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# FASB Balloons Balance Sheet with New Lease Accounting Standard

The FASB's new lease accounting standard ushers in a new era in which lessees will recognize most leases on-balance sheet.[1] This will increase their reported assets and liabilities – in some cases very significantly. Lessor accounting remains substantially similar to current U.S. GAAP but with some important changes.

Well before the new standard becomes effective, lessees and lessors will need to assess how widespread its effects will be so they can plan for necessary business and process changes.

## Effective Dates and Transition

| | The entity is … | |
|---|---|---|
| **Question** | **… a public business entity[2]** | **… any other type of entity** |
| **When does Topic 842 take effect?** | Annual and interim periods in fiscal years beginning after **12/15/2018** | • Annual periods beginning after **12/15/2019**<br>• Interim periods in fiscal years beginning after **12/15/2020** |
| **Can entities early adopt?** | Yes, all entities can adopt Topic 842 immediately | |
| **What is the transition method?** | Modified retrospective, with elective reliefs, which requires application of the new guidance for all periods presented | |

[1] FASB ASC Topic 842, Leases, issued February 25, 2016. Topic 842 replaces ASC Topic 840, Leases (current U.S. GAAP). Both are available at www.fasb.org.

[2] This includes (a) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market and (b) employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission.

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### *Modified Retrospective Transition*

Lessees and lessors will apply the new guidance at the beginning of the earliest period presented in the financial statements in which they first apply the new standard. This may significantly change comparative period balance sheets from what was previously reported for many lessees.

The modified retrospective approach includes elective reliefs that all lessees and lessors may apply in transition. These include:

| | |
|---|---|
| **Must be elected as a package** | • At the adoption date, the entity may elect not to reassess:<br>– Whether expired or existing contracts contain leases under the new definition of a lease;<br>– Lease classification for expired or existing leases; and<br>– Whether previously capitalized initial direct costs would qualify for capitalization under the new standard |
| **May be elected individually or with the other practical expedients** | • The entity may use hindsight in determining the lease term and in assessing impairment of right-of-use (ROU) assets |

An entity that elects to apply all of the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with current U.S. GAAP unless the lease is modified (or remeasured) on or after the effective date, except that lessees are required to:

- Recognize a ROU asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments under current U.S. GAAP; and
- Apply the new requirements with respect to changes in estimates that affect lease accounting during the lease term (i.e., reassessments as discussed further below) beginning on the effective date.

The new standard also provides specific transition guidance for sale-leaseback transactions, build-to-suit leases, leveraged leases, and amounts previously recognized for leases in business combinations. This guidance will, for example, conform the determination of whether a lessee in a build-to-suit lease arrangement will recognize the entire underlying asset on its balance sheet to the requirements in the new standard.



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## Key Impacts to Lease Accounting

***Lessees Will Recognize Most Leases on-Balance Sheet.*** All leases, including operating leases, will be recognized on-balance sheet via a *ROU asset* and *lease liability*, unless the lease is a short-term lease (i.e., one with an accounting lease term of *12 months or less*). This may require a substantial effort to identify all of the entity's leases and accumulate the lease data necessary to apply the new guidance. Lease classification will determine whether a lease is reported as a financing transaction in the income statement and statement of cash flows.

***New Judgments Are Required to Identify a Lease.*** The definition of a lease is the new test for whether a transaction is on- or off-balance sheet. While the new definition is similar to current U.S. GAAP and will yield similar results in most cases, some arrangements that currently contain a lease no longer will. In addition, a new requirement to determine whether the customer has the right to direct the use of the identified asset will require significant new judgments.

***Lessee Reassessments Will Require New Processes and Controls.*** Lessees will be required to reassess, and potentially change, aspects of their accounting for leases (e.g., assessments of the lease term, lessee purchase options, and lease classification) during the lease term, and remeasure lease assets and lease liabilities even if there is not a lease modification.

***Accounting for Executory Costs.*** All (or a portion of) fixed payments by the lessee to cover lessor costs related to ownership of the underlying asset (e.g., property taxes or insurance – also referred to as executory costs) that do not represent payments for a good or service will be considered *lease payments* and reflected in the measurement of lease assets and lease liabilities by lessees (and in the lessor's net investment in the lease for sales-type and direct financing leases). Under current U.S. GAAP, payments for executory costs, including those to reimburse lessors for costs related to the underlying asset, are excluded from *minimum lease payments* and, therefore, from lease accounting.

***Collectibility Considerations and Variable Payments Will Affect Lessors' Accounting in New Ways.*** While the new lessor accounting guidance is generally consistent with current U.S. GAAP, the new standard changes how lessors account for leases in which collectibility of the lease payments is uncertain. Lessors may now have to recognize some lease payments received as liabilities in those cases. The new standard also may affect leases for which there are significant variable payments because they no longer will be classified as operating leases solely due to the extent of variable payments. This may result in a negative implicit rate for the lease or loss recognition at lease commencement.

***Fewer Lease Origination Costs Will Be Capitalizable.*** The new standard has a narrow definition of *initial direct costs* that will require lessors and lessees to recognize more lease origination costs as expenses when incurred. Only incremental costs incurred as a result of the lease being executed (e.g., commissions) meet the new definition and can be capitalized. Accordingly, costs incurred to negotiate and arrange a lease that are *not incurred only as a result of executing the lease* (e.g., legal fees and certain internal employee costs) – some of which are capitalized under current U.S. GAAP – will now be expensed when incurred. This could particularly affect lessors that incur significant costs in the lease origination process.



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***Expanded Quantitative and Qualitative Disclosures.*** The new standard requires lessees and lessors to disclose more qualitative and quantitative information about their leases than current U.S. GAAP does. Entities should consider whether they have appropriate systems, processes, and internal controls to capture completely and accurately the lease data necessary to provide those expanded disclosures.

***Significant Changes to Sale-Leaseback Accounting Will Affect Seller-Lessees and Buyer-Lessors.*** The new standard essentially eliminates sale-leaseback accounting as an off-balance sheet financing proposition. This is because seller-lessees will recognize a ROU asset and lease liability in place of the underlying asset (and any asset financing repaid with the sale proceeds). In addition, under the new guidance:

- There likely will be fewer failed sales in sale-leaseback transactions involving real estate, but there may be more failed sales in equipment sale-leaseback transactions.
- Buyer-lessors will have to consider the same sale guidance in the new revenue recognition standard as seller-lessees to determine whether they have purchased the underlying asset, which may result in a failed purchase.[3] A buyer-lessor accounts for a failed purchase as a financing arrangement (i.e., a loan to the seller-lessee) rather than the acquisition of an asset and a lease.
- Seller-lessees will recognize the entire gain from the sale of the underlying asset (i.e., the difference between the selling price and the carrying amount of the underlying asset) at the time the sale is recognized rather than over the leaseback term.

***Current Build-to-Suit Lease Guidance Replaced.*** The new guidance on determining when a lessee controls an underlying asset before lease commencement probably will result in fewer transactions where the lessee is considered the accounting owner of an asset during the construction period than current U.S. GAAP.[4] This means that fewer build-to-suit lease arrangements will become subject to the sale-leaseback accounting requirements. The changes to the sale-leaseback guidance also make it easier for lessees to remove real estate assets recognized during the construction period from their books. Finally, the transition provisions of the new standard will permit many entities to derecognize *build-to-suit* assets and liabilities that have remained on the balance sheet after the end of the construction period under current U.S. GAAP.

[3] FASB ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

[4] FASB ASC paragraphs 840-40-55-2 through 55-16.

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## Tell Me More

This section provides more information about some of the key differences between the new lease accounting standard and current U.S. GAAP.

A lessee will recognize a ROU asset and a lease liability on its balance sheet for most leases, which is a significant change from current U.S. GAAP.

### Most Leases on-Balance Sheet for Lessees

Under the new standard, a lessee will recognize a (financial) lease liability and a (nonfinancial) ROU asset for all leases, including operating leases, with a term greater than 12 months on its balance sheet.[5] This effectively means that lessees will appear more asset-rich, but also more heavily leveraged. On-balance sheet recognition for most leases shifts the critical accounting determination from lease classification under current U.S. GAAP to whether a contract is, or contains, a lease under the new standard.

The current accounting model for lessees distinguishes between capital leases, which are recognized on-balance sheet, and operating leases, which are not. The lease classification distinction continues to exist in the new standard, but it now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

| Changes Introduced by Topic 842 | | | |
|---|---|---|---|
| **Lease Classification** | **Balance Sheet** | **Income Statement** | **Statement of Cash Flows** |
| **Finance Leases** | ✔ Similar to capital lease accounting under current U.S. GAAP | | |
| **Operating Leases** | ⚠ **Recognized on-balance sheet under Topic 842** | ✔ Similar to operating lease accounting under current U.S. GAAP | |

### KPMG Observation

Recognizing ROU assets and lease liabilities for all leases other than short-term leases will enhance balance sheet transparency. Currently, many analysts adjust financial statements for off-balance sheet lease obligations. After the new requirements are applied, analysts will be able to see an entity's own assessment of its lease liabilities, calculated using a methodology that all entities reporting under U.S. GAAP must follow. However, because analysts do not all evaluate leases in the same way or for the same reasons, they may continue to make adjustments to lessee financial statements after the new standard becomes effective.

[5] Lessees may *elect*, by class of underlying asset, not to recognize short-term leases on the balance sheet and instead account for them in the same manner as current operating leases.

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### *Measurement of the Lease Liability and the ROU Asset*

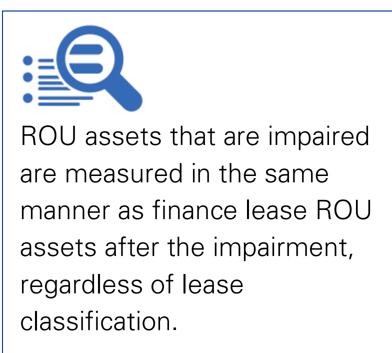
Under the new standard, the lease liability at lease commencement and throughout the lease term (for both finance and operating leases) equals the present value (PV) of the unpaid *lease payments*, discounted at the *rate implicit in the lease* (if known) or the lessee's *incremental borrowing rate*. *Lease payments* exclude contingent payments other than in-substance fixed payments.

The ROU asset (for finance and operating leases) is initially measured as:

Subsequent measurement of the ROU asset (i.e., after lease commencement) depends on the classification of the lease. ROU assets, whether resulting from a finance lease or an operating lease, are subject to the long-lived asset impairment guidance.[6] After a ROU asset is impaired, it is measured in the manner depicted below for finance lease ROU assets, regardless of lease classification.

#### Finance Lease

The ROU asset is amortized generally on a straight-line basis over the lease term.



ROU assets that are impaired are measured in the same manner as finance lease ROU assets after the impairment, regardless of lease classification.

#### Operating Lease

The subsequent measurement of the ROU asset in an operating lease can be determined in either of two ways, which yield the same carrying amount.

- **Method 1 – Amortize the ROU Asset**

The amortization of the ROU asset each period equals the difference between the straight-line lease cost for the period (which is effectively the

[6] FASB ASC Topic 360, Property, Plant, and Equipment, available at www.fasb.org.

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cost recognized for operating leases under current U.S. GAAP) and the periodic accretion of the lease liability using the effective interest method.

- **Method 2 – Derive the ROU Asset from the Lease Liability**

  The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period as illustrated below.

  Method 2 is what a lessee would use if it does not want to recognize ROU assets and lease liabilities for operating leases until it closes its books during the financial reporting process. Under this method, at each reporting date, the lessee creates a journal entry to (1) credit a lease liability for the present value of the remaining unpaid lease payments, (2) reverse other accrual-based operating lease accounting balances reflected in the balance sheet (i.e., prepaid or accrued rent, unamortized initial direct costs, and unamortized lease incentives), and (3) debit a ROU asset for the balancing amount.

### Example – Subsequent Measurement of Operating ROU Asset

Assume a 5-year operating lease with annual payments (in arrears) of $100 that increase by $5 per year and a discount rate of 6%. Also assume that the lessee incurs $10 of initial direct costs. At lease commencement the lease liability equals $461 and the ROU asset equals $471 (the lease liability plus the initial direct costs). The lessee will recognize straight-line lease cost of $112 each year of the lease, which includes $2 in amortization of initial direct costs.

#### Method 1

Year 1 amortization of the ROU asset is $84, calculated as the Year 1 lease cost – Year 1 accretion of the lease liability ($112 – [$461 × 6%]). The end of Year 1 carrying amount of the ROU asset is therefore $387 ($471 – $84).

Year 2 amortization of the ROU asset is $89, calculated as the Year 2 lease cost – Year 2 accretion of the lease liability ($112 – [$389 × 6%]). The end of Year 2 carrying amount of the ROU asset is therefore $298 ($387 – $89).

#### Method 2

At the end of Year 1 the lessee has an accrued rent balance of $10 ($110 lease cost excluding amortization of initial direct costs – $100 lease payment) and unamortized initial direct costs of $8 ($10 – $2 in Year 1 amortization). The carrying amount of the lease liability at the end of Year 1 is $389 (present value of remaining unpaid lease payments discounted at 6%). Therefore, at the end of Year 1 the carrying amount of the ROU asset is $387 ($389 – $10 + $8).



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**Example – Subsequent Measurement of Operating ROU Asset**

At the end of Year 2 the lessee has an accrued rent balance of $15 ($110 lease cost excluding amortization of initial direct costs – $105 lease payment + previous accrued rent balance of $10) and unamortized initial direct costs of $6 ($10 – $2 in Year 1 amortization – $2 in Year 2 amortization). The carrying amount of the lease liability at the end of Year 2 is $307 (present value of remaining unpaid lease payments discounted at 6%). Therefore, at the end of Year 2 the carrying amount of the ROU asset is $298 ($307 – $15 + $6).

**KPMG Observations**

Method 2 is the only method described in the new standard. In the standard's Basis for Conclusions, the FASB indicated that this method will permit many entities to perform the new accounting for operating leases without significant changes to systems or processes. However, we believe Method 2 generally will not be practicable to apply for entities other than those with few leases that are relatively straightforward. Method 2 is inherently a manual process that likely will be unwieldy when applied to a large portfolio of leases, especially in the context of the more complex circumstances that will arise under the new standard (e.g., modifications, remeasurements, impairments, and issues related to foreign exchange).

We believe Method 1 will more readily enable a lessee to implement systems, processes, and internal controls where lease liabilities and ROU assets are tracked separately in a manner more consistent with other assets and liabilities. It is more likely to be effective for addressing the more complex circumstances outlined above that are likely to arise for many lessees.

Additional judgments will be required in determining whether a contract contains a lease. Correctly identifying leases will have a greater effect on financial reporting than under current U.S. GAAP because this is the new on- / off-balance sheet test.

## Identifying a Lease

A lease exists under the new standard when a contract conveys to the customer the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration. The definition of a lease embodies two conditions that are familiar under current U.S. GAAP: (1) there is an identified asset in the contract that is land or a depreciable asset (i.e., property, plant, and equipment), and (2) the customer has the right to control the use of the identified asset.

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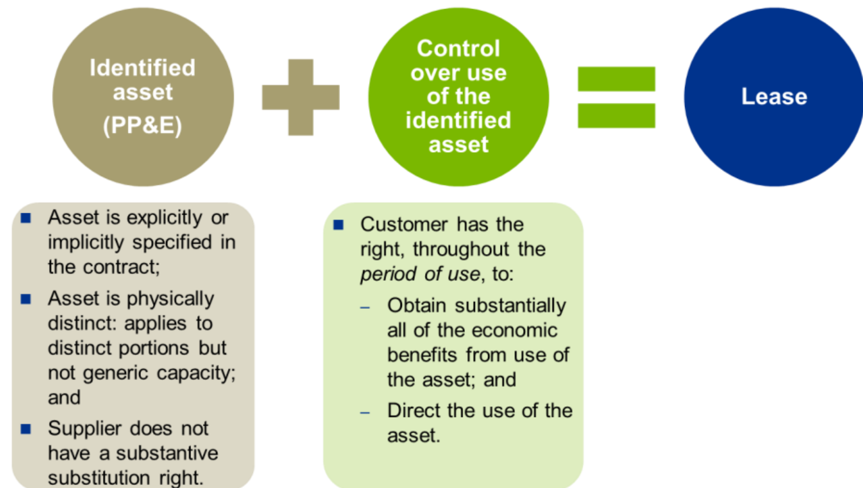


While those two conditions appear similar to the requirements under current U.S. GAAP, important details have changed. Most notably, determining whether the customer has the right to control the use of an identified asset is now closely aligned with how control is defined and applied in the new revenue recognition standard. This is because there is now both a "benefits" element and a "power" element to the evaluation of control.

In most cases, a customer will have the right to direct the use of an identified asset if it can direct (and change) how and for what purpose the asset will be used throughout the period of use by controlling what, when, and/or how much output the asset produces. However, if the asset's use is predetermined before the beginning of the lease term (e.g., in the contract or by the asset's design), a customer is still deemed to direct the use of the asset if it (a) has operational control over the asset or (b) designed those aspects of the asset that predetermine how and for what purpose it will be used throughout the lease term.

## KPMG Observations

In general, we believe that most arrangements that meet the definition of a lease under current U.S. GAAP will continue to meet the definition of a lease under the new standard. However, because of the new direct-the-use aspect of the definition, *some* contracts that were previously considered to be leases under current U.S. GAAP will not meet the new definition of a lease. This is most likely to be the case for arrangements that meet the current definition of a lease solely because the customer receives substantially all of the output or utility from the identified asset (e.g., some power purchase or outsourcing arrangements). Judgment will be required in applying the new definition, and companies will have to familiarize themselves with the changes from current U.S. GAAP, in particular the new guidance about directing the use of an identified asset.



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Given the pervasive, and potentially material, effect that the lease reassessment guidance will have on a lessee's financial statements, lessees will need to implement new processes and controls to address the new risk points. This effort likely will need to involve cross-functional coordination to ensure timely identification of events requiring revisions to lease accounting.

## Lease Accounting Requires Circumstance-Driven Reassessments by Lessees

The new standard requires a lessee to revise (or update) its lease accounting by remeasuring its lease liability in any of the following circumstances:

1. There is a change in the assessment of the lease term;
2. There is a change in the assessment of whether the lessee will exercise an option to purchase the underlying asset;
3. There is a change in the amount probable of being owed by the lessee to satisfy a residual value guarantee; or
4. A contingency is resolved that results in some or all of the variable lease payments that were to be paid over the remainder of the lease term becoming fixed. For example, if the payments for Years 2-10 of a retail store lease will be based on 10 percent of Year 1 retail store sales, at the end of Year 1, the lease payments for Years 2-10 become fixed payments.

A lessee reassesses the lease term (#1) or the likelihood that a purchase option will be exercised (#2) only when a significant event or a significant change in circumstances occurs that is within the lessee's control and directly affects whether the lessee is reasonably certain to exercise a renewal or a purchase option (i.e., a triggering event). The new standard identifies example triggering events, including a decision by the lessee to construct significant leasehold improvements that are expected to have substantial economic value at the end of the lease term or to enter into a sublease that effectively requires exercise of a renewal option.

The accounting steps a lessee must undertake depend on the circumstances.

| | Circumstance | | | |
|---|---|---|---|---|
| **Accounting Steps** | **1** | **2** | **3** | **4** |
| Remeasure and reallocate the consideration in the contract to the remaining lease and non-lease components of the contract. | ✔ | ✔ | ✔ | ✔ |
| Remeasure the lease liability to reflect the revised lease payments, using a discount rate determined at the remeasurement date.[7] | ✔ | ✔ | ✘ | ✘ |
| Remeasure the lease liability to reflect the revised lease payments, using the original discount rate.[7] | ✘ | ✘ | ✔ | ✔ |
| Adjust the amount of the ROU asset by the amount of the remeasurement of the lease liability. However, once the ROU asset is reduced to zero, then the remaining amount of the lease liability remeasurement is recognized in the income statement. | ✔ | ✔ | ✔ | ✔ |

[7] When the *lease payments* are remeasured, variable lease payments that depend on an index or a rate are remeasured using the index or rate as of the remeasurement date.



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| Accounting Steps | Circumstance 1 | Circumstance 2 | Circumstance 3 | Circumstance 4 |
|---|---|---|---|---|
| Reassess the lease classification at the remeasurement date based on the circumstances at that date (e.g., fair value and remaining economic life of the underlying asset at the remeasurement date). | ✔ | ✔ | ✘ | ✘ |
| If there is a change in lease classification, adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively. | ✔ | ✔ | ✘ | ✘ |

### KPMG Observations

The reassessment and remeasurement guidance applicable to lessees is a significant change from current U.S. GAAP, which generally does not require revisions to lease accounting for lessees or lessors unless the terms and conditions of the contract are modified. Lessees will have to implement processes and controls to monitor for events or changes that require revisions to the accounting for a lease.

## Some Executory Costs May Be Included in Lease Assets and Lease Liabilities

Payments to cover the lessor's costs of ownership, such as property taxes and insurance, are no longer excluded from lease accounting as they are under current U.S. GAAP.

The new standard only governs the accounting for leases. If there are lease and non-lease (e.g., service) components of a contract, lessors must apply the new standard to the lease component(s) and other GAAP to the non-lease component(s). Lessees have the option to either separately account for lease and non-lease components or account for any non-lease components as part of the lease component to which they relate. An entity separates lease and non-lease components of a contract and allocates the contract consideration to those components generally on a relative stand-alone price basis, which is broadly consistent with current U.S. GAAP. However, the guidance in the new standard may change how an entity identifies, separates, and allocates contract consideration to the components of a contract.

Specifically, the new standard states that lessee payments for lessor ownership costs of an underlying asset (e.g., property taxes or insurance) do not transfer a good or service to the lessee and, therefore, are not components of the contract. Therefore, none of the consideration in the contract is allocated to those items. Instead, payments for those items are allocated to the lease and non-lease components on the same basis as the remainder of the consideration in the contract (i.e., generally on a relative stand-alone price basis). If there are no non-lease components, fixed payments for those costs will be accounted for entirely as *lease payments*. This treatment represents a change from current U.S. GAAP, under which all executory costs are excluded from minimum lease payments.



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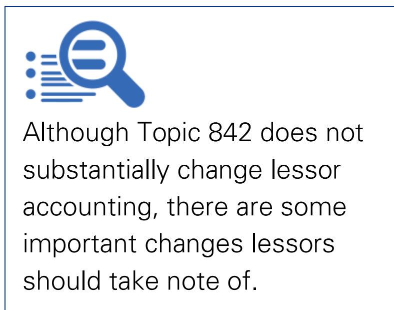
| Current U.S. GAAP | Topic 842 |
|---|---|
| All executory costs excluded from minimum lease payments | Executory costs that do not represent payments for a good or service are allocated to the lease and non-lease components in the same manner as all other payments in the contract |

### KPMG Observations

Lessees making fixed payments that cover the lessor's ownership costs for items like property taxes or insurance will recognize larger lease assets and lease liabilities than they would have if the new standard had retained the previous guidance that excluded all executory costs from lease payments. Maintenance services (e.g., common area maintenance) generally transfer a good or service to the lessee other than the right to use the underlying asset and are, therefore, a non-lease component of the contract. As a result, consideration is allocated to those services and that consideration generally is excluded from lease payments by lessees that elect to separately account for lease and non-lease components, and by lessors.

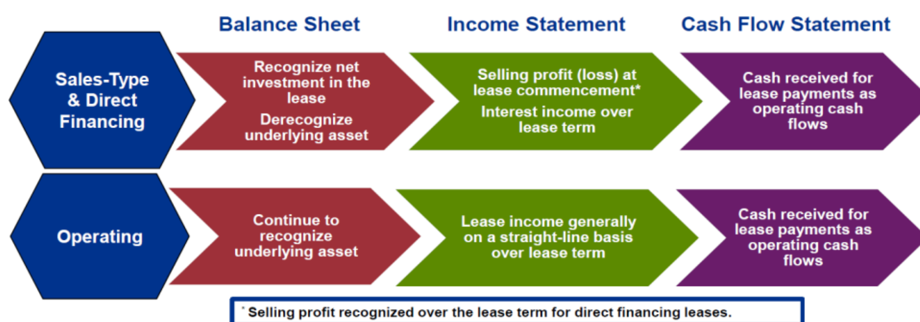
Because variable payments do not meet the new standard's definition of *lease payments*, lessees may account differently for economically similar leases based solely on how their payments are structured. All (or a portion of) payments that are structured as a direct pass-through of the lessor's actual costs are likely to meet the definition of variable lease payments, which a lessee will exclude from the measurement of its ROU asset and lease liability (and a lessor from its net investment in the lease), but be required to disclose. Conversely, all (or a portion of) fixed payments designed to cover lessor ownership costs will meet the definition of lease payments and be included in the measurement of the lessee's ROU asset and lease liability (and the lessor's net investment in the lease for sales-type and direct financing leases).



Although Topic 842 does not substantially change lessor accounting, there are some important changes lessors should take note of.

## Changes to Lessor Accounting

The new standard does not substantially change lessor accounting from current U.S. GAAP as illustrated below.

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In addition, most of the key definitions and concepts underlying the lessor accounting model are generally consistent with current U.S. GAAP (e.g., what is included in lease assets, the discount rate, and the lease classification test). However, there are some important changes that lessors should be aware of.

### *Collectibility*

Under current U.S. GAAP, if collectibility of the *minimum lease payments* is not *reasonably predictable*, a lease is classified as an operating lease (i.e., it cannot be classified as a sales-type, direct financing, or leveraged lease). Topic 842 eliminates this reasonably predictable criterion and introduces new requirements with respect to collectibility.

- Uncertainty about the collectibility of the lease payments no longer will preclude a lease from being classified as a sales-type lease. However, if collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is not probable in a sales-type lease, the lessor will (a) continue to recognize the underlying asset and (b) recognize lease payments received as a deposit liability generally until the earliest date that:
  - Collectibility becomes probable;
  - The contract is terminated and the lease payments received are nonrefundable; or
  - The lessor has repossessed the underlying asset, has no further obligations to the lessee under the contract, and the lease payments received are nonrefundable.
- For leases that are not sales-type leases, if collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee (provided by the lessee or a third party) is not probable, the lease must be classified as an operating lease. Cumulative lease income is then limited to the amount of the lease payments (including variable lease payments) that have been paid unless the assessment of collectibility changes during the lease term.

### *Significant Variable Lease Payments*

Current U.S. GAAP contains conditions under which lessors often classify leases with predominantly variable payments as operating leases even if the lease meets one of the four primary criteria to be classified as a sales-type or direct financing lease (e.g., the lease term is more than 75 percent of the asset's estimated economic life).[8] Operating lease classification for these leases eliminates the potential for up-front loss recognition solely because the present value of the minimum (i.e., non-variable) lease payments and unguaranteed residual value is less than the asset's carrying amount at lease commencement. However, those conditions are eliminated by the new standard. As a result, these leases are likely to be classified as sales-type or direct financing leases under the new standard, creating the potential for loss recognition at lease commencement.

[8] The primary classification criteria are in FASB ASC paragraph 840-10-25-1 and the other conditions are in ASC paragraph 840-10-25-42.

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### KPMG Observations

For leases with significant variable lease payments (e.g., in some renewable energy arrangements), the undiscounted sum of (a) the lease payments and (b) the estimated residual value of the underlying asset at the end of the lease term may be less than the underlying asset's fair value and/or carrying amount at lease commencement. If so, sales-type lease classification for these leases will require loss recognition at lease commencement when the discount rate used in measuring the lessor's net investment in the lease is positive even if the lessor expects the lease to ultimately be profitable. This does not seem to best reflect the economics of these leases.

The new standard requires the lessor to use the *rate implicit in the lease* as its discount rate to measure its net investment. That rate is defined in a way that generally requires the present value of (a) the lease payments and (b) the estimated residual value of the underlying asset at the end of the lease term to be no less than the underlying asset's fair value at lease commencement. For leases with significant variable lease payments, following that definition could mean that the lessor would be required to use a negative discount rate. It also could mean that no loss would be recognized at lease commencement unless the fair value of the underlying asset was less than its carrying amount.

It is not clear whether the FASB considered the possibility (or expected) that discount rates might be negative under the new standard's requirements. In addition, it is not clear to what extent the fact that the Board's new revenue recognition standard may require up-front loss recognition in arrangements with significant variable (or contingent) consideration even if the seller expects the arrangement to ultimately be profitable factored into its consideration of these leases. We expect the accounting for these transactions to generate further debate given the interplay between sales-type lease accounting and the new revenue recognition standard, and the current ambiguity around the Board's intent about lessor discount rates in these leases.

### *A Narrower Definition of Initial Direct Costs*

The new definition of *initial direct costs* includes only those "incremental costs of a lease that would not have been incurred if the lease had not been obtained" (e.g., commissions or payments made to existing tenants to obtain the lease), which is a more narrow definition than in current U.S. GAAP. Accordingly, costs that an entity is permitted to capitalize as initial direct costs under current U.S. GAAP, such as external legal fees incurred to negotiate a lease or draft lease documents or allocations of internal employee costs for time spent directly related to negotiating or arranging a lease, will now be expensed when incurred.

### KPMG Observations

While this issue is expected to affect lessors more than lessees, the narrowed definition of initial direct costs also may affect lessees that previously capitalized or deferred costs that do not meet the new, narrower definition. For some lessors the new definition may result in recognizing more expenses at the start of a lease and higher margins over the lease term.



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### *Leveraged Lease Accounting Eliminated Prospectively*

The new standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date. A lessee's exercise of an option to renew or extend a leveraged lease when exercise previously was not considered reasonably assured is considered a lease modification for this purpose.

## Expanded Quantitative and Qualitative Disclosures

Increased disclosure requirements may necessitate additional systems capabilities, processes, and controls for lessees and lessors.

The new standard's disclosure objective is to provide financial statement users sufficient information to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, lessees and lessors will disclose qualitative and quantitative information about lease transactions. This generally will result in increased information being disclosed compared to current U.S. GAAP. Accordingly, entities will need to evaluate whether they have appropriate systems, processes, and internal controls to capture complete and accurate lease data necessary to prepare the financial statement notes.

| Lessees | Lessors |
|---|---|
| **Example Qualitative Disclosures** | |
| • Information about leases<br>– Nature of variable payment arrangements<br>– Termination, renewal, and purchase options<br>• Significant accounting judgments and estimates | |
| • Leases that have not yet commenced, but that create significant rights and obligations for the lessee, including involvement in construction or design of the underlying asset | • Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk |
| **Example Quantitative Disclosures** | |
| • Amortization of ROU assets and interest on lease liabilities (including amounts capitalized) for finance leases<br>• Operating lease cost<br>• Variable lease cost<br>• Short-term lease cost | • Table of lease income:<br>– Selling profit (or loss) recognized at lease commencement for sales-type leases and interest income for sales-type and direct financing leases<br>– Operating lease income<br>– Variable lease income |

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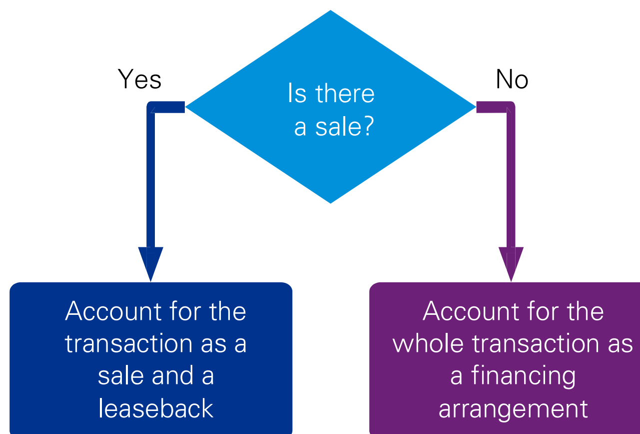
| Lessees | Lessors |
|---|---|
| • Weighted-average remaining lease term, separately for finance and operating leases<br>• Weighted-average discount rate as of the balance sheet date, separately for finance and operating leases<br>• Maturity analysis of lease liabilities, reconciling undiscounted cash flows to the recognized lease liabilities, separately for finance leases and operating leases | • Maturity analysis of lease receivables, reconciling the undiscounted cash flows to the recognized lease receivables (for sales-type and direct financing leases), and of future lease payments (for operating leases)<br>• For operating leases, general property, plant, and equipment disclosures by significant class of underlying asset separately from those disclosures for the lessor's other owned assets |

Although Topic 842 eliminates sale-leaseback transactions as an off-balance-sheet financing proposition, sale-leaseback transactions still may attract interest because a seller-lessee generally will be able to recognize any gain on the sale in full at the sale date and the balance sheet effect of the leaseback may be less significant than that of the asset and related financing.

## Sale-Leaseback Accounting Substantially Changed

Topic 842 essentially eliminates sale-leaseback accounting as an off-balance sheet financing proposition by requiring the seller-lessee to account for the leaseback in the same manner as other leases – i.e., on-balance sheet for most leases. However, some of the off-balance sheet benefits of sale-leaseback accounting are preserved as, in many cases, the amount of the ROU asset and the lease liability recognized may be substantially less than the previous carrying amounts of the underlying asset and any related financing.

If the transaction qualifies for sale accounting (i.e., the sale leg of the transaction meets the contract identification and transfer of control requirements for a sale in the new revenue recognition standard), a seller-lessee's balance sheet will reflect an asset that represents the seller-lessee's right to use the underlying asset and a liability to make the leaseback payments. However, if the sale-leaseback transaction does not qualify for sale accounting, the seller-lessee, *and* the buyer-lessor, will account for the whole arrangement as a financing transaction.



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### KPMG Observation

In a significant change from current U.S. GAAP, the buyer-lessor is required to evaluate whether a sale of the underlying asset has occurred based on the sale guidance in the new revenue recognition standard and, if a sale has not occurred, to account for the transaction as a financing arrangement. Under current U.S. GAAP, a failed sale for the seller-lessee is not accounted for as a failed purchase by the buyer-lessor. This may complicate the accounting by buyer-lessors, particularly for sale-leaseback transactions with significant variable payments that do not qualify for sale/purchase accounting.

### *Recognition of Gains on Sale No Longer Will Depend on the Rights Retained by the Seller-Lessee*

Under current U.S. GAAP, the timing of gain recognition on the sale in a sale-leaseback transaction depends on the rights retained by the seller-lessee. In contrast, when a sale-leaseback transaction qualifies for sale accounting under the new standard, the seller-lessee is required to recognize the full amount of the gain (which will be adjusted for off-market terms, if any) when the buyer-lessor obtains control of the underlying asset. This is consistent with the guidance that will apply to the sale of any nonfinancial asset under either the new revenue recognition standard (if the sale is to a customer) or the other income accounting guidance (if the sale is to a non-customer).[9]

### *Different Sale-Leaseback Accounting Provisions for Real Estate and Assets Other Than Real Estate Eliminated*

The new standard eliminates the different accounting for sale-leaseback transactions involving real estate versus other assets that exists in current U.S. GAAP. Under the new standard, the same guidance applies to all sale-leaseback transactions regardless of the type of underlying asset.

### *Sale-Leaseback Accounting Easier to Achieve for Real Estate Than under Current U.S. GAAP; More Difficult for Other Assets*

The new standard stipulates that a sale is recognized in a sale-leaseback transaction when the transaction meets the contract identification and transfer of control requirements for the sale of goods in the new revenue recognition standard. It also includes additional guidance for recognizing a sale in a sale-leaseback transaction:

- The leaseback by itself does not preclude a sale-leaseback transaction from meeting the sale requirements in the new revenue recognition standard;
- A sale (purchase) is not recognized if the leaseback would be classified as a finance lease by the seller-lessee (sales-type lease by the buyer-lessor); and
- An option for the seller-lessee to repurchase the underlying asset results in a failed sale unless (a) the option strike price is the fair value of the asset at the option exercise date ***and*** (b) alternative assets that are substantially the same as the underlying asset are readily available in the marketplace.

[9] FASB Topic 610, Other Income, available at www.fasb.org.

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### KPMG Observations

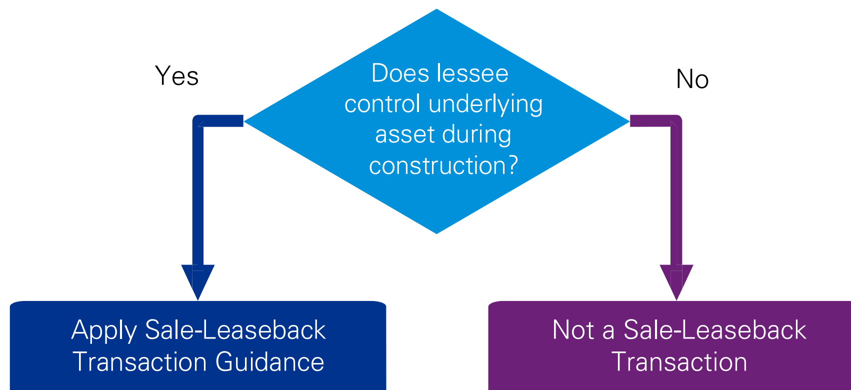
In the United States, equipment sale-leaseback transactions often include an option for the seller-lessee to repurchase the equipment. This does not result in a failed sale under current U.S. GAAP unless the option is a bargain repurchase option. Because most repurchase options will preclude a sale, the new standard will make it more difficult for many equipment sale-leaseback transactions to qualify for sale-leaseback accounting than under current U.S. GAAP.

Conversely, current U.S. GAAP requires failed sale accounting for real estate sale-leaseback transactions if the seller-lessee has any continuing involvement (including a repurchase option at any strike price) with the real estate other than a normal leaseback. As a result, failed sales are common in real estate sale-leaseback transactions. Because the new standard supersedes the continuing involvement provisions in current U.S. GAAP, and the sale requirements in the new revenue recognition standard are comparatively less difficult to meet, it generally will be easier for real estate sale-leaseback transactions to qualify for sale-leaseback accounting under the new standard than under current U.S. GAAP. However, a seller-lessee repurchase option generally will still preclude sale-leaseback accounting for a real estate sale-leaseback transaction, even if the strike price of the option is the fair value of the real estate on the exercise date. This is because two real estate assets typically will not be considered substantially the same.

## Current Build-to-Suit Lease Accounting Guidance Replaced

Current U.S. GAAP addresses a lessee's involvement with the construction of an asset that the lessee will lease when construction is complete (i.e., build-to-suit lease accounting). Under that guidance, the transaction is subject to the sale-leaseback guidance if the lessee is deemed to be the accounting owner of the asset during the construction period because it has substantially all of the construction period risks (or meets other specified criteria).

The new standard supersedes the current build-to-suit lease accounting guidance and stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the lease commencement date. The new standard includes implementation guidance to assist entities in determining whether the lessee controls an underlying asset that is under construction.

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The new standard further specifies that payments made by a lessee for the right to use the underlying asset are not costs related to the construction or design of the underlying asset but are lease payments regardless of when the payments are made (e.g., before lease commencement) or how the payments are made (e.g., contribution of construction materials). When a lessee incurs costs related to the construction or design of an underlying asset for which it is not considered the accounting owner during the construction period, it will account for them as lease payments unless they relate to goods or services provided to the lessee (in which case it will account for them under other U.S. GAAP).[10]

### KPMG Observations

The new guidance about when a lessee controls an asset under construction that it will lease is similar to the guidance in the new revenue recognition standard about when a customer controls an asset under construction (or that is being modified) that it will purchase.

We believe the new guidance will result in fewer instances where the lessee is deemed to be the accounting owner of an asset that is under construction, but those instances will still occur. However, importantly, when a lessee is deemed to be the accounting owner of an asset under construction, the changes to the sale-leaseback guidance in the new standard may make it easier for the lessee to derecognize the underlying asset at the end of the construction period.

## Summary of Similarities and Differences between U.S. GAAP and IFRS

On January 13, 2016, the IASB issued IFRS 16, *Leases*, which requires lessees to recognize ROU assets and lease liabilities on-balance sheet for leases that are not short-term or of assets with a low value when new (e.g., $5,000 or less). IFRS 16 introduces a single, on-balance sheet lessee accounting model that is similar to the current accounting under IFRS for finance leases (and U.S. GAAP for capital leases). Lessor accounting will remain similar to current practice, (i.e., lessors will continue to classify leases as finance and operating leases).

IFRS 16 is effective for companies that apply IFRS for annual periods beginning on or after January 1, 2019. Earlier application is permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers*, at or before the date of initial application of IFRS 16.

Although some key aspects of Topic 842 and IFRS 16 are converged (e.g., the definition of a lease and the recognition of most leases on-balance sheet), many are not, including the following:

- Lessee accounting model, including reassessment requirements for variable lease payments that depend on an index or rate;
- Lessor profit recognition for some leases;

[10] For example, FASB ASC Topic 330, Inventory, and Topic 360, Property, Plant and Equipment, available at www.fasb.org.



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- Recognition and measurement exemption for leases of low-value assets under IFRS 16;
- Classification of subleases by the sublessor;
- Accounting for leases between related parties;
- Gain recognition on sale-leaseback transactions; and
- Transition requirements and alternatives.

Our summary table provides additional information about the similarities and differences between Topic 842 and IFRS 16.

## Staying Informed

KPMG will host a CFO Financial Forum Webcast on March 7, 2016, to provide an overview of the new standard. This spring KPMG also will:

- Release an Issues In-Depth that provides a more comprehensive analysis of the new lease accounting standard.
- Host a series of CFO Financial Forum Webcasts to discuss specific aspects of the new standard in more detail.

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