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In This Issue:

- Issues and Decisions
- Next Steps
- Contacts

At "Lease" They're Making Some Progress

Boards Continue to Redeliberate Lease Accounting

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The FASB supported a dual-model approach that would allow lessees to use a straight-line expense pattern for certain leases, whereas the IASB supported a single-model approach under which all leases would be treated as a financing arrangement.

At their meeting last week, the FASB and IASB continued redeliberating their revised joint exposure draft[1] (ED) on leases. Specifically, the boards discussed the following items:

- Lease classification by lessees.
- Lease classification by lessors.
- The determination of lease term.
- A scope exception for short-term leases.
- Possible scope exceptions for small-ticket[2] leases.

While the boards made tentative decisions on these items, they did not always reach the same conclusions. For example, the FASB supported a dual-model approach that would allow lessees to use a straight-line expense pattern for certain leases, whereas the IASB supported a single-model approach under which all leases would be treated as a financing arrangement.

This *Heads Up* summarizes the significant issues discussed at the meeting and the boards' tentative decisions.

Issues and Decisions

Lessee Accounting — Lease Classification

Under the ED, a lessee's subsequent accounting for a lease is based on the nature of the underlying leased asset (i.e., whether it is property[3] or something other than property) and the terms of the lease (e.g., lease term, lease payments). A straight-line expense pattern (Type B lease) would generally be used to recognize property leases; all other leases would generally be recognized as the financing of the right-of-use (ROU) asset (Type A lease).

The boards received a number of negative comments on the classification model proposed in the ED. Concerns ranged from (1) whether there should be different lease classifications (i.e., Type A versus Type B) for different leases and (2) if so, where the line should be drawn between the different classifications.

[1] Issued by the FASB as the proposed Accounting Standards Update *Leases*.

[2] According to agenda paper 3F/273, the term small-ticket leases "generally refers to high-volume, low-value leases." Examples could include, but are not limited to, copier machines, laptop computers, and office furniture.

[3] The ED defines property as "land or a building, or part of a building, or both."

At last week's meeting, both boards confirmed that leases should generally be on the balance sheet. Accordingly, the discussion focused on two alternative approaches for lease classification and how lease classification should affect the subsequent measurement of the ROU asset. Under the first approach (referred to as Approach 1 in the agenda papers for the meeting), lease classification would be eliminated, and every lease would be treated the same — that is, as a financed purchase of the ROU asset (a Type A lease). Under the alternate approach (referred to as Approach 3 in the agenda papers), lease classification would be retained for determining the appropriate subsequent accounting; however, rather than distinguishing leases of "property" from leases of "other than property" as proposed in the ED, entities would use the existing classification model in IAS 17[4] to determine whether a lease should be treated as Type A or Type B.

The FASB supported Approach 3 on the basis that it would result in less dramatic changes to the income statement than Approach 1. In contrast, the IASB supported Approach 1 on the basis that a single model has more conceptual merits and would reduce complexity. Although they were unable to converge their views, the boards acknowledged that there were merits and challenges associated with each approach.

Both boards agreed that leases should generally be "on the balance sheet" but supported different approaches for the subsequent measurement of the ROU asset.

Editor's Note: Under Approach 3, a lessee would account for a lease as a Type A lease if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- It is reasonably certain that a lessee will "exercise an option to purchase the underlying asset."
- "The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease."[5]

These criteria are essentially the same as the existing lease classification criteria in IAS 17, although they are not identical to the requirements under current U.S. GAAP. As a result, an existing operating lease may be classified as a Type A lease, while an existing capital lease may be classified as a Type B lease.

For example, under Approach 3, a lessee would assess land and other elements separately unless the land element is clearly immaterial. This approach is consistent with IFRSs. Under U.S. GAAP, however, if a lease does not transfer ownership of the real estate or contain a bargain purchase option, a lessee would evaluate the lease classification for the land and other elements as a single unit unless the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. This change may result in more bifurcation of real estate leases into separate elements and may affect the allocation of the lease payments to the various elements.

In addition, the FASB's tentative decision effectively eliminates the bright-line rules under ASC 840[6] for assessing a lessee's ability to obtain substantially all the remaining benefits of the underlying asset — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset.

[4] IAS 17, *Leases*.

[5] See agenda paper 3A/268, which notes that a lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset if any of the following criteria are met:
- "The lease term is for a major part of the remaining economic life of the underlying asset."
- "The sum of the present value of the lease payments [including residual value guarantees] amounts to substantially all of the fair value of the leased asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

[6] FASB Accounting Standards Codification Topic 840, *Leases*.

Lessor Accounting — Lease Classification

Under the ED, lessors would have been required to classify leases as either Type A or Type B by using the same approach prescribed for lessees (i.e., on the basis of the nature of the leased asset and the terms of the lease). Type A leases would have been accounted for under the receivable-and-residual approach (an approach similar in nature to accounting for capital leases under ASC 840), whereas Type B leases would have been accounted for like operating leases under existing GAAP.

A large number of respondents to the ED recommended that the boards remove lessor accounting from the scope of their lease accounting project. While some respondents saw benefit to maintaining symmetry between the lessor and lessee accounting models, a significant number did not support making comprehensive changes to the lessor model.

As a result of this feedback, the boards discussed at their meeting last week whether they wanted to make substantive changes to the existing lessor accounting model as part of the joint leases project. Both boards generally agreed that they would prefer to not make wholesale changes to the existing lessor accounting model. Rather, they agreed on an approach similar to the existing capital/finance lease and operating lease models in ASC 840 and IAS 17 but decided to align the U.S. GAAP classification requirements with the criteria in IAS 17.

While the boards generally agreed on the underlying approach for lessors, there were differing views about when lessors in a sales-type lease should be permitted to recognize seller's/manufacturer's profit (i.e., any difference between the fair value and carrying amount of the leased asset).

The boards generally agreed that they would prefer to not make wholesale changes to the existing lessor accounting model.

In a manner consistent with Approach 2 described in agenda paper 3C/270, the FASB concluded that a lessor should only be able to recognize selling profit (if any) at lease commencement if "the lessee obtains control of the underlying asset as a result of the lease."[7] Lessors would make this determination by evaluating the lease classification criteria from the lessee's perspective and would not consider "any portion of the risks or benefits of the underlying asset that are transferred to a party other than the lessee" (e.g., a third-party residual value guarantee). If the lessee does not obtain control of the underlying asset, the lessor would defer recognition of the selling profit and recognize it over the lease term as part of the constant periodic rate of return (i.e., interest income) recognized on the net investment in the lease.

In contrast, the IASB agreed that for all Type A leases, a lessor would recognize selling profit (if any) in accordance with existing guidance (i.e., at lease commencement).

Editor's Note: The effects on lessors of conforming the U.S. GAAP classification requirements to IFRSs may be similar to those discussed above for lessees.

Example: Lessor Accounting — Profit and Loss Recognition

Facts

A lessor leases equipment to a lessee. The leased asset has a carrying amount of $20,000 and a fair value of $25,000 at lease commencement. The terms of the lease are as follows:

Terms	
Lease term	8 years
Annual lease payments	$3,500, due at the end of each year
Estimated useful life of underlying asset	12 years
Rate the lessor charges the lessee (implicit rate in the lease)	6.98%
Estimated residual value at the end of the lease term	$ 7,000

[7] As described in the FASB's summary of tentative decisions for the meeting, "[t]his requirement aligns the notion of what constitutes a sale in the lessor accounting guidance with that in the forthcoming revenue recognition standard, which evaluates whether a sale has occurred from the customer's perspective."

Ownership of the asset does not transfer at the end of the lease, and there is no bargain purchase option.

In addition, as part of its risk management program, the lessor obtains a third-party residual value guarantee equal to the expected residual value of $7,000.

Analysis

On the basis of the boards' tentative decisions to adopt the IAS 17 classification criteria, the lessor would conclude that the lease represents a Type A (or capital) lease because the present value of the lease payments and the third-party residual value guarantee "amounts to substantially all of the fair value of the underlying [leased] asset."[8] However, while the IASB's approach would allow the lessor to recognize the selling profit up front, the FASB's approach would not permit the lessor to recognize the profit at lease commencement because the lessee has not obtained "control" of the leased asset; that is, the existence of the third-party residual value guarantee prevents the lessee from obtaining substantially all of the remaining benefits of the leased asset. Consequently, the lessor would be required to defer the profit and recognize it at a constant periodic rate over the term of the lease.

The following table illustrates the different accounting for the lease under the IASB's and FASB's approaches:

In response to concerns expressed by stakeholders about the costs and complexity associated with the ED's lease-term reassessment requirements, the staffs presented a number of recommendations.

Year	IASB's Approach			FASB's Approach	
	Net Investment in Lease (Balance Sheet)	Interest Income	Selling Profit	Net Investment in Lease (Balance Sheet)	Interest Income
0	$ 25,000		$ 5,000	$ 20,000	
1	23,244	$ 1,744		18,953	$ 2,453*
2	21,366	1,622		17,778	2,326
3	19,356	1,491		16,459	2,181
4	17,207	1,350		14,978	2,019
5	12,447	1,200		13,315	1,837
6	14,907	1,040		11,448	1,633
7	9,815	868		9,353	1,404
8	7,000	685		7,000	1,147
		$ 10,000	$ 5,000		$ 15,000

* Under the FASB's approach, the lessor would not recognize the selling profit and revenue at lease commencement because the lease does not transfer control of the underlying asset to the lessee. Instead, the lessor would recognize the selling profit through higher interest income over the term of the lease.

Lease Term

Under the ED, the lease term includes all noncancelable periods and those renewal (or termination) options for which the lessee had a "significant economic incentive" to exercise. This terminology differs from that in ASC 840 and IAS 17 (i.e., "reasonably assured" and "reasonably certain," respectively), prompting respondents to the ED to ask how the significant economic incentive threshold would compare with the reasonably certain or reasonably assured thresholds.

Similarly, a number of respondents expressed concerns about the costs and complexity associated with the ED's lease-term reassessment requirements. As a result, the IASB and FASB staffs presented to the boards last week a number of recommendations regarding (1) the determination of the lease term, (2) the reassessment of the lease term, and (3) the accounting for purchase options.

[8] See agenda paper 3C/270.

Determination of the Lease Term

Both boards generally agreed that the threshold for including a renewal period in the lease term for both lessees and lessors should be fairly high, though there was some debate about what the appropriate threshold should be. Because they did not want to change current practice, the boards ultimately decided to replace the "significant economic incentive" terminology in the ED with "reasonably certain" (the current IAS 17 threshold). The boards indicated that entities should consider economic factors similar to those described in the ED in performing the reasonably certain assessment. In addition, the boards recommended that the staffs clarify in the final standard that the reasonably certain threshold is a relatively high threshold that is substantially the same as the reasonably assured threshold in current U.S. GAAP.

Reassessment of Lease Term

Under the ED, lessees and lessors would have been required to continually reassess the lease term and make adjustments to the recognized lease assets and liabilities when appropriate. Most preparer respondents believed that such a reassessment requirement would be overly burdensome, resulting in unnecessary cost and complexity.

The staffs therefore presented to the boards two alternative approaches: (1) requiring reassessment only upon the occurrence of a significant event or significant change in circumstances and (2) eliminating the reassessment requirement altogether.

Both boards tentatively decided that only lessees should be required to reassess the lease term after lease inception. Further, rather than being performed on an ongoing basis, the reassessment would only be triggered by the occurrence of a significant event or change in circumstances that is directly attributable to the actions of the lessee.

Reassessments of lease term would only be triggered by the occurrence of a significant event or change in circumstances that is directly attributable to the actions of the lessee.

Editor's Note: The boards discussed an example in which a lessee had entered into a real estate lease for a particular location and, as a result of infrastructure changes in the surrounding area, it becomes reasonably certain that the lessee will exercise its renewal option. The boards indicated that because the change in circumstances was not directly attributable to the actions of the lessee, a reassessment of the lease term would not be required.

Accounting for Purchase Options

The boards received little feedback about their proposed accounting for purchase options; however, the staffs recommended that purchase options be accounted for in a manner similar to renewal or termination options. The boards agreed with this recommendation and confirmed that the evaluation of whether a purchase option is expected to be exercised should be consistent with the evaluation for renewal (and termination) options.

Lessee Accounting for Short-Term Leases

The ED contains a scope exception for leases with a maximum possible lease term of 12 months or less, including any options to renew. Leases that qualified for the scope exception would be accounted for in a manner similar to current operating leases — off the balance sheet and with a straight-line rent expense in the income statement.

In their comments on the ED, respondents generally supported the short-term-lease scope exception. However, a number of constituents believed that the scope exception should be (1) expanded (i.e., the maximum possible lease term should be increased from 12 months to something more like 24 or 36 months) and (2) aligned with the definition of lease term (i.e., the scope exception should take into account the lease term, rather than the maximum possible lease term, in the determination of whether a lease qualifies for the scope exception).

At last week's meeting, the boards tentatively reconfirmed that the final standard would contain a short-term-lease scope exception and that the exception should be based on a 12-month-or-less requirement. In addition, the boards decided to align the short-term-lease scope exception with the definition of "lease term." Therefore, entites would use the lease term rather than the maximum possible lease term (including options to renew) to determine whether a lease qualifies for the short-term-lease scope exception.

Editor's Note: As a result of the boards' decision to align the short-term-lease scope exception with the definition of lease term, more leases are likely to be eligible for the exception. However, entities will need to determine the lease term first before assessing whether the scope exception applies. The boards have not yet addressed how a change in lease term would affect whether a lease continues to qualify for the short-term-lease scope exception.

The boards also decided that entities applying the short-term-lease scope exception should separately disclose the lease expense related to short-term leases for the reporting period. They would also need to disclose qualitative information if the lease expense disclosed does not reflect the expected lease obligation for short-term leases (e.g., because significant leases have been entered into that qualify for the short-term-lease scope exception near the end of the reporting period).

Alternatives or Exemptions for Small-Ticket Leases

As a result of the boards' decision to align the short-term-lease scope exception with the definition of lease term, more leases are likely to be eligible for the exception.

During their outreach process, the boards became aware of preparer concerns related to the cost and complexity of applying the ED to small-ticket leases that are not considered essential to the underlying business of an entity. To address those concerns, the boards discussed the following three potential alternatives at last week's meeting: (1) providing an explicit materiality exception in the leases standard, (2) allowing leases to be accounted for at a portfolio level, and (3) providing a scope exception for small-ticket leases.

Explicit Materiality Exception

Some respondents to the ED suggested that the boards include an exemption for immaterial leases by establishing an explicit materiality threshold (e.g., a stated percentage of net assets). However, members of both boards overwhelmingly agreed that a scope exception should not be created for immaterial leases by using an explicit materiality threshold. They indicated that ASC 105[9] and IAS 8[10] provide guidance on assessing leases from a materiality standpoint.

Portfolio Approach

The boards also considered adding explicit language to the final standard allowing lessees to account for similar leases at a portfolio level. The staffs suggested that this alternative would alleviate some of the cost and complexity associated with applying the leases guidance to small-ticket leases.

Members of both boards supported this approach, but their views differed on how it should be implemented. The IASB agreed that the guidance on applying a portfolio approach should be included as application guidance in its final standard while the FASB agreed to include similar language in the Basis for Conclusions of its standard.

Exemption for Small-Ticket Leases

The boards also discussed a recognition and measurement exemption for leases of certain small-ticket items. This exemption would apply when the underlying assets are individually small in value and not specialized in nature.

[9] FASB Accounting Standards Codification Topic 105, *Generally Accepted Accounting Principles*.
[10] IAS 8, Accounting Policies, *Changes in Accounting Estimates and Errors*.

Most IASB members, but no FASB members, supported the exemption. Those opposed to it were concerned that the aggregate value of small-ticket leases subject to the exemption might be material to the financial statements as a whole and that material amounts could remain off the balance sheet. Similarly, other board members challenged the need for the exemption given that ASC 105 and IAS 8 (or even an entity's own capitalization policies) provide guidance on identifying leases that are immaterial.

Although it did not support the exemption, the FASB asked its staff to conduct additional research to help it better understand the population of small-ticket leases and the potential effects of the exemption. The FASB also asked its staff to obtain additional information about (1) what threshold would be used to determine whether a lease qualifies for the small-ticket exemption, (2) whether this alternative would result in significant relief for preparers, and (3) whether all companies could consistently apply the approach. The boards are expected to revisit this topic at a later date.

The boards have not yet indicated an expected completion date for the project.

Next Steps

While the boards did not indicate next steps at last week's meeting, they still have a number of items to discuss before finalizing the leases standard, including:

- Scope.
- Definition of a lease.
- Measurement (e.g., lease term, variable lease payments, residual value guarantees).
- Sale-leaseback and leveraged lease arrangements.
- Presentation and disclosure requirements.
- Transition requirements.
- Other items (e.g., effects of business combinations, related-party leases).
- Effective date.

The boards have not yet indicated an expected completion date for the project. For updates on the project and additional information, see the project page on the FASB's Web site.

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