rate, different lease payments based on lessor accounting requiring payments to be measured reliably with no similar requirement for lessee accounting). However, the Boards concluded that the head lease and sublease were different transactions and therefore should be accounted for separately (no special measurement treatment allowed).

How we see it

The application of the right-of-use accounting model can result in significantly different accounting than presently afforded to subleases. For example, the recognition of the assets and liabilities for all leases (both the head lease and the sublease) can result in a substantial increase to amounts recorded on the balance sheet. For example, consider an intermediate lessor in a head lease and sublease currently accounted for as operating leases. Under the right-of-use model the intermediate lessor will recognize assets and liabilities on the head lease and the sublease, whereas current accounting would only result in the recognition of an accrued loss to the extent one was expected.

In addition, the application of the right-of-use model can affect the timing of income or loss recognized on subleases. Under current accounting, when an entity enters into a sublease that will result in a loss, the loss is recorded when the sublease is executed. Under the right-of-use model, the recognized right-of-use asset on the head lease will be subject to impairment and any loss would be recognized based on the application of the guidance for asset impairment (see Section 2.4.2). Also, if the sublease is accounted for under the derecognition approach, the intermediate lessor could recognize a gain in net income at the commencement of the sublease.

4.3 Leases in a business combination

As discussed previously, the current model for lease accounting draws a fundamental distinction between operating and finance leases and the determination of whether a lease is classified as operating or finance is made at the inception of a lease. Under current accounting, the acquirer in a business combination accounts for the leases of an acquiree differently depending on how the lease is classified. As long as a lease is not modified as part of the business combination, the acquirer looks to the acquiree's original classification determination at the inception of the lease.

Under current accounting, a business combination that includes an operating lease requires an assessment of whether the operating lease terms are favorable or unfavorable given market conditions that exist at the date of the acquisition. To the extent the lease arrangement is favorable or unfavorable relative to market on the acquisition date, an asset or liability is recognized at fair value in the business combination. An acquirer of an entity that is a lessee in an operating lease recognizes an asset or liability for any off-market provisions of the lease. An acquirer of an entity that is a lessor in an operating lease recognizes the underlying leased asset at fair value as well as asset or liability for any off-market provisions of the lease. The asset or liability for any off-market provisions of the lease recognized by a lessor also include the value of an in-place lease (e.g., direct costs associated with obtaining a new tenant that are avoided by acquiring the lease instead of originating the lease).

Under current accounting, a business combination that includes an asset under a capital lease and a capital lease obligation requires both the asset and obligation to be independently recorded at fair value as of the date of the acquisition. That is, an acquirer of an entity that is a lessee in a capital lease recognizes the capital lease obligation at fair value (measured similar to assumed debt) and the underlying asset itself at fair value. A business combination that includes the acquisition of a sales-type or direct finance lease receivable (i.e., an acquisition of an entity that is a lessor in a sale-type or direct finance lease) requires the receivable to be recorded at fair value as of the date of the acquisition. Special provisions exist for acquisitions of leveraged leases in a business combination.

As the ED proposes to do away with lease classification, the accounting for leases in a business combination will be affected. Although the ED does not address accounting for leases in a business combination, these issues have been deliberated by the Boards as part of the leases project and tentative decisions have been reached. The FASB has tentatively decided that the acquirer in a business combination will measure the assets and liabilities arising from lease contracts in accordance with the proposed lease accounting model (i.e., as if it were a new lease entered into at that date). That is, an exception to the general requirement that assets acquired and liabilities assumed in a business combination be measured at fair value will be provided for the assets and liabilities that arise in a lease. Based on Board deliberations and tentative decisions to date we believe that the FASB will propose consequential amendments to ASC 805, *Business Combinations,* to require that leases in a business combination be accounted for as described below.

4.3.1 Acquisition of a lessee

In a business combination in which the acquiree is a lessee, the acquirer will recognize a right-of-use asset and a liability to make lease payments. The liability to make lease payments will be measured as if the lease was a new lease contract entered into at the acquisition date. That is, an acquirer would apply the measurement principles described in Section 2. The right-of-use asset would be measured as the amount of the liability to make lease payments adjusted for any difference between the rate charged in the lease and market rates as of the date of acquisition. That is, the right-of-use asset would include an adjustment similar to the intangible asset or liability recognized under current accounting standards for the off-market provisions of the lease. Subsequent to the date of acquisition, the asset and liability will be measured at amortized cost in accordance with the lessee accounting model proposed in the ED. The liability to make lease payments will also be subject to the reassessment provisions described in Section 2.4.3.

4.3.2 Acquisition of a lessor that applies the performance obligation approach

In a business combination in which the acquiree is a lessor in a lease accounted for under the performance obligation approach, the acquirer will recognize a right to receive lease payments (i.e., lease receivable) and a lease liability. The right to receive lease payments will be measured as if the lease was a new lease contract entered into at the acquisition date. That is, an acquirer

would apply the measurement principles described in Section 3. The lease liability will be measured as the amount of the right to receive lease payments adjusted for any difference between the rate charged in the lease and market rates as of the date of acquisition. That is, the lease liability will include an adjustment similar to the intangible asset or liability recognized under current accounting standards for the off-market provisions of an operating lease. The Boards have not discussed whether or not the fair value of an in-place lease would be included in this adjustment as it is in current practice. Subsequent to the date of acquisition, the right to receive lease payments and the lease liability will be measured at amortized cost in accordance with the lessor accounting model proposed in the ED. The right to receive lease payments will also be subject to the reassessment provisions described in Section 3.4.6 and those reassessments will be recognized in the same manner as all other reassessments for leases under the derecognition approach to lessor accounting (see Section 3.5.3).

4.3.3 Acquisition of a lessor that applies the derecognition approach

In a business combination in which the acquiree is a lessor in a lease accounted for under the derecognition approach, the acquirer will recognize a right to receive lease payments (i.e., lease receivable) and a residual asset. The right to receive lease payments will be measured as if the lease was a new lease contract entered into at the acquisition date. That is, an acquirer will apply the measurement principles described in Section 3. The residual asset will be measured at fair value as of the acquisition date. Subsequent to the date of acquisition, the right to receive lease payments will be measured at amortized cost in accordance with the lessor accounting model proposed in the ED. The residual asset will not be subsequently remeasured except for impairment or when reassessment of the lease receivable results in a change to the residual asset. The right to receive lease payments will also be subject to the reassessment provisions described in Section 3.4.6 and those reassessments will be recognized in the same manner as all other reassessments for leases under the derecognition approach to lessor accounting (see Section 3.6.4).

How we see it

In deliberations to date the Boards have not discussed if the determination of the appropriate approach to lessor accounting (i.e., use of performance obligation approach or derecogniton approach) will be made by the acquirer as of the date of the acquisition or if the acquirer will look to the assessment performed by the acquired entity as of the inception of the lease. Performing the assessment at a different date could result in a different conclusion as to whether or not the lessor retains significant exposure to the risks or benefits associated with the underlying asset.

In addition, the Boards have not discussed the accounting for leases in an asset acquisition (i.e., acquisition of assets that do not constitute a business) and whether or not a similar approach will apply in such situations.

Chapter 5: Disclosures

5.1 Disclosures

The ED requires disclosures covering both quantitative and qualitative financial information. The disclosures should:

- Identify and explain the amounts recognized in the financial statements arising from leases
- Describe how leases may affect the amount, timing and uncertainty of the entity's cash flows

The ED requires a significant volume of disclosures; however, the proposal allows for the use of judgment in the level of detail and extent necessary to satisfy the disclosure requirements. Entities should aggregate or disaggregate disclosures so that useful information is not obscured by either too much detail or by summarizing items that have different characteristics. Required disclosures for both lessees and lessors include, but are not limited to:

- The nature of the lease arrangements, including a general description of the entity's leases and key terms of contingent rentals, residual value guarantees, renewal and termination options, amortization methods and any restrictions or purchase options
- Initial direct costs incurred during the reporting period and included in the measurement of the right-of-use asset or right to receive lease payments
- Information about significant assumptions and judgments and any changes in assumptions and judgments relating to renewal options, uncertain payments and the discount rate used when determining the present value of the lease payments
- Information about the principal terms of any leases that have not yet commenced
- Nature and amount of significant subleases
- Discussion of leases accounted for using the simplified method allowed for short-term leases and for lessees, the amount recognized in the financial statements
- For lessees only:
    1. Reconciliation of the beginning and ending balances of right-of-use assets and liabilities to make lease payments, disaggregated by class of underlying asset, including total cash lease payments paid during the period
    2. Terms and conditions of sale-leaseback transactions and any related impact to net income
    3. Maturity analysis of the liability to make lease payments which shows the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years (distinguish both the minimum lease payments specified in the lease and the amounts recognized in the balance sheet)

- For lessors only:

  1. Reconciliation of the beginning and ending balances of the right to receive lease payments account, lease liabilities (for leases accounted for using the performance obligation approach) and residual assets (for leases accounted for using the derecognition approach)
  2. Information about its exposure to the risks or benefits associated with the underlying asset that the lessor used in determining whether to apply the performance obligation approach or derecognition approach
  3. Nature and amount of each class of residual asset
  4. Information about the nature of significant service obligations related to its leases
  5. Impairment losses arising from leases, separately disclosed for leases accounted for using the performance obligation approach and leases accounted for using the derecognition approach
  6. Maturity analysis of the right to receive lease payments which shows the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years (distinguish both the minimum lease amounts receivable specified in the lease and the amounts recognized in the balance sheet)

How we see it

The ED requires a significantly increased volume of disclosures in comparison to current guidance. Certain requirements, including disclosing significant judgments and estimates and balance sheet rollforward information, will necessitate that information on leases not previously needed for disclosure purposes be tracked and compiled. Some companies may be currently tracking the required disclosure information outside the accounting system on a decentralized and lease-by-lease basis. Companies should carefully assess the disclosure requirements and the potential IT impact to help ensure the appropriate information will be efficiently captured by the date of initial adoption at the level of disaggregation and extent of disclosure necessary.

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