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Implications of the New Revenue Recognition and Leases Standards on Real Estate

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Revenue Project

Overview

Core principle: Recognize revenue to depict the *transfer of promised goods or services to customers* in an amount that reflects *the consideration the entity expects to be entitled* in exchange for those goods or services

Identify the contract with a customer (Step 1)

Identify the performance obligations in the contract (Step 2)

Determine the transaction price (Step 3)

Allocate the transaction price to performance obligations (Step 4)

Recognize revenue as the entity satisfies a performance obligation (Step 5)

Revenue recognition under the model is <u>control based</u>.

Potential Effects on Real Estate

Elimination of Bright-Line Tests

- Prescriptive guidance provided by ASC 360-20 (Sales of Real Estate) and ASC 605 (Construction) will be lost:
  - Buyer's financial commitment
  - Collectability of transaction price
  - Continuing involvement by seller
  - Sales to limited partnerships/joint ventures
  - Guarantee buyer return
  - Partial sales
  - Condominium sales
- Will likely result in more transaction qualifying as sales of real estate with gains being accelerated
  - Example: Consider probability of a conditional repurchase obligation outside the seller's control
- Collectability threshold was added
  - Must be probable (not necessarily reasonably assured) that the entity will ultimately collect the consideration it is entitled to receive

Revenue Recognition

Recoverable Expenses

- As part of Leases deliberations, FASB staff has indicated that lessor's promise to provide services (CAM) or pay for utilities consumed by the lessee would be non-lease components
- FASB position could change in final standard
- If not, revenue will need to be recognized in accordance with the new revenue standard
- Would likely be a performance obligation satisfied over time as the lessee simultaneously receives and consumes the benefit as the entity performs – thus recognize revenue as services are provided
- Or, are recoverable expenses considered non-lease components of leases, which could via policy elections, be considered a single lease component

Revenue Recognition

REIT To-Do's

- Assess impact on sales of real estate – recognition timing, disclosure
- Take inventory of non-lease related revenue streams
  - Asset management, property management, JV management fees
  - Termination agreements
  - Settlement agreements
  - Recoverable expenses within leases (CAM, insurance, real estate taxes)
- May need to dual-track revenue streams starting 1/1/2015
- Consider capability of systems, changes to processes and staffing
- Share preliminary conclusions with auditors

Joint Leases Project

Timeline

Q3 2010	2011-2013	2014	Q3 2015 ?
Exposure Draft (ED)	Re-deliberations and 2nd ED	Re-deliberations	Final Standard

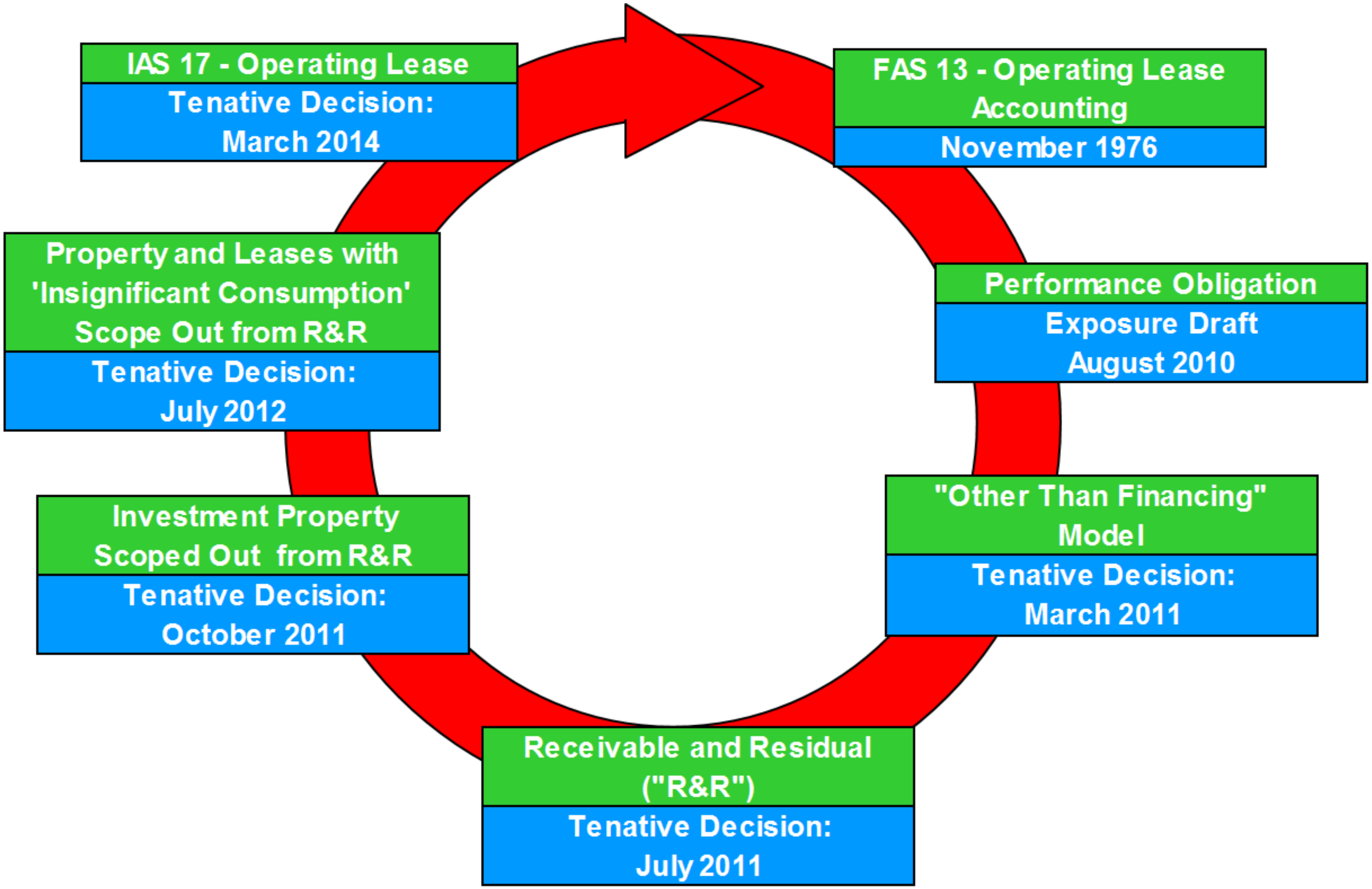
2014 re-deliberations are focusing on:

- Definition and scope
- Lease classification
- Lessee accounting
- Lessor accounting
- Sale and leaseback transactions
- Subleases
- Measurement
- Disclosure
- Effective Date

A final standard is not expected until the second half of 2015

Lessor Accounting…

"And where I did begin, there I shall end" - Shakespeare



Joint Leases Project

Classification Principle

At Lease Commencement	
TYPE A Leases	TYPE B Leases

• Transfer of title
• Reasonably certain to exercise purchase option
• Lessee obtains substantially all of the remaining benefits:
  • Lease term is for major part of economic life
  • Lease payments and residual value guarantee are substantially all of the fair value of asset
  • Asset is not expected to have an alternative use at end of lease term (due to specialized nature)
	• Control does not pass to the lessee?

Joint Leases Project

Initial Direct Costs (IDC)

The Boards decided that only **incremental** costs would qualify as IDCs

- Costs would be incremental if they would not have been incurred absent the lease being **obtained**. For example:
  - Commissions paid upon execution of a lease would be incremental
  - Salaries of sales force would not be incremental

Lessees:

- Include IDCs in initial measurement of lease right-of-use asset

Lessors:

- Definition intended to be consistent with new revenue standard
- Type A leases – include IDCs in lease receivable or expensed
- Type B leases – recognize over lease term (same basis as income)
  - Expensed for Type A leases that include selling profit

NAREIT Letter to FASB on IDC

- Would be a step backward in reporting the economics of investment property performance if direct costs of internal leasing staff were accounted for differently from cost of external leasing resources
- Proposed accounting could force companies to abandon the most effective leasing structure (internal leasing staff) for an external structure or dramatically change internal compensation arrangements
- Possible alternatives for structuring the leasing function under the FASB proposal:
  - Maintain non-commission based compensation and expense a significant portion of internal leasing costs
  - Modify compensation structure to pay internal commissions on signed leases
  - Engage external leasing services which may be less effective and more expensive
- Given the wide diversity in accounting treatment for cost within US GAAP (e.g. commitment fees, credit card fees and costs, loan syndication fees, loan origination fees and direct loan origination costs, interest costs, etc.), recommend FASB forego further evaluation of accounting for IDC within the Leases project

Redeliberations – Lessor Disclosure

Boards decided to retain many of the 2013 ED's requirements

- Information about the nature of leases
- Significant assumptions and judgments made in accounting
- Information about management of residual value risk of leased asset
- Table of lease income during reporting period
- Maturity analyses
- Undiscounted cash flows for Type A leases with reconciliation to amounts presented on the balance sheet (or in notes)
- Undiscounted lease payments to be received for Type B leases

Boards simplified other disclosure requirements

- Presentation of Type A lease interest income
- Eliminated reconciliation requirement for Type A lease net investments
    - Replaced with qualitative, quantitative disclosure of changes of residual asset (FASB) and lease receivable and residual asset (IASB)

Boards added disclosure of information about assets under Type B leases

- Same as current requirements for property, plant and equipment

Lease Accounting Exposure Draft

REITs as Lessees

- Examples of instances where a REIT could be the lessee:
  - Ground leases
  - Copier and printer leases
  - Other equipment leases (i.e., postage meters, etc.)
  - NOT energy contracts
- Consider taking inventory of all such leases
- Assess materiality
- Share preliminary conclusions with auditors
- Monitor new leases where REIT is the lessee

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Leases — Board Redeliberates Certain FASB-Only Issues

August 28, 2014 — At yesterday's FASB-only meeting, the Board continued redeliberating its revisions to lease accounting but only addressed U.S. GAAP issues. Specifically, the Board discussed (1) the discount rate that nonpublic business entity (NBE) lessees should use, (2) the accounting for related-party leases, (3) the accounting for sale-leaseback transactions that involve repurchase options, and (4) whether to eliminate leveraged-lease accounting.

The following table summarizes the tentative decisions reached at the meeting:

Issue	Decision
NBE lessee discount rate	The May 2013 exposure draft (ED)[1] allows NBE lessees to elect, as an accounting policy, to use a risk-free interest rate in lieu of their incremental borrowing rate when measuring their lease liabilities. At yesterday's meeting, the board tentatively reaffirmed this guidance.
Related-party leases	The May 2013 ED requires lessees and lessors to account for related-party leasing arrangements on the basis of the legally enforceable terms and conditions of the lease rather than the substance of the arrangement. Further, the May 2013 ED indicates that lessors and lessees must provide the related-party disclosures required by ASC 850.[2] At yesterday's meeting, the FASB tentatively reaffirmed this guidance.
Sale-leaseback accounting	*Consideration of Substantive Repurchase Options* At their July 2014 joint meeting, the FASB and IASB discussed whether a substantive repurchase option held by the seller-lessee in a sale-leaseback transaction would preclude a conclusion that a sale has occurred. The IASB tentatively agreed that a seller-lessee's substantive repurchase option would preclude sale recognition; however, the FASB did not vote on this issue and directed the staff to perform additional analysis. At yesterday's meeting, the FASB tentatively decided that a seller-lessee's option to repurchase an asset would prevent the seller-lessee from concluding that the underlying asset was sold unless the asset is a nonspecialized asset and the exercise price is at fair value. The Board also tentatively decided that the final standard would include application guidance on how repurchase options should be evaluated. *Accounting for "Failed" Sale-Leaseback Transactions* The boards also discussed the accounting for "failed" sale-leaseback transactions at their July 2014 meeting. In a manner consistent with the guidance in the May 2013 ED, the IASB tentatively decided that a transaction that results in a failed sale should be accounted for as a financing arrangement. The FASB did not vote on this provision at the July 2014 meeting because it first wanted to assess the staff's additional analysis of repurchase options. At yesterday's FASB-only meeting, the Board tentatively reaffirmed the May 2013 ED's guidance on this topic (i.e., the seller-lessee and buyer-lessor should account for a failed sales transaction as a financing arrangement).

[1] FASB Proposed Accounting Standards Update, *Leases*.

[2] FASB Accounting Standards Codification Topic 850, *Related Party Disclosures*.

Issue	Decision
Leveraged leases	The May 2013 ED would have eliminated the current guidance on accounting for leveraged leases and does not include any specific transition guidance related to this topic. At yesterday's meeting, the FASB reaffirmed its decision to eliminate leveraged-lease accounting for all new arrangements. However, the Board tentatively decided to allow entities to continue to apply the current leveraged-lease guidance to leveraged-lease arrangements that exist as of the final standard's effective date.

While the boards have redeliberated many aspects of the proposed leases model, they still need to discuss a number of issues, including the following:

- Lessee disclosures.
- Transition.
- Effective date.

Other items that the boards may revisit include previous decisions on the lessee accounting model and small-ticket lease exceptions.

Deloitte.

Accounting Journal Entry

Leases — FASB and IASB Continue Redeliberations

June 20, 2014 — At their June 18, 2014, joint meeting, the FASB and IASB continued redeliberating the revisions to lease accounting. The boards discussed (1) subleases, (2) lessee balance sheet presentation, and (3) cash flow presentation.

The following table summarizes the tentative decisions reached at the meeting:

Issue	Decision
Subleases	An entity may enter into an arrangement to lease an asset from another entity (i.e., the entity is a lessee) and then subsequently lease all or part of the asset to a third party (i.e., the entity acts as an intermediate lessor). While there is U.S. GAAP guidance on an intermediate lessor's accounting for subleases, IFRSs do not contain such guidance. *Accounting for Head Lease and Sublease* The boards agreed that in a manner consistent with their May 2013 exposure draft (ED), an intermediate lessor should generally account for the head lease and sublease as two separate contracts.[1] However, the FASB and IASB had differing views on the approach for determining the intermediate lessor's accounting for the sublease. The FASB tentatively decided that the sublease classification (i.e., whether the intermediate lessor should treat the sublease as a capital or an operating lease) is determined by reference to the underlying asset, whereas the IASB tentatively decided that the sublease classification should be determined by reference to the remaining right-of-use (ROU) asset resulting from the head lease. *Offsetting Lease Assets With Lease Liabilities* The boards also tentatively decided that an intermediate lessor would generally be prohibited from offsetting lease assets resulting from a sublease with lease liabilities related to the head lease arrangement, unless the transactions meet the U.S. GAAP or IFRS offsetting requirements.

[1] An exception would be situations in which the underlying head lease and sublease contracts meet the contract combination requirements that the FASB and IASB discussed at their April 2014 joint meeting.

Issue	Decision
	Offsetting Lease Income With Lease Expenses Similarly, the boards tentatively decided that an intermediate lessor would be prohibited from offsetting the lease income from a sublease with the lease expense from the head lease, unless the entity is acting as an agent for the sublessee. This evaluation would be determined in accordance with the "principal-agent guidance" in the recently issued revenue standard.
Lessee balance sheet presentation	*Type A ROU Assets and Lease Liabilities* The boards tentatively decided that a lessee should present its Type A ROU assets and lease liabilities as separate line items on the balance sheet or in the notes to its financial statements. A lessee that elects not to present its Type A ROU assets or lease liabilities as a separate line item on the balance sheet would be required to disclose in the notes the respective amounts and balance sheet line items that include these balances. Regarding Type A ROU assets, the IASB tentatively decided that if the lessee elects not to present such assets separately on the balance sheet, an entity would be required to present them in the same line item as similar purchased assets; the FASB decided not to provide prescriptive guidance on this topic. Further, the boards tentatively agreed not to specify which balance sheet line item should include the Type A lease liability if the lessee elects not to present the liability separately on the balance sheet. *Type B ROU Assets and Lease Liabilities (FASB Only)* In addition, the FASB tentatively decided that the lessee should present its Type B ROU assets and lease liabilities separately from its other assets and liabilities. Alternatively, a lessee can separately disclose its Type B ROU assets and liabilities in the notes to its financial statements. Further, the FASB decided against specifying where a lessee should present its Type B ROU assets and lease liabilities on the balance sheet; however, a lessee is prohibited from presenting Type B ROU assets and lease liabilities in the same line item as Type A amounts.
Cash flow presentation	*Lessor Cash Flow Presentation* Under current U.S. GAAP and IFRS accounting, a lessor is required to classify cash receipts from leases in cash inflows from operating activities in its statement of cash flows. The May 2013 ED carried forward this approach in the proposed new accounting model. At the meeting, the boards tentatively decided to retain this approach in the final leases standard.

Issue	Decision
	Lessee Cash Flow Presentation The boards also discussed the cash flow statement presentation from the lessee standpoint but had differing views on the appropriate classification. The FASB tentatively decided that cash payments related to a Type A lease should be presented as cash flows from financing activities (for principal) and cash flows from operating activities (for interest), whereas cash payments related to a Type B lease would be reflected as cash flows from operating activities. The IASB tentatively decided that a lessee would present repayments of the principal portion of the liability in financing activities but could classify, as an accounting policy election, the interest portion of the payment in cash outflows from operating or financing activities. Such classification would be consistent with the existing "interest paid" guidance in IAS 7.[2] The IASB also tentatively decided to require a lessee to disclose the aggregate lease payments in the financial statements, although no particular location was specified (i.e., could be on the face of the cash flow statement or in the notes).

While the boards have made significant progress, they still need to redeliberate a number of aspects of their proposed leases guidance, including the following:

- Disclosures.
- Sale-and-leaseback transactions.
- Transition.
- Effective date.
- Leveraged leases and private-company/not-for-profit issues (FASB only).
- Other (e.g., related-party leases).

Other items that the boards may need to revisit include lessee accounting and small-ticket lease exceptions.

[2] IAS 7, *Statement of Cash Flows*.

Deloitte.

Accounting Journal Entry

Leases — FASB and IASB Continue Redeliberations

May 23, 2014 — At their joint meeting yesterday, the FASB and IASB continued redeliberating their revisions to lease accounting. The boards discussed (1) the definition of a lease, (2) separating lease and nonlease components, and (3) initial direct costs.

The following table summarizes the tentative decisions reached at the meeting:

Issue	Decision
Definition of a lease	The boards tentatively reconfirmed their decision from the May 2013 ED that a lease possesses both of the following characteristics: • The fulfillment of the contract depends on the use of an identified asset. • The contract conveys the right to control the use of the identified asset for a certain period in exchange for consideration. *Use of an Identified Asset* The boards agreed to provide additional guidance on when a lessor's substitution rights are considered substantive in the evaluation of whether an identified asset exists. Specifically, the boards decided that for a substitution right to be considered substantive, a lessor would need to have the "practical ability" to substitute the identified asset and must economically benefit from the substitution. In addition, the boards tentatively decided that a lessee can presume that a substitution right is not substantive when it is impractical to prove otherwise. *Right to Control the Use of an Identified Asset* The boards agreed to provide additional guidance on evaluating whether a customer has the right to control the use of the underlying asset. Specifically, the boards decided to clarify that the control analysis should focus on the customer's ability to affect the economic benefits derived from using the underlying asset. The boards also tentatively agreed to provide a more robust framework and examples related to determining which decisions on directing the use of the asset would have the greatest impact on the economic benefits derived from use of the asset.

Separating lease and nonlease components	The boards tentatively reconfirmed the guidance in their May 2013 ED on when multiple lease components in a contract should be combined or separated from one another. The boards also reconfirmed that both lessees and lessors would be required to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the forthcoming revenue recognition standard, and lessees would do so on a relative stand-alone price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, lessees would be permitted "to elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components, and instead account for the entire contract . . . as a single lease component."[1] In addition, the boards concluded that both lessees and lessors would be required to "reallocate the consideration in a contract when the contract is modified and the modification is not a separate, new contract."[2] Lessees would also be required to reallocate the consideration in the contract upon a reassessment of the lease term or a change in the likelihood that a purchase option will be exercised.
Initial direct costs	The boards tentatively decided that the definition of initial direct costs for both lessees and lessors should include only those costs that are incremental to the arrangement and that the entity would not have incurred if the lease had been obtained. This definition would be consistent with the notion of incremental cost in the impending revenue recognition standard. Under this definition, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. In contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) would be excluded from this definition. In addition, the boards tentatively agreed that a lessee would include all initial direct costs in its initial measurement of the right-of-use asset.

[1] See Agenda Paper 3B/283.

[2] The evaluation for determining whether a modification would result in a new contract is based on the boards' tentative decisions on lease modifications made at their April 2014 joint meeting. See Deloitte's April 25, 2014, journal entry for more information.

For Type A leases, with the exception of leases that result in the recognition of manufacturers' profit, lessors would include all initial direct costs in the initial measurement of the lease receivable. Lessors entering into arrangements that result in the recognition of sales profit would recognize initial direct costs as expenses at lease commencement. For Type B leases, lessors would defer the initial direct costs and amortize them as expenses over the term of the lease.

The boards plan to discuss the following items related to the leases project at future meetings:

- Subleases.
- Sale-and-leaseback transactions.
- Leases of "small" assets.
- Presentation and disclosure.
- Cost-benefit concerns, transition, and effective date.
- FASB only: (1) leveraged leases and (2) private-company and not-for-profit issues.
- Other (e.g., related-party leases).

No. 2014-09
20 March 2014

To the Point

FASB — proposed guidance

Boards back away from some key aspects of leases proposal

The Boards remain committed to putting most leases on the balance sheets of lessees.

What you need to know

- The IASB supported a single on-balance sheet model for lessee accounting while the FASB supported a dual on-balance sheet model. Despite this fundamental difference, the Boards reiterated their commitment to seek a converged solution.
- The Boards also indicated that they do not intend to significantly change lessor accounting. Instead, they supported retaining a dual classification model.
- The Boards reached certain tentative decisions on lease term, a short-term lease exception and other ways to simplify their May 2013 exposure draft.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) are looking for ways to simplify their 2013 proposal on leases in response to feedback from constituents that the accounting would have been too complex and costly to apply.

The Boards reiterated their commitment to putting most leases on the balance sheets of lessees and to reaching a converged solution. But this week's discussion of how to simplify lessee accounting highlighted differences between the Boards that may be difficult to resolve.

At this week's meetings, the Boards reached certain tentative decisions on the lease term, a short-term lease exception and other ways to simplify their May 2013 exposure draft (the ED).[1]

Building a better working world

Lessee accounting model

The Boards discussed the following two approaches for lessees to subsequently measure the lease asset and obligation:

- A single model that would require lessees to account for all leases (except certain leases excluded from the scope of the guidance) as Type A leases (i.e., a financing). Therefore, lessees would reflect the acquisition of a right of use asset and a corresponding liability on the balance sheet, and interest and amortization expense would be recognized separately on the income statement.

- A dual model that would classify leases as Type A (i.e., financings) or Type B (leases with a generally straight-line lease expense pattern) using the classification principles in IAS 17,[2] which are similar to current US GAAP but without the bright lines. Both Type A and Type B leases would be on-balance sheet, but the expense recognition and presentation would be different.

The IASB overwhelmingly supported the single-model approach. However, the FASB expressed similar support for the dual-model approach.

The IASB members that supported the single model believe it is the most conceptually sound approach because all leases contain a financing element. They also think it would be beneficial for users of the financial statements because it would provide separate interest and amortization expense information for most leases.

The FASB members that supported the dual-model approach believe the primary objective of the project is to put leases on the balance sheets of lessees without significant disruption to preparers and users. Therefore, because the dual model would use today's lease classification principles, it would be less costly for preparers to apply (e.g., transition, ongoing compliance) and for users to understand (e.g., obtaining useful balance sheet information about leases).

How we see it

The Boards' decisions raise the possibility that there could be differences in lessee accounting in any final standards. The Boards appear to recognize that risk and said they will continue to work to resolve their differences.

Lessor accounting model

The Boards discussed two possible approaches for the lessor accounting model.

In comment letters and other feedback, a majority of constituents (including users) expressed support for retaining today's dual model for lessor accounting. In response, the Boards considered two approaches that would use today's IAS 17 dual classification approach, which is similar to, but not identical to, ASC 840.[3] Leases that transfer substantially all of the risks and rewards of ownership would be classified as Type A (similar to today's sales-type or direct financing leases). All other leases would be classified as Type B (similar to today's operating leases).

The difference between the two approaches relates to the recognition of selling profit on certain Type A leases (i.e., when the underlying asset's fair value is greater than its carrying value). The IASB indicated a preference for evaluating the transfer of substantially all the risks and rewards from the lessor's perspective. That is, lessors would consider all risks and rewards transferred to other parties when making the "substantially all" evaluation. This would include risks and rewards transferred to parties other than the lessee (e.g., a residual value guarantee provided to a lessor by a third-party insurer).

The FASB, however, indicated a preference for evaluating the transfer of substantially all the risks and rewards only from the lessee's perspective. That is, risks and rewards transferred to third parties other than the lessee would not be considered.

How we see it

Aligning the lessor model with IAS 17 would eliminate the bright lines in today's US GAAP. While eliminating the bright lines in US GAAP addresses one of the major criticisms of lease accounting, it would increase diversity in application.

Other tentative decisions

The Boards reached tentative decisions on the lease term (initial lease term and reassessment), the use of the portfolio approach and a short-term lease exception. These changes were made in response to constituents' concerns that the cost of applying the 2013 proposal would have outweighed the benefits.

The Boards' decisions on the portfolio approach and short-term leases are intended to provide relief to preparers.

Lease term – lease renewal and termination options

The Boards confirmed that a high threshold should be used to determine the lease term for leases with options to extend or terminate the lease (as well as an option to purchase a leased asset). However, they decided to change the term used to describe the threshold to "reasonably certain," which is used in IAS 17. The Boards also said that "reasonably certain" means the same thing as "reasonably assured" in ASC 840. In doing so, the Boards agreed not to use the new term they had proposed (i.e., significant economic incentive) to avoid inferring that practice should change.

The Boards also decided that lessees would be required to reassess the lease term upon the occurrence of significant events or changes in circumstances that are within the lessee's control (i.e., market-based factors would be excluded). The Boards expect that such events would occur infrequently. Finally, the Boards decided that lessors would determine the lease term at the commencement date in the same manner as lessees but would not reassess the lease term.

Portfolio approach

Many constituents had expressed concerns that the cost of applying the 2013 ED would exceed the benefits for leases that are high in volume, small in value and generally have similar characteristics (e.g., leases of a fleet of similar cars). The Boards decided that lessees and lessors would be able to apply any final guidance using a portfolio approach (rather than a lease-by-lease approach). Entities would be able to use a portfolio approach when they reasonably expect that doing so would not result in a material difference from accounting for the leases on an individual basis. It is not clear how the Boards would define "reasonably expect" and "material" for these purposes. The ED didn't address the portfolio approach, which led many constituents to infer that it would not be permitted. The FASB decided to include the portfolio guidance in the Basis for Conclusions while the IASB would include it in the application guidance of a final standard.

Other relief for small-ticket leases (lessees only)

The Boards considered but rejected relief for lessees with small-ticket leases based on specified materiality thresholds. The Boards also discussed a scope exception for leases of "small-ticket" assets (e.g., leases of office furniture), which IASB members decided to provide. However, the FASB members generally opposed it. The Boards will revisit this topic in a future meeting after the staffs research the types of assets that would qualify and how such an exception could affect the financial data of entities across various industries.

How we see it

The use of a small-ticket exception appears to be a more important issue to those advancing a single on-balance sheet model.

Short-term leases

The ED would have allowed lessees to make an accounting policy election (by class of asset) to exclude leases with a maximum possible contractual lease term (including all optional periods) of 12 months or less from the recognition and measurement provisions of the ED. The Boards confirmed that the threshold for short-term leases should be 12 months or less.

However, the Boards agreed to align the definition of "short-term lease" with that of "lease term." Specifically, the revised short-term lease definition would only consider lease renewal or termination options that a lessee is reasonably certain to exercise. This change would broaden the population of leases that might qualify for the exception. Certain quantitative and qualitative disclosures would be required for short-term leases if an entity makes such a policy election.

What's next

The Boards will continue to redeliberate lessee accounting, lessor accounting, leases of "small-ticket" assets and other issues (e.g., lease scope, definition) at future meetings. We expect redeliberations to continue through much of 2014.

Endnotes:

[1] See the Proposed Accounting Standards Update (revised), *Leases (Topic 842)*, on the FASB's website and our Technical Line, *How the lease accounting proposal might affect your company* (BB2589).

[2] International Accounting Standard (IAS) 17, *Leases*.

[3] Accounting Standards Codification (ASC) 840, *Leases*.

No. 2014-13
24 April 2014

To the Point

FASB — proposed guidance

Boards make more progress on leases project

A final leases standard is not likely before 2015.

What you need to know

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

Overview

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

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

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

Key decisions

Lease modifications

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

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

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

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

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

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

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

How we see it

The Boards' decisions on lease modifications are responsive to comments received from stakeholders, including seeking clarity on what constitutes a lease modification.

Contract combinations

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

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

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

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

Index- and rate-based variable lease payments

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

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

In-substance fixed payments

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

Discount rate

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

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

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

How we see it

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

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

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

What's next

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

Endnotes:

1 See the Proposed Accounting Standards Update (revised), *Leases (Topic 842)*, on the FASB's website.

2 See our To the Point, *Boards back away from some key aspects of leases proposal* (BB2718).

3 International Financial Reporting Standard (IFRS) 9, *Financial Instruments*.

4 Accounting Standards Codification (ASC) 310, *Receivables*.

5 Standing Interpretations Committee (SIC) Interpretation 27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*, provides guidance for combining two or more transactions involving a lease when the overall economic effects cannot be understood without considering the series of transactions as a whole.

6 International Accounting Standard (IAS) 17, *Leases*.

7 ASC 840, *Leases*.

8 Center for Audit Quality, *Daily Media Briefing* (18 April 2014).

SCORE No. BB2742

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No. 2014-19
29 May 2014

To the Point

FASB — proposed guidance

Is it a lease? Boards defer decision on definition, make progress on other topics in leases project

No decision was reached on the definition of a lease.

What you need to know

- At their May meeting, the FASB and the IASB continued to seek ways to clarify and simplify their 2013 joint proposal on leases.
- The Boards reached converged decisions on how to separate lease and non-lease components, how to allocate contract consideration and the accounting for initial direct costs.
- The Boards deferred a decision on the definition of a lease. Instead, the Boards' directed the staffs to draft language and further develop examples that demonstrate how the proposed definition would be applied.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) continued redeliberating their 2013 proposal[1] to put most leases on lessees' balance sheets. At their May meeting, they focused on the definition of a lease and the proposed requirements for separating lease and non-lease components and accounting for initial direct costs.

The Boards directed their staffs to further develop the approach they recommended to clarify the definition of a lease, implicitly acknowledging that the definition of a lease is fundamental to the operability of any final standard. However, by reaching converged decisions on the other topics discussed, the Boards signaled that they continue to seek ways to minimize any differences between US GAAP and IFRS while addressing constituents' concerns that their 2013 proposal would have been too complex and costly to apply. It remains unclear when or whether

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the Boards will revisit their fundamental differences that arose earlier in redeliberations on the proposed lessee and lessor accounting models.[2] The Boards' latest decisions, like all decisions to date, are tentative.

Definition of a lease

The Boards did not reach a decision on the definition of a lease at this meeting. Instead, they elected to continue to evaluate the staffs' recommendations, which attempt to clarify the 2013 proposal. Under that proposal, the definition of a lease would require entities to determine whether a contract contains a lease by assessing whether:

- The fulfillment of the contract depends on the use of an identified asset.
- The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

The staffs recommended that the Boards retain this principle but clarify how an entity would determine whether a contract depends on an identified asset and how to evaluate whether an entity has the right to control the use of such an identified asset.

The definition of a lease is of added importance because it will also determine which transactions are subject to the new revenue recognition standard.

Identified asset

Under the 2013 proposal, an asset would not be an identified asset if the supplier has a substantive substitution right (i.e., the supplier can substitute an alternative asset without the customer's approval, and there are no barriers to such substitution). At the May meeting, the staffs recommended that the Boards clarify that fulfillment of a contract would depend on an identified asset when either of the following criteria is met:

- The supplier does not have the practical ability to substitute an alternative asset (e.g., the customer can prevent substitution, an alternative asset cannot be sourced by the supplier within a reasonable time period).
- The supplier would not benefit from substituting an alternative asset.

A customer would presume that fulfillment of a contract depends on an identified asset when it is impractical to evaluate either of these criteria. No presumption for suppliers is necessary because they generally have sufficient information to make such a determination.

While the Boards did not reach a decision, they indicated that suppliers and customers would apply the criteria qualitatively.

Right to control the use of an identified asset

The 2013 proposal stated that an entity would have a right to control the use of an identified asset when the entity has the ability to both direct the use of the asset and obtain substantially all of the potential economic benefits from the asset's use. Constituents said additional guidance was needed for determining whether a customer has the ability to direct the use of an identified asset in more complex arrangements such as those involving significant services (e.g., power purchase agreements, oil rigs).

To address these concerns, the staffs recommended providing additional guidance on how entities would determine when a customer has the ability to direct the use of the identified asset (e.g., how to identify the decisions that most significantly affect the economic benefits to be derived from the asset's use and which party has the ability to most significantly affect those economic benefits, including when the supplier and customer both have decision-making rights). This recommendation appears to more closely align the right to control concept with existing consolidation guidance and the new revenue recognition standard[3] the Boards issued this week. The staffs also recommended that certain guidance from the 2013 proposal for determining whether an asset is incidental to a supplier's delivery of a service be excluded from any final standard.

How we see it

The Boards appeared to generally support the recommendations of their staffs. However, until a decision on the definition of a lease is reached, it will be unclear how certain concerns about the 2013 proposal are addressed.

Key decisions

Separating lease and non-lease components

The Boards agreed to retain the following guidance proposed in 2013 for:

- Identifying separate lease components (i.e., in contracts that contain multiple rights of use) when the lessee can benefit from a right of use (on its own or with other readily available resources) and the underlying asset is not dependent on or highly interrelated with other underlying assets in the contract
- Separating the lease components and non-lease components of a contract and allocating contract consideration to each component

However, in a change from their 2013 proposal, the Boards agreed on a practical expedient that would permit lessees to make an accounting policy election (by class of underlying asset) to account for lease and non-lease components as a single lease component.

Identifying the components in a contract

The Boards decided that activities (or lessor costs) in a contract that do not provide the lessee with an additional good or service would not be considered lease or non-lease components, and lessees and lessors would not allocate contract consideration to such activities (or lessor costs). Examples might include certain administrative costs.

In their discussions, the Boards agreed that activities and costs, such as a lessor's promises to provide services (e.g., common area maintenance), operate the underlying asset (e.g., vessel charter, aircraft wet lease) or pay for utilities consumed by the lessee would represent non-lease components.

Allocating contract consideration

The Boards agreed that lessees would allocate, subject to the practical expedient described previously, contract consideration to the lease and non-lease components on a relative standalone price basis. Lessees would use observable standalone prices when available. However, the Boards clarified that lessees would be permitted to use estimated standalone prices when observable standalone prices are not available. In estimating standalone prices, lessees would be required to maximize the use of observable information and to apply estimation methods in a consistent manner. This would be similar to how lessees allocate contract consideration under current US GAAP[4] and IFRS.[5]

The Boards confirmed that lessors would be required to apply the new revenue standard to allocate contract consideration between the lease and non-lease components of a contract.

The Boards also reached decisions about the reallocation of consideration in a contract. Lessees would be required to reallocate consideration upon a contract modification that is not accounted for as a separate, new contract, or upon a reassessment of the lease term or a lessee's purchase option (i.e., whether the lessee is, or is not, reasonably certain to exercise the option). Lessors would be required to reallocate the consideration in a contract upon a modification that is not accounted for as a separate, new contract.[6] Modifications resulting in a separate, new lease for lessors would require consideration to be allocated to the lease and non-lease components (as applicable), as with any new lease.

Initial direct costs

The Boards agreed to clarify that only incremental costs would qualify as initial direct costs. Costs would be considered incremental if they would not have been incurred absent the lease being obtained (i.e., executed), such as commissions. From the lessor's perspective, initial direct costs would be consistent with the concept of incremental costs in the new revenue recognition standard. The Boards also clarified that lessees and lessors would apply the same definition of initial direct costs.

Consistent with the 2013 proposal, lessors would include initial direct costs in the initial measurement of the lease receivable for Type A leases (generally sales-type or direct finance leases today). However, the Boards clarified that initial direct costs related to Type A leases that include selling profit would be expensed at lease commencement. Lessors would recognize initial direct costs associated with Type B leases (generally operating leases today) over the lease term on the same basis as lease income, consistent with the 2013 proposal.

The Boards agreed that lessees' initial measurement of the right-of-use asset would include initial direct costs. Lessees' costs that are incurred in a lease modification and meet the definition of initial direct costs would be included in the measurement of the new right-of-use asset (i.e., for a modification that results in a separate, new lease) or the adjustment to the right-of-use asset (i.e., for a modification that does not result in a separate, new lease).[6]

How we see it

For US GAAP, the Boards' decision to clarify that only incremental costs would qualify as initial direct costs would result in two key changes in practice. Lessors' initial direct costs would exclude allocated internal costs (e.g., salaries) and costs incurred before the lease is executed (e.g., legal advice, tax advice).

What's next

In June 2014, the Boards plan to redeliberate residual value guarantees, subleases and sale-leaseback accounting. A final standard is not expected before 2015.

Endnotes:

1 See the Proposed Accounting Standards Update (revised), *Leases (Topic 842)*, on the FASB's website.
2 See our To the Point, *Boards back away from some key aspects of leases proposal* (BB2718).
3 See Accounting Standards Update 2014-09, *Revenue from Contracts with Customers (Topic 606)*, on the FASB's website.
4 Accounting Standards Codification 840, *Leases*.
5 IFRS Interpretations Committee (IFRIC) Interpretation 4, *Determining whether an Arrangement contains a Lease*.
6 See our To the Point, *Boards make more progress on leases project* (BB2742).

No. 2014-21
19 June 2014

To the Point

FASB — proposed guidance

Boards continue their march toward new leases standard

The Boards reached different decisions about lessor classification of subleases.

What you need to know

- The Boards continued redeliberating ways to clarify and simplify their 2013 joint proposal on leases.
- They reached converged decisions on how intermediate lessors would present subleases in the balance sheet and income statement. However, they reached different decisions about how such subleases would be classified.
- The Boards reached converged decisions on how lessees would present Type A right-of-use assets and lease liabilities in the balance sheet and lessors' presentation in the statement of cash flows. They also decided that lessees' presentation in the statement of cash flows would be consistent with what they proposed in 2013.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) met again this week to redeliberate their 2013 proposal[1] to put most leases on lessees' balance sheets.

They focused on the accounting for subleases, lessee balance sheet presentation and the statement of cash flows presentation for lessees and lessors. By reaching converged decisions on the financial statement presentation of subleases, lessee balance sheet presentation for Type A leases and lessor presentation in the statement of cash flows, the Boards again looked to minimize differences in any final standards they issue for US GAAP and IFRS. However, a fundamental difference that arose earlier in redeliberations on the proposed lessee accounting

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model[2] led the Boards to reach different decisions on how intermediate lessors would classify subleases. As a reminder of those earlier discussions, the FASB is pursuing a dual approach to lessee accounting (i.e., there would be two types of leases, Type A and Type B) while the IASB is pursuing a single lessee model (i.e., Type A leases) with an exemption for leases of small-ticket assets. The latest decisions, like all decisions to date, are tentative.

Key decisions

Subleases

The Boards decided that an intermediate lessor (i.e., the entity that is a lessee in the head lease and the lessor in the sublease) would account for a head lease (as a lessee) and a sublease (as a lessor) as two separate lease contracts, as they had proposed in 2013. However, the Boards clarified that when contracts are entered into at or near the same time, an intermediate lessor would be required to consider the criteria for combining contracts (i.e., whether the contracts are negotiated as a package with a single commercial objective or the consideration to be paid in one contract depends on the price or performance of the other contract). If either criterion is met, the intermediate lessor would account for the head lease and sublease as a single combined transaction.

Intermediate lessors would generally present sublease revenue on a gross basis.

The Boards reached different decisions on how an intermediate lessor would classify a sublease as Type A (similar to a sales-type or direct financing lease today) or Type B (similar to an operating lease today). The FASB decided that an intermediate lessor would consider the lease classification criteria with reference to the underlying asset. The IASB, however, decided that an intermediate lessor would consider the lease classification criteria with reference to the remaining right-of-use asset from the head lease. The IASB's decision was driven primarily by its previous decision to only permit Type A leases for lessees (with certain exceptions). The IASB expects its decision to result in Type A classification for the sublease more often than if the lease classification were to be made with reference to the underlying asset (i.e., consistent with the Type A classification of the related head lease).

The Boards agreed on an intermediate lessor's presentation of subleases in the balance sheet and income statement. Specifically, an intermediate lessor would not be permitted to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, unless those liabilities and assets meet the applicable requirements for offsetting financial instruments.[3] The Boards also agreed that an intermediate lessor would apply the principal-agent guidance from the new revenue recognition standard[4] to determine whether sublease revenue should be presented on a gross or net (i.e., reduced for head lease expenses) basis. The Boards expect that intermediate lessors would generally present sublease revenue on a gross basis.

How we see it

The Boards are trying to align various aspects of the proposed leases guidance (e.g., the principal-agent considerations for sublease revenue) with the new joint revenue recognition standard.[5] Lessors should familiarize themselves with the new revenue standard because it will also influence their accounting for leases under a final leases standard.

Lessee balance sheet presentation

Consistent with their 2013 proposal, the Boards decided that lessees' Type A right-of-use assets would be presented in the balance sheet in either of the following ways:

- Separately from other assets (e.g., owned assets)
- Together with the corresponding underlying assets as if they were owned, with disclosure of the balance sheet line items that include Type A right-of-use assets and the amounts of those assets

The FASB decided that lessees' Type B right-of-use assets would be presented in the balance sheet separately from Type A right-of-use assets with disclosure of the balance sheet line items that include Type B right-of-use assets. The FASB decided not to specify how lessees would separately present Type B right-of-use assets in the balance sheet except to say that the presentation should be rational and consistent for similar leases.

The Boards also decided that lessees' Type A lease liabilities would be presented in the balance sheet in either of the following ways:

- Separately from other liabilities
- Together with other liabilities with disclosure of the balance sheet line items that include Type A lease liabilities and the amounts of those liabilities

In addition, the FASB decided that lessees' Type B lease liabilities would be presented in the balance sheet separately from Type A lease liabilities (similar to Type B right-of-use asset presentation and disclosure). The FASB did not specify how lessees would separately present Type B lease liabilities in the balance sheet. The FASB wants lessees to present Type B lease liabilities in a manner that is most appropriate based on the facts and circumstances. Furthermore, the FASB noted that this decision does not call into question the Boards' previous determination that lease liabilities are financial liabilities.

Presentation of leases in the statement of cash flows

Consistent with the 2013 proposal, the Boards agreed that lessors would present cash receipts from leases within operating activities in the statement of cash flows.

The Boards also decided to retain the requirements they proposed in 2013 for lessees' presentation in the statement of cash flows.

Under the 2013 proposal, lessees applying US GAAP would present the following in the statement of cash flows:

- Cash payments for the principal portion of Type A lease liabilities within financing activities
- Cash payments for the interest portion of Type A lease liabilities within operating activities
- Cash payments for Type B leases within operating activities

Lessees applying IFRS would present cash payments for the principal portion of Type A lease liabilities within financing activities and would present cash payments for the interest portion within operating or financing activities (based on an accounting policy election under IAS 7[6]).

What's next

Before issuing a final standard, the Boards will redeliberate several remaining issues, including the definition of a lease, leases of small assets (i.e., the IASB's recognition and measurement exemption for leases of small-ticket assets), sale and leaseback transactions, disclosures, and transition. The FASB will separately discuss leveraged leases and private company and not-for-profit issues (e.g., use of a risk-free discount rate as a policy election).

Endnotes:

[1] See the Proposed Accounting Standards Update (Revised), *Leases (Topic 842)*, on the FASB's website.

[2] See our To the Point, *Boards back away from some key aspects of leases proposal* (BB2718).

[3] See International Accounting Standard (IAS) 32, *Financial Instruments: Presentation*, and Accounting Standards Codification (ASC) 210-20, *Balance Sheet — Offsetting*.

[4] ASC 606-10-55-36 through 606-10-55-40 (IFRS 15.B34-B38).

[5] See Accounting Standards Update 2014-09, *Revenue from Contracts with Customers (Topic 606)*, on the FASB's website.

[6] IAS 7, *Statement of Cash Flows*.

No. 2014-27
24 July 2014

To the Point

FASB — proposed guidance

Boards address sale and leaseback transactions, lessor disclosures

The Boards' decisions would cause seller-lessees to recognize gains on sale and leasebacks differently under IFRS and US GAAP.

What you need to know

- The Boards continued redeliberating how to clarify and simplify their 2013 joint proposal on leases, reaching converged decisions on most lessor disclosure requirements and some aspects of the accounting for sale and leaseback transactions.
- The IASB decided to limit the immediate gain that seller-lessees would recognize on successful sale and leaseback transactions.
- The FASB determined that a Type A leaseback would preclude sale accounting, but seller-lessees would recognize the entire gain immediately on successful sale and leaseback (i.e., Type B leaseback) transactions.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) continued to redeliberate their 2013 joint proposal[1] to put most leases on lessees' balance sheets.

At a meeting this week, they reached converged decisions on most lessor disclosure requirements and some aspects of the accounting for sale and leaseback transactions. However, the Boards reached different decisions on seller-lessee gain recognition and the accounting for Type A leasebacks in sale and leaseback transactions. The FASB also deferred decisions on some topics so its staff could do more research.

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As we've said in previous publications,[2] the FASB is pursuing a dual approach to lessee accounting (i.e., there would be two types of leases, Type A and Type B), while the IASB is pursuing a single Type A lease model with an exemption for leases of small assets. Both Boards' lessee models would provide a recognition and measurement exemption for short-term leases. The latest decisions, like all decisions to date, are tentative.

Key decisions

Sale and leaseback transactions

Consistent with their 2013 proposal, the Boards decided that a seller-lessee would use the definition of a sale in the new revenue recognition guidance[3] to determine whether a sale has occurred in a sale and leaseback transaction. That is, a seller-lessee would assess whether the buyer-lessor has gained control of the underlying asset. Control of an underlying asset refers to the ability to direct the use of the asset and obtain substantially all of the remaining benefits from the asset. The Boards also confirmed their earlier decision that the presence of a leaseback, in and of itself, would not preclude a sale. However, each Board decided that different circumstances would preclude a sale.

The FASB decided that a sale and a purchase would not occur when a leaseback involves a Type A lease from the seller-lessee's perspective. The FASB believes that its Type A lease is effectively a financed purchase of the underlying asset. Therefore, it would be inappropriate for a seller-lessee to account for the sale of an underlying asset that it concurrently repurchases. Because the IASB is pursuing a single lessee accounting model (with an exemption for leases of small assets), it did not discuss this issue.

It may not be clear whether a seller-lessee's repurchase option is substantive.

Consistent with the new revenue recognition guidance, the IASB decided that a sale and a purchase would not occur if the seller-lessee has a substantive option to repurchase the underlying asset because the buyer-lessor would not obtain control of that asset. The presence of a non-substantive repurchase option (e.g., an option that is exercisable only at the end of the underlying asset's economic life) would not preclude sale accounting. The FASB deferred a decision on whether a substantive repurchase option should preclude a sale and instructed its staff to perform more analysis. Specifically, the FASB questioned whether an option to repurchase an asset at fair value (at the time of exercise) should preclude a sale.

The IASB decided, subject to its staff performing additional analysis, that when a sale does not occur, the seller-lessee and the buyer-lessor would account for the transaction as a financing. The FASB did not decide whether the liability in a failed sale and leaseback transaction would be accounted for as a financing obligation or another obligation; however, it instructed its staff to perform additional research on the topic.

Accounting for the sale

The Boards decided that when the buyer-lessor obtains control of the underlying asset in a sale and leaseback transaction (i.e., Type B leasebacks only in the FASB's proposal), the buyer-lessor would recognize the purchase of the asset based on other GAAP and account for the leaseback under the proposed lessor guidance. The Boards decided that the seller-lessee would do each of the following:

- Derecognize the underlying asset
- Recognize a lease liability and right-of-use asset for the leaseback (subject to the IASB's exemption for leases of small assets and the joint exemption for short-term leases)
- Recognize a loss (if any) immediately (adjusted for off-market terms)

The Boards reached different decisions on how the seller-lessee would recognize a gain (if any) on the sale (adjusted for off-market terms). The FASB determined that the seller-lessee would recognize the full gain immediately. However, the IASB decided that the seller-lessee's immediate gain would be limited to the portion related to the residual asset (i.e., the residual interest in the underlying asset transferred to the buyer-lessor). The remaining gain (i.e., related to the leaseback) would be recognized as a reduction to the initial measurement of the right-of-use asset, thus reflected as a reduction in the amortization of the right-of-use asset over the term of the leaseback. Under the IASB's approach, a seller-lessee would recognize a smaller immediate gain on a leaseback covering a large portion of the life of the underlying asset as compared to a similar transaction with a shorter leaseback of the same asset.

How we see it

The Boards' decisions on the immediate gain (if any) to be recognized in a sale and leaseback transaction represent another US GAAP and IFRS difference that would result in similar transactions being accounted for differently.

The Boards proposed in 2013 that a seller-lessee (and a buyer-lessor) would adjust the sale price (and purchase price) in a sale and leaseback transaction for any off-market terms. For example, a transaction might include a sale price that is not at fair value or lease payments that are not at market rates. This week, the Boards reaffirmed that approach and clarified that entities would determine such off-market adjustments using the fair value of the underlying asset or the market lease payments, whichever provides the more readily determinable evidence. Entities would be expected to maximize the use of observable prices and information when determining which measure is the most appropriate to use.

When the sale price is (or the total lease payments are) less than the underlying asset's fair value (or the total market lease payments), a seller-lessee would increase the initial measurement of the right-of-use asset. This treatment would be similar to the proposed accounting for lease prepayments. When the sale price is (or the total lease payments are) greater than the underlying asset's fair value (or the total market lease payments), a seller-lessee would recognize an additional financial liability (i.e., additional financing from the buyer-lessor) separately from the lease liability. Buyer-lessors would also be required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments would be recognized as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee.

Accounting for the leaseback

The Boards decided that when a sale occurs, both the seller-lessee and the buyer-lessor would account for the leaseback in the same manner as any other lease (i.e., in accordance with the lessee and lessor guidance, respectively, with adjustments for any off-market terms).

Transition

The Boards were scheduled to discuss transition for transactions previously accounted for as sale and leasebacks. However, they deferred their discussion to a future meeting when they will redeliberate the transition provisions for their entire leases proposal.

Lessor disclosure requirements

The Boards also reached decisions to retain many of the lessor disclosure requirements in their 2013 proposal, including:

- Information about the nature of leases (e.g., general description, existence, and terms and conditions of options to extend or terminate the lease)
- Significant assumptions and judgments made in accounting for leases (e.g., determination of whether a contract contains a lease, allocation of contract consideration)

- Information about how the lessor manages risk associated with the residual value of its leased assets, except it would apply to all leases (not just Type A, as initially proposed)
- A table of lease income recognized during the reporting period that includes income from Type A leases (i.e., profit/loss at commencement, interest income), lease payments on Type B leases and variable lease payments
- A maturity analysis of undiscounted cash flows (on an annual basis for five years after the balance sheet date and in total thereafter) that comprise Type A lease receivables and a reconciliation to lease receivables presented on the balance sheet (or in the notes)
- A separate maturity analysis of undiscounted lease payments (on an annual basis for five years after the balance sheet date and in total thereafter) to be received for Type B leases

The Boards also decided to further simplify the proposed lessor disclosure requirements by:

- Allowing lessors to present interest income on the net investment in Type A leases in the table of lease income, either in aggregate or individually, for each component of the net investment (i.e., lease receivable and residual asset)
- IASB only — Requiring lessors to qualitatively and quantitatively explain significant changes in the balance of net investments in Type A leases rather than requiring them to reconcile the opening and closing balances of lease receivables and residual assets (i.e., the net investment) for Type A leases
- FASB only — Requiring lessors to qualitatively and quantitatively explain significant changes in residual values of Type A leases (disclosure of significant changes in the lease receivable portion of the net investment would follow other US GAAP)

Lessors would be required to disclose more information than today about how they manage the risks related to residual values.

The Boards also decided that for assets leased under Type B leases, lessors would disclose the same information that is currently required[4] for property, plant and equipment (e.g., balances by major class, accumulated depreciation, general description of method of computing depreciation).

What's next

Before issuing a final standard, the Boards will redeliberate several remaining issues, including the IASB's recognition and measurement exemption for leases of small assets, lessee disclosures and transition. It is not clear whether, when or to what extent the Boards will discuss the definition of a lease. The FASB will separately discuss leveraged leases and private company and not-for-profit issues.

Endnotes:

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1 See the Proposed Accounting Standards Update (Revised), *Leases (Topic 842)*, on the FASB's website.

2 See our To the Point, *Boards back away from some key aspects of leases proposal* (BB2718).

3 See Accounting Standards Update 2014-09, *Revenue from Contracts with Customers* (*Topic 606*), on the FASB's website.

4 See Accounting Standards Codification 360-10, *Property, Plant and Equipment — Overall*, and International Accounting Standard 16, *Property, Plant and Equipment*.