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Defining Issues®

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# FASB and IASB Continue Discussions on Lease Accounting

During the second quarter of 2014, the FASB and IASB (the Boards) continued redeliberations on the proposals in their 2013 exposure drafts (EDs) on lease accounting.[1] While they agreed on many aspects of lease accounting, the Boards disagreed about when lessees would reassess variable lease payments and how a sublessor would determine the classification of a sublease.

## Key Facts

The Boards reached converged decisions about:

- ***Definition of a Lease.*** The Boards expressed support for the EDs' proposed definition of a lease – i.e., a contract that conveys the right to use an asset for a period of time in exchange for consideration, and agreed to clarify some of the key factors in applying the definition.[2]
- ***Lease Modifications and Contract Combinations.*** The Boards agreed on how to define and account for lease modifications and on guidance for when it is appropriate to combine contracts.
- ***Separating Lease and Non-lease Components.*** The Boards agreed to keep the EDs' proposals for lessors to separate lease and non-lease components and allocate consideration to those separate components using the guidance in the new revenue recognition standard. However, they decided to modify the EDs' proposals about when and how lessees would separate lease and non-lease components and allocate consideration to those separate components.[3]

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[1] FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org. The Boards met to discuss the project on April 23, May 22, and June 18. For more information about the Boards' previous redeliberations on the EDs see KPMG's Defining Issues No. 14-17, FASB and IASB Take Divergent Paths on Key Aspects of Lease Accounting. For more information about the EDs' proposals, see KPMG's Defining Issues No. 13-24, FASB and IASB Issue Revised Exposure Drafts on Lease Accounting, and Issues In-Depth No. 13-3, Implications of the Revised FASB and IASB Exposure Drafts on Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network.

[2] The IASB voted to retain the EDs' proposed definition of a lease. The FASB expressed general support for the principle supporting the EDs' proposed definition of a lease, but did not proceed to a formal vote.

[3] FASB Accounting Standards Update 2014-09, Revenue from Contracts with Customers, May 28, 2014, available at www.fasb.org, and IASB IFRS 15, Revenue from Contracts with Customers.

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- ***Initial Direct Costs.*** The Boards agreed that only *incremental* direct costs – i.e., costs that an entity would not have incurred if the lease had not been *obtained* – would qualify for capitalization on origination of a lease.
- ***Discount Rate.*** The Boards agreed to limit the lessor discount rate to the implicit rate and to change the circumstances that would require a reassessment of the discount rate, but to otherwise keep the EDs' discount rate proposals.
- ***Financial Statement Presentation.*** The Boards substantially agreed on several aspects of financial statement presentation, including balance sheet presentation for lessees and cash flow presentation for lessees and lessors.

The Boards failed to reach converged decisions about:

- ***Variable Lease Payments.*** The Boards agreed that only variable payments that (a) are in-substance fixed payments, or (b) depend on an index or rate would be included in the initial measurement of lease assets and liabilities, consistent with the EDs' proposals. However, the Boards disagreed about the circumstances that would require a lessee to reassess the measurement of those payments.
- ***Subleases.*** The Boards agreed on the presentation of lease assets and liabilities and income and expense related to a head lease and a sublease. However, the Boards disagreed about how a sublessor would determine the classification of a sublease.

## Key Impacts

- Changes in the definition of a lease are likely to mean that some arrangements will no longer be accounted for as leases. For example, some power purchase agreements that are leases under current GAAP because the purchaser obtains substantially all of the output from the asset during the term of the arrangement may be affected.
- Many of the Boards' decisions are designed to simplify the guidance and reduce its application costs, while others are designed to align the concepts supporting lease accounting with those underpinning the new revenue recognition requirements.
- Further divergence in the Boards' decisions (i.e., for variable lease payments and sublessor lease classification), which is in part due to their earlier lack of convergence on key aspects of lessee accounting, will make the task of comparing lessees applying U.S. GAAP with those applying IFRS more difficult than under current accounting standards – particularly given the lack of consistency in how lease liabilities will be measured during the lease term.
- For lessors, the Boards' recent decisions continue to be guided by an objective of keeping current lessor accounting requirements largely intact.



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## Background

The Boards began the leases project with the objective of developing a converged standard that would reduce complexity and arbitrary rules in current GAAP and require lessees to recognize all leases on-balance sheet. The EDs proposed that for all leases other than short-term leases, a lessee would recognize a right-of-use (ROU) asset for its right to use the underlying asset during the lease term and a lease liability for its obligation to make lease payments based on the present value of the lease payments. Subsequently, the lessee would measure the lease liability at amortized cost. However, subsequent accounting for the ROU asset and presentation of lease expense would depend on whether the lease was classified as Type A or Type B.

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

At the Boards' March 2014 meeting, the FASB decided to retain the EDs' proposed dual model but to replace the EDs' proposed lease classification approach for all types of underlying assets with a classification test similar to that in IAS 17.[4] The IASB opted for a single model based on the EDs' proposed Type A model. These differing approaches will cause significant differences between lessees applying U.S. GAAP and lessees applying IFRS in the measurement and presentation of lease expense, with consequential impacts on the balance sheet.

During the eight years the leases project has been on their respective agendas, the Boards have increasingly focused primarily on the goal of requiring lessees to recognize leases on-balance sheet and less on their other original objectives. Even so, many constituents were surprised by the Boards' decreased willingness to converge the key aspects of their proposals – particularly for lessee accounting – in previous redeliberations of the EDs' proposals. Although the additional divergence in their decisions during the second quarter of 2014 is in part a result of their earlier lack of convergence on key aspects of lessee accounting, one development is particularly noteworthy. Before the decisions the Boards reached during the second quarter, lease liabilities for lessees reporting under U.S. GAAP would have been measured the same way throughout the lease term as lease liabilities for lessees reporting under IFRS. This is no longer the case for some leases given the Boards' disagreement about when a lessee would be required to reassess the measurement of variable lease payments based on an index or rate.

The Boards will continue redeliberations of the EDs during the second half of 2014 and expect to discuss the following issues:

- Sale and lease-back transactions;
- Small-ticket leases;
- Disclosures;
- Leveraged leases (FASB only);
- Private company and not-for-profit issues (FASB only);

[4] IAS 17, Leases.

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- Transition and effective date;
- Cost-benefit considerations; and
- Related-party leases, consequential amendments, etc.

This edition of *Defining Issues* discusses the Boards' more significant decisions during the second quarter of 2014 and provides KPMG's observations on their potential impacts. The Boards' remaining decisions during the quarter are included in the Summary of Decisions Reached in Redeliberations.

## Definition of a Lease

The IASB decided to retain the EDs' proposals that a contract would contain a lease if fulfillment of the contract depends on the use of an identified asset and the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration. The proposed guidance is expected to clarify when and how these aspects of the definition are applied. The FASB expressed general support for the principle underlying the EDs' proposed definition of a lease, but directed its staff to provide additional information about the way the principle would be articulated in the standard along with examples of its application before proceeding to a formal vote.

One of the areas that constituents asked the Boards to clarify is how to determine whether an asset is identified when the supplier has a substitution right. The Boards agreed that a supplier's substitution right must be substantive to overcome the conclusion that there is an identified asset. A supplier's substitution right would be substantive only if:

- The supplier has the practical ability to substitute an alternative asset; and
- The benefits to the supplier of exercising the substitution right would be expected to outweigh the costs.

A supplier would not be considered to have the practical ability to substitute an alternative asset if:

- The customer could prevent the supplier from substituting the asset, or
- An alternative asset is not expected to be readily available and could not be sourced by the supplier within a reasonable period of time.

In addition, the Boards agreed to clarify that a customer would be required to assume that a supplier's substitution right is not substantive if it is impractical for the customer to determine that the conditions for the right to be considered substantive are met.

### KPMG Observations

The assessment of whether an arrangement is, or contains, a lease is, in effect, the new test to determine whether an arrangement is on-balance sheet or off-balance sheet for the customer. Realistically, it is likely to remain a key judgment however hard the Boards work to clarify and supplement the definition.

Changes in the definition of a lease will require all entities to reassess current leases and service arrangements upon adoption of the final leases standard to determine whether lease accounting applies. The new definition is unlikely to exclude most common lease

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arrangements (e.g., leases of vehicles, office equipment, and real estate) from the revised lease accounting requirements, however the result could be different for outsourcing and similar arrangements that include significant services. The implementation guidance and illustrative examples in the final standard will be critical in helping entities make this evaluation.

The guidance the Boards decided to provide about substitution rights is likely to limit the circumstances in which they would be a basis for concluding that there is not an identified asset in a potential lease arrangement. However, some arrangements that are currently accounted for as leases may no longer be as a result of the guidance on the right to control the use of an identified asset. This is most likely to be the case in arrangements that include significant services where the purchaser receives substantially all of the output of identified assets that are necessary for the seller to perform in accordance with the terms of the arrangement (e.g., certain outsourcing, power purchase and shipping arrangements).

The determination of whether the purchaser obtains the right to control the use of an identified asset often will depend on the extent of the decisions the purchaser can make about how the asset will be used – i.e., that are not pre-specified in the agreement. Two of the examples the Boards considered with respect to purchaser decisions involved shipping arrangements.

In the first arrangement, the contract specified cargo to be transported that would fill the capacity of an identified ship, where the cargo would be picked up, its destination, and the timing of transportation. In this example, the Boards concluded that because the customer did not have the right to redirect the use of the ship after executing the agreement, the customer did not have the right to control the use of the ship and therefore the arrangement did not contain a lease.

In the second arrangement, the contract specified that the customer would have the right to transport cargo on an identified ship for a specified time period to destinations of the customer's choosing during the contract term. In this example the Boards concluded that the arrangement contained a lease because the customer had the right to control the use of the ship during the term of agreement.

### Example 1: Lease Definition

*Facts:*

- A lessee enters into a three-year lease of a multifunction copier/printer.
- The contract provides the lessee the right to determine how to use the machine during the three-year term subject to the limitations of its design and capabilities.
- The vendor is required to provide an equivalent machine if the one originally delivered ceases to operate properly.
- The lessee has agreed that the vendor may substitute an equivalent machine for the original machine at any time at the vendor's expense.
  - The vendor has other equivalent machines readily available.
  - It is unlikely that the vendor would be able to generate more income by substituting an equivalent machine for the original machine than it would by leaving the original

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machine in place.

- The vendor would incur costs to transport and install an equivalent machine at the lessee's location.

*Results:*

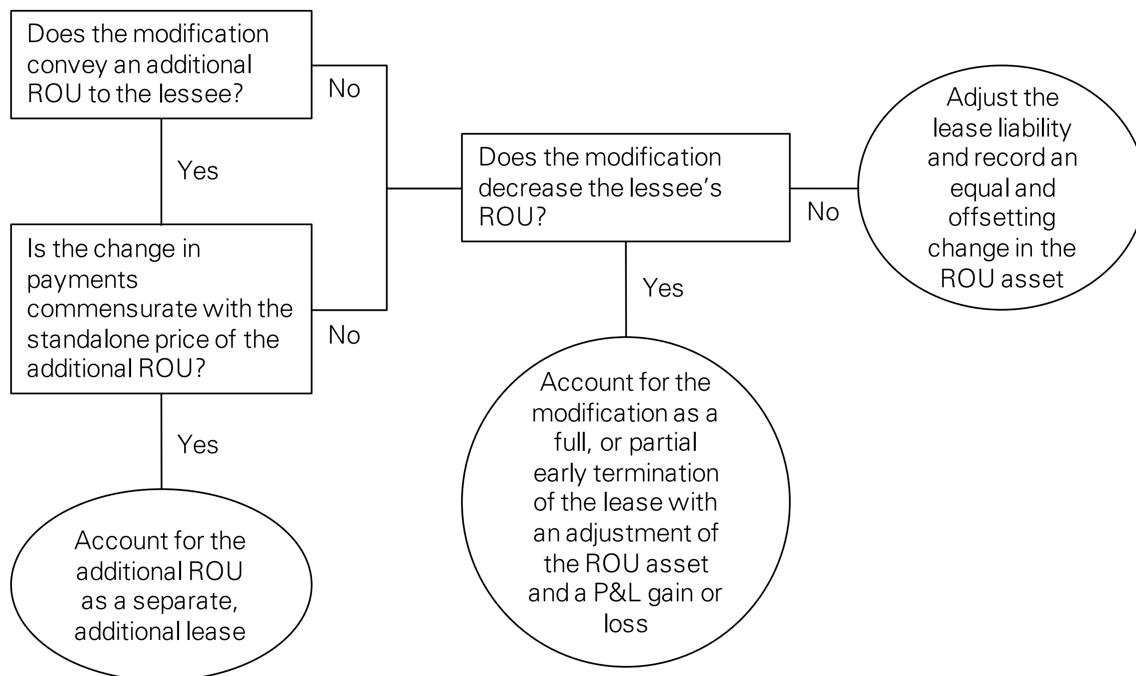
The substitution rights in this example are not considered substantive because the benefits to the vendor of exercising the substitution right would not be expected to outweigh the costs, and the contract therefore contains a lease.

## Lease Modifications and Contract Combinations

### Lease Modifications

The Boards agreed to define a lease modification as *any* change to the contractual terms and conditions that wasn't part of the original terms and conditions of the lease. A modification would be accounted for as a separate, additional lease when it conveys an additional right-of-use (ROU) to the lessee and the price of that additional ROU within the lease is commensurate with its standalone price.

*Modification Accounting by Lessees*

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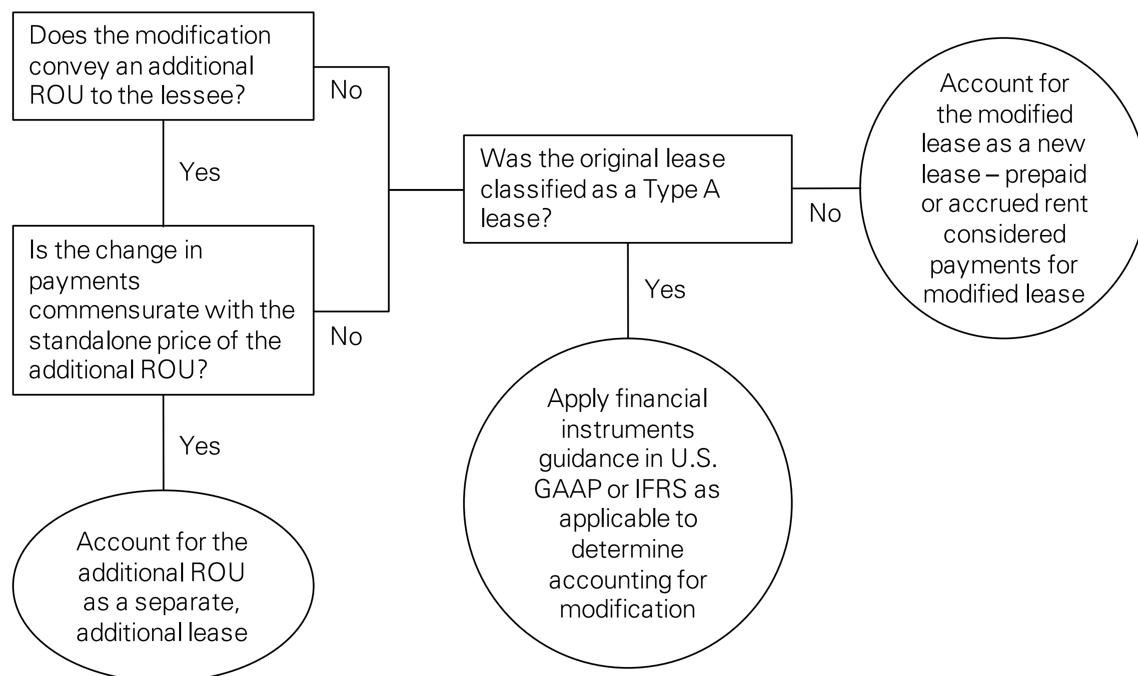
If a lease modification does not meet the criteria to be considered a separate, additional lease, the treatment for lessees is based on the nature of the modification. For all modifications except those that decrease the lessee's ROU, the lessee would adjust the ROU asset by the amount of the change in the lease liability. A reduction in the lease payments would not, by itself, be considered a decrease in the lessee's ROU. Modifications that decrease the lessee's ROU would be treated as a full or partial early termination of the lease with the entry offsetting the decrease in the lease liability apportioned between an adjustment to the balance of the ROU asset and a gain or loss recognized in the income statement.

*Modification Accounting by Lessors*




For lessors, the treatment of lease modifications that do not meet the criteria to be considered a separate, additional lease would depend on the lease classification. For leases originally classified as Type B leases, any modified lease would be essentially treated as a new lease, which would not fundamentally change lessor accounting for these types of modifications compared with current accounting guidance. Any prepaid or accrued rent balance relating to the original lease would be considered part of the payments for the modified lease. If the modified lease remains a Type B lease, no gain or loss would be recognized. If the modified lease is classified as a Type A lease, selling profit or loss likely would be recognized at the modification date. For leases originally classified as Type A leases, modifications would be accounted for under current GAAP on financial instruments.[5] The Type A modification accounting wouldn't change existing IFRS requirements, but it would represent a change for U.S. GAAP. Under U.S. GAAP, existing modification guidance for sales-type and direct financing leases is contained within the requirements for lease accounting and is less likely to result in an income statement effect than the modification guidance that applies to financial instruments.[6]

[5] FASB ASC Topic 310, Receivables, available at www.fasb.org, and IFRS 9, Financial Instruments.

[6] FASB ASC Topic 840, Leases, available at www.fasb.org.

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## KPMG Observations

The proposed lease modification accounting differs from the accounting for lease reassessments in situations where the modification decreases the lessee's ROU as illustrated in Scenarios C and D of Example 2. This may create an incentive for some lessees to enter into lease modifications to eliminate optional features in a lease because there is a difference between the accounting for a modification and the accounting for a reassessment. The proposed accounting for modifications that decrease the lessee's ROU also is inconsistent with the FASB's rationale for Type B lessee accounting – i.e., that the lease liability and ROU asset are inextricably linked – because the amount of the change in the lease liability would be different than the amount of the change in the ROU asset.

## Example 2: Lease Modification Scenarios for a Lessee

*Scenario A – Modification that is a separate, additional lease*

A lessee enters into a lease for four floors of an office building for a 10-year period with an optional renewal period of two years. At lease commencement it is reasonably certain that the lessee will exercise the renewal option. After five years, the lessee and lessor modify the original lease to add another floor in the same building for a 5-year term with an optional renewal period of two years. The increase in total lease consideration corresponds to the current market rate for one floor in that building for that lease term (including the optional renewal period).

*Result – Two leases.* The original, unmodified lease would remain on the lessee's books and a new, separate lease would be recorded for the additional floor.

*Scenario B – Modification that increases the lessee's ROU*

Assume the same facts as Scenario A, except in this case the consideration for the additional office space is not at market rates.

*Result – One lease.* The lessee would remeasure the lease liability based on the remaining term (5 years or 7 years depending on whether exercise of the renewal option is considered reasonably certain at the modification date), the total, modified consideration, and the lessee's incremental borrowing rate at the effective date of the modification. The lessee would also adjust the ROU asset by the amount of the change in the lease liability.

*Scenario C – Modification that decreases the lessee's ROU*

Assume the same facts as Scenario A for the initial lease. For this scenario, the lease is modified after year 5 to eliminate the lessee renewal option. The pre-modification carrying amount of the lease liability is $420,000. The amount of the reduction in the lease liability as a result of the modification is $115,000. The pre-modification carrying amount of the ROU asset is $370,000.

*Result – One lease.* The lessee would remeasure the lease liability based on the consideration over the 5-year remaining term and the lessee's incremental borrowing rate in effect at the effective date of the modification. The amount of the remeasured lease liability would be $305,000 ($420,000 – $115,000). The lessee would decrease the ROU asset by the amount of the decrease in its ROU. One way to make this determination is using the proportion of the decrease in the lease liability or $101,310 ($115,000 ÷ $420,000 × $370,000). The difference

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between the decrease in the ROU asset and the decrease in the lease liability would be recognized as a gain or loss in the income statement at the effective date of the modification. In this case the difference results in a gain of $13,690 ($115,000 – $101,310).

*Scenario D – Lease reassessment*

Assume the same facts as Scenario A for the initial lease. For this scenario, assume a lease reassessment is required after year 5. In performing the reassessment, the lessee concludes that exercise of the renewal option is no longer reasonably certain. The pre-reassessment carrying amount of the lease liability is $420,000. The amount of the reduction in the lease liability as a result of the reassessment is $115,000. The pre-reassessment carrying amount of the ROU asset is $370,000.

*Result* – The lessee would remeasure the lease liability based on the consideration over the 5-year remaining term and the lessee's incremental borrowing rate in effect at the reassessment date. The amount of the remeasured lease liability would be $305,000 ($420,000 – $115,000). The lessee would decrease the ROU asset by the amount of the decrease in the lease liability or $115,000. The amount of the remeasured ROU asset would be $255,000 ($370,000 – $115,000). No gain or loss would be recognized in the income statement as a result of the reassessment.

## Contract Combinations

The Boards also discussed when it is appropriate to combine contracts. They decided that two or more contracts should be combined if:

- 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 another contract.

### KPMG Observations

The Boards' contract combination decisions are intended to be consistent with the new revenue recognition standard's guidance and serve as a deterrent to structuring contracts to obtain, or avoid, a particular accounting treatment.

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## Separating Lease and Non-lease Components

<table>
<tr><th></th><th>Lessee</th><th>Lessor</th></tr>
<tr><td>When there is an observable standalone price for each component</td><td rowspan="2">Unless accounting policy elected (see below), separate and allocate based on relative standalone price of components – maximize the use of observable information</td><td rowspan="2">Always separate and allocate using the revenue recognition standard's guidance (i.e., on a relative standalone selling price basis)</td></tr>
<tr><td>When there is not an observable standalone price for some or all components</td></tr>
<tr><td>Taxes and insurance on the property</td><td colspan="2">Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract</td></tr>
<tr><td>Accounting policy election by class of underlying asset</td><td>Account for lease and non-lease components together as a single lease component</td><td></td></tr>
</table>

The Boards decided to retain the EDs' guidance for lessors to always separate lease and non-lease components and to allocate consideration to those components using the new revenue recognition standard's guidance (i.e., on a relative standalone selling price basis). The Boards also decided that lessors would reallocate consideration only when a modification occurs that is not accounted for as a separate, additional lease.

For lessees, the Boards decided to modify the EDs' proposed guidance to allow a policy election by class of underlying asset, to *not* separate lease components from non-lease components. If a lessee elects not to separate lease and non-lease components, the contract would be accounted for as a lease in its entirety.

If a lessee elects to separate lease and non-lease components, the lessee would allocate consideration to the components based on their relative standalone prices. Lessees would be required to maximize the use of observable inputs in determining standalone prices and to estimate standalone prices if observable prices are not available. Lessees also would be required to reallocate consideration when (a) there is a reassessment of either the lease term or whether it is reasonably certain that the lessee will exercise a purchase option, or (b) there is a contract modification that is not accounted for as a separate, additional lease.

The Boards also decided that activities or costs of the lessor that do not transfer a good or service to the lessee (e.g., reimbursement or payment of the lessor's taxes and insurance on the property) would not be considered separate components in a contract and, therefore, would not be accounted for separately or receive a separate allocation of consideration in the contract. This represents a change from current GAAP under which executory items such as taxes and insurance are explicitly excluded from lease accounting.

*Leases with Multiple Underlying Assets*

The Boards agreed to retain the EDs' proposals for an entity to account for the right to use an individual underlying asset (or group of underlying assets) as a separate lease when an arrangement includes the right to use multiple underlying assets only if:

- The lessee can benefit from use of the asset (or group of assets) either on its own or together with other resources that are readily available to the lessee; and


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- The underlying asset (or group of assets) is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

## KPMG Observations

It was important under the EDs' proposals to identify each lease component and assess the nature of the primary asset in order to determine classification as either a Type A or Type B lease. However, the Boards' decisions on lease classification in March (for lessees applying IFRS all leases would be Type A leases, and for all other leases under IFRS and U.S. GAAP classification would be based on IAS 17 criteria rather than the nature of the underlying asset) reduced the importance of separating out different lease components.

Nevertheless, the guidance on components has acquired a potential new significance for the IASB version of the proposals. Identifying separate lease components as the unit of account will establish a "floor" below which an entity will not be able to further disaggregate an asset when applying the final standard. This will be critical if the IASB proceeds with a small-ticket lease exemption for lessees, as it will limit the ability of lessees to break-down a lease of a large asset into smaller leases of separate parts in order to qualify for the exemption.

The decision to allow for lessees to use estimation techniques (e.g., a residual approach) in determining stand-alone selling prices of components (if observable prices are not available) for the allocation of contract consideration will eliminate the need for lessors to potentially provide proprietary pricing information to lessees. The use of estimation techniques will also help to reduce the costs and complexity of applying the proposals.

Providing lessees an alternative to not separate lease and non-lease components could lessen comparability between entities. However, the Boards believe that lessees will typically elect the alternative only for leases with insignificant non-lease components (to minimize their lease liabilities).

The Boards' decision that property tax and insurance obligations of the lessor are not separate components in a contract may result in different accounting by lessees depending on whether the lease is a gross lease or a net lease. For example, a lessee could enter into a gross lease in which it pays the lessor $5,000 per month and has no separate obligation with respect to the lessor's property taxes or insurance on the property. Alternatively, the lessee and lessor could enter into a net lease that obligates the lessee to (a) pay the lessor $4,500 per month, (b) separately obtain property insurance that includes the lessor as a named beneficiary, and (c) reimburse the lessor for its actual property tax assessments during the lease term. Under the gross lease, the amount of the lessee's lease liability and ROU asset would be determined using the payment of $5,000 per month whereas the lease liability and ROU asset under the net lease would be determined using the payment of $4,500 per month.



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## Variable Lease Payments

The Boards agreed to include variable lease payments (VLPs) that are in-substance fixed payments in the definition of lease payments used to initially measure lease assets and liabilities. In-substance fixed payments would include payments that do not create genuine variability and the minimum payments the lessee is required to make when it has alternative payments that it can select from under the lease (e.g., due to optional features within the lease). This is consistent with current practice and the EDs' proposals.

The Boards decided that the only other VLPs that would be included in the initial measurement of lease assets and liabilities are VLPs that depend on an index or rate, consistent with the proposals in the EDs. These VLPs would be measured using the index or rate at the lease commencement date. Lessors would not reassess VLPs during the lease term. Conversely, the Boards decided that lessees would be required to reassess VLPs based on an index or rate in some circumstances. However, they could not agree on the circumstances that would require reassessment.

The FASB decided that lessees would only reassess VLPs based on an index or rate when lease payments are remeasured for other reasons, such as a change in the lease term. The IASB decided that lessees would also reassess VLPs based on an index or rate when there is a contractual change in cash flows (i.e., when an adjustment to the lease payments based on an index or rate takes effect under the terms of the lease).

### KPMG Observations

Although the Boards agreed on the principle that VLPs that are in-substance fixed payments would be included in the initial measurement of lease assets and liabilities, they had difficulty reaching agreement on the application of that principle to examples provided by their staff. The Boards acknowledged that the principle has been applied in practice and is well understood. As a result, they decided not to include examples addressing that principle in the standard.

One of the reasons for the Boards' divergence on when to reassess VLPs based on an index or rate could be the diverse geographical makeup of financial statement preparers applying IFRS. A key index that is often used in VLPs is the consumer price index (CPI) or its equivalent. In some countries that use IFRS, the periodic fluctuations in CPI can be extreme. The financial statement impact, particularly for the balance sheet, of reassessments when there are contractual changes in cash flows related to lease payments based on an index or rate is much more likely to be material in those economic environments than it is in the United States where CPI is fairly stable.

The difference in the Boards' lessee accounting models complicates the evaluation of the implications of their divergence on when to reassess VLPs based on an index or rate. Under the FASB approach, most leases will be accounted for as Type B leases. Reassessment of VLPs based on an index or rate for Type B leases will only impact the balance sheet – net income and lease expense will be unaffected. Under the IASB approach, all leases that don't qualify for a practical expedient (e.g., some short-term leases) will be accounted for as Type A leases. Reassessment of VLPs based on an index or rate for Type A leases will impact both the balance sheet and the income statement, although the income statement effect may often be immaterial. The differences in the balance sheet and income statement impact for Type A versus Type B leases may be significant without regard to the treatment of VLPs based on an

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index or rate. However, when combined with the Boards' non-converged lessee accounting models, the different approaches to reassessment of VLPs will not only further distort the comparability of the ROU asset but will also result in different subsequent measurement of the lessee's lease liability. VLPs based on an index or rate are a common feature in lease agreements, especially leases of property, and for a majority of these leases the subsequent measurements of both a lessee's ROU asset and lease liability will be accounted for differently under the Boards' respective proposals. Consequently, the differing triggers for reassessment of VLPs based on an index or rate will create additional effort and complexity for financial statement users attempting to compare lessees applying U.S. GAAP to lessees applying IFRS.

**Example 3: In-Substance Fixed Payments**

A lessee enters into a 10-year lease with a lessor for payments that are initially $20,000 per month in arrears. The payments increase by 1% annually for every 0.1% increase in CPI from the prior year (resulting in a leverage factor of 10 times the change in CPI), limited to a maximum increase of 2% per year. Once VLPs increase they cannot decrease under the provisions of the lease. The CPI increase has exceeded 1% in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than 0.2% during the term of the lease.

*Result* – The facts in this example are such that the payments under the CPI escalation provision likely would be considered in-substance fixed payments rather than VLPs, given the remote likelihood that the change in CPI would be less than 0.2%. If so, the lessee and lessor would include a 2% annual increase in the measurement of lease payments.

## Other Topics Discussed

The Boards' decisions on initial direct costs, discount rate, subleases, and financial statement presentation are included in the section, *Summary of Decisions Reached in Redeliberations*. With the exception of the decisions on subleases and cash flow presentation, the Boards' decisions on these topics were substantially converged, not significantly different than the proposals in the EDs, and would not result in a significant change from current GAAP.

The Boards did not agree on how a sublessor would determine the classification of a sublease. The FASB decided that a sublessor would consider the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease, which is consistent with current U.S. GAAP. Conversely, the IASB decided that a sublessor would consider the ROU asset to be the leased asset in determining the classification of the sublease, which is not consistent with current practice under IFRS.

The Boards reached decisions on cash flow presentation that were substantially converged and consistent with the EDs' proposals. Specifically, lessee principal payments for Type A leases would be classified as financing activities and lessee payments for Type B leases, VLPs, and payments for leases that are eligible for a practical expedient (such as some short-term leases) would be classified as operating activities. Lessees applying U.S. GAAP would classify interest payments on Type A leases as operating activities while lessees applying IFRS would classify



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interest payments on leases as either operating or financing activities based on the lessee's accounting policy choice under IAS 7.[7]

## KPMG Observations

### *Subleases*

The Boards' decisions on subleases are likely to result in Type B classification by the sublessor for most subleases under U.S. GAAP. Conversely, subleases are more likely to be classified as Type A leases by the sublessor under IFRS. Although the difference in the Boards' decisions is at least partly a result of their lack of convergence on lessee accounting, it will create additional effort and complexity for financial statement users attempting to compare lessee-sublessors applying U.S. GAAP to lessee-sublessors applying IFRS.

### *Cash Flow Presentation*

The Boards' cash flow presentation decisions would not result in significant changes in operating and financing cash flows for lessees applying U.S. GAAP. However, they would likely significantly change the composition of operating and financing cash flows for lessees applying IFRS. Under current IFRS most leases are classified as operating leases and, therefore, most lease payments by lessees are classified as operating cash flows. Because all leases other than those that qualify for a practical expedient would be Type A leases, a substantial proportion of lease payments would be classified as financing cash flows by lessees applying IFRS under the IASB's proposed lessee accounting model. The IASB decided to require lessees to disclose total lease payments in the notes to the financial statements to mitigate the difficulty that financial statement users would otherwise encounter in comparing the cash flows from leasing activities for lessees applying IFRS to those for lessees applying U.S. GAAP.

[7] IAS 7, Statement of Cash Flows.

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# Summary of Decisions Reached in Redeliberations

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Definition of a Lease[8]</td><td colspan="2">• A contract would contain a lease if:<br>– Fulfillment of the contract depends on the use of an identified asset; and<br>– The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration</td></tr>
<tr><td rowspan="2">Practical Expedients and Targeted Reliefs</td><td colspan="2">• Optional lessee exemption for short-term leases – i.e., leases for which the lease term as determined under the revised proposals ≤ 12 months<br>• Portfolio-level accounting would be permitted if it does not differ materially from applying the requirements to individual leases</td></tr>
<tr><td>• No exemption for small-ticket leases</td><td>• Optional lessee exemption for small-ticket leases (e.g., leases of IT equipment and office furniture), even if material in aggregate</td></tr>
<tr><td>Lessee Accounting Model</td><td>• Dual lease accounting model<br>• Lease classification test based on IAS 17 classification criteria<br>• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability<br>– Type A leases would be treated as the purchase of an asset on a financed basis<br>– Type B leases generally would have straight-line recognition of total lease expense</td><td>• Single lease accounting model<br>• No lease classification test<br>• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability<br>– Treated as the purchase of an asset on a financed basis</td></tr>
<tr><td>Lessor Accounting Model</td><td colspan="2">• Dual lease accounting model<br>• Lease classification test based on IAS 17 classification criteria<br>• Type B accounting model based on IAS 17 operating lease accounting<br>• Type A accounting model based on IAS 17 finance lease accounting with recognition of net investment in lease comprising lease receivable and residual asset</td></tr>
</table>

[8] The IASB voted on this definition. The FASB expressed general support for the principle supporting the definition, but has not yet proceeded to a formal vote.

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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td>– Selling profit would not be recognized on commencement of leases that qualify for Type A classification only due to involvement by third parties other than the lessee</td><td>– There would be no restriction on recognizing selling profit on commencement of Type A leases</td></tr>
<tr><td>Lease Term and Purchase Options</td><td colspan="2">• Optional (e.g., renewal) periods and purchase options would be included in lease accounting if it is reasonably certain that the lessee will exercise those options, consistent with the high threshold in current GAAP<br>• Lessees would reassess renewal and purchase options if there is a significant event or change in circumstances that is within the control of the lessee – e.g., construction of significant leasehold improvements<br>• No reassessment of renewal and purchase options by lessors</td></tr>
<tr><td>Initial Direct Costs</td><td colspan="2">• Initial direct costs would include only incremental costs that an entity would not have incurred if it had not obtained the lease<br>• Lessees would include initial direct costs in the initial measurement of the ROU asset and amortize the costs over the lease term<br>• Initial direct costs would be included in determining the lessor's implicit rate unless the lease is a Type A lease for which selling profit would be recognized at lease commencement<br>• Lessors would include initial direct costs for Type A leases<br>– In the initial measurement of the lease receivable if no selling profit is recognized at lease commencement<br>– In expense at lease commencement if selling profit is recognized at lease commencement<br>• Lessors would capitalize initial direct costs for Type B leases and amortize the costs over the lease term in the same pattern as lease income</td></tr>
<tr><td>Discount Rate</td><td colspan="2">• The lessee's discount rate would be the lessor's implicit rate if available; otherwise, the lessee's incremental borrowing rate<br>– The value used to determine the lessee's incremental borrowing rate would be the cost of the ROU asset<br>• Lessees would reassess the discount rate when there is<br>– A change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option; and<br>– A lease modification<br>• The lessor's discount rate would be the rate implicit in the lease (i.e., the</td></tr>
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| Redeliberations of 2013 Exposure Drafts | | |
|---|---|---|
| **Topic** | **FASB Decisions** | **IASB Decisions** |
| | implicit rate)<br>– Initial direct costs would be included in determining the implicit rate unless the lease is a Type A lease for which selling profit will be recognized at lease commencement<br>• Lessors would reassess the discount rate when there is a lease modification | |
| **Variable Lease Payments** | • Lease payments used in the initial measurement of lease assets and liabilities would include<br>– Variable payments based on an index or rate using prevailing (spot) rates or indices at lease commencement; and<br>– Variable payments that represent in-substance fixed payments (consistent with current practice)<br>• No reassessment of variable lease payments by lessors<br>• Variable payments that are not based on an index or rate and are not in-substance fixed payments would be excluded from the measurement of lease assets and liabilities and recognized as expense as incurred or income as earned | |
| | • Lessees would reassess variable lease payments based on an index or rate when lease payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term) | • Lessees would reassess variable lease payments based on an index or rate when:<br>– Lease payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)<br>– There is a contractual change in the cash flows (i.e., when an adjustment to the lease payments based on an index or rate takes effect under the terms of the lease) |
| **Arrangements with Lease and Non-lease Components; Contract Combinations** | • Activities (or costs of the lessor) that do not transfer a good or service to the lessee (e.g., taxes and insurance on the property) would not be considered components in a contract<br>• Lessors would always separate lease and non-lease components and allocate consideration using the new revenue recognition standard's guidance (i.e., on a relative standalone selling price basis)<br>– Reallocate consideration when there is a contract modification that is not accounted for as a separate, additional lease<br>• Lessees would choose an accounting policy by class of underlying asset | |

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<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">to either:<br>– Separate lease and non-lease components and allocate consideration based on relative standalone price of components, maximizing the use of observable information<br>▪ Reallocate consideration when (a) there is a reassessment of either the lease term or whether exercise of a lessee purchase option is reasonably certain, or (b) there is a contract modification that is not accounted for as a separate, additional lease<br>– Account for lease and non-lease components together as a single lease component<br>• Two or more contracts would be combined as a single transaction if:<br>– The contracts are negotiated as a package with a single commercial objective; or<br>– The amount of consideration to be paid in one contract depends on the price or performance of the other contract</td></tr>
<tr><td>Lease Modifications</td><td colspan="2">• Lease modifications 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<br>• A modification would be considered a separate lease when it grants the lessee an additional ROU that was not included in the original lease and that ROU is priced commensurate with its stand-alone price in the context of that particular contract<br>• For lessees, when a modification is not considered a separate, additional lease:<br>– If the modification does not reduce the lessee's ROU, the ROU asset would be adjusted by the amount of the adjustment to the lease liability<br>– If the modification reduces the lessee's ROU, the modification would be treated as a full or partial early termination of the lease with a resulting income statement effect<br>• For lessors, when a modification is not considered a separate, additional lease:<br>– Type B lease modifications would be treated as a new lease with any prepaid or accrued rent on the original lease considered part of the lease payments for the new lease<br>– Type A lease modifications would be accounted for under the financial instruments requirements in U.S. GAAP or IFRS as applicable</td></tr>
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<td rowspan="2">Subleases</td>
<td colspan="2">• A lessee-sublessor would account for the head lease and the sublease as two separate contracts unless those contracts meet the contract combinations guidance<br>– The head lease would be accounted for in accordance with the lessee accounting proposals<br>– The sublease would be accounted for in accordance with the lessor accounting proposals<br>• A lessee-sublessor would not offset lease liabilities and assets arising from a head lease and sublease unless they meet the financial instruments requirements for offsetting in U.S. GAAP or IFRS as applicable<br>• A lessee-sublessor would not offset lease income from a sublease and lease expense from a head lease unless it meets the requirements for offsetting in other U.S. GAAP or IFRS as applicable (e.g., the new revenue recognition standard)[9]</td>
</tr>
<tr>
<td>• A sublessor would consider the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease</td>
<td>• A sublessor would consider the ROU asset to be the leased asset in determining the classification of the sublease</td>
</tr>
<tr>
<td rowspan="2">Lessee Presentation – Balance Sheet</td>
<td colspan="2">• Lessees would present Type A ROU assets and lease liabilities either as separate line items on the balance sheet or disclose separately in the notes to the financial statements<br>– If not separately presented on the balance sheet lessees would:<br>▪ Present Type A ROU assets on the balance sheet as if the underlying asset were owned<br>▪ Disclose in the notes the line items on the balance sheet in which Type A ROU assets and lease liabilities are included and their amounts</td>
</tr>
<tr>
<td>• Lessees would not include Type B ROU assets and lease liabilities in the same line items as Type A ROU assets and lease liabilities on the balance sheet<br>– If not separately presented on the balance sheet lessees would disclose in the notes the line items on the balance sheet in which Type B ROU assets and lease liabilities are included and their amounts</td>
<td>• N/A – no Type B lease classification</td>
</tr>
</table>

[9] Members of both Boards believe it is unlikely that sublease income and head lease expense would qualify to be offset if the sublease is classified as a Type B lease.

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<table>
<tr><td>Lessee Presentation – Statement of Cash Flows</td><td>• Lessees would classify cash paid for:<br>– Principal on Type A lease liabilities as financing activities<br>– Interest on Type A lease liabilities as operating activities<br>– Type B leases, variable lease payments, and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities</td><td>• Lessees would present cash paid for:<br>– Principal on lease liabilities as financing activities<br>– Interest on lease liabilities as either operating or financing activities based on the lessee's accounting policy choice under IAS 7<br>– Variable lease payments and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities<br>• Lessees would disclose total lease payments in the notes to the financial statements</td></tr>
<tr><td>Lessor Presentation</td><td colspan="2">• Lessors would present lease assets and liabilities and income and expense consistent with the current guidance in IAS 17<br>• Lessors would classify all cash inflows from leases as operating activities in the statement of cash flows</td></tr>
</table>

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