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Defining Issues®

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FASB and IASB Enter Home Stretch in Redeliberations on Lease Accounting – but on Different Tracks

At their July and October joint meetings, the FASB and the IASB (the Boards) continued redeliberations on the proposals in their 2013 exposure drafts (EDs) on lease accounting.[1] The FASB also met separately in August to discuss aspects of the proposals that are specific to U.S. GAAP.[2] As in each joint meeting since March 2014, while the Boards reached converged decisions in the reconsideration of some of their proposals, there were key areas on which they did not agree.

This edition of *Defining Issues* discusses the Boards' more significant decisions subsequent to the first half of 2014 and provides KPMG's observations on their potential impacts. The Boards' remaining decisions during redeliberations are included in the Summary of Decisions Reached in Redeliberations. The Boards expect to substantially complete their redeliberations by the end of this year.

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Key Facts

The Boards failed to reach converged decisions about:

- ***Sale-Leaseback Transactions.*** The Boards agreed that (a) a sale would be recognized in a sale-leaseback transaction that meets the requirements for

[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 jointly to discuss the project on July 25 and October 22, 2014. For more information about the Boards' previous redeliberations on the EDs see KPMG's Defining Issues Nos. 14-29, FASB and IASB Continue Discussions on Lease Accounting, and 14-17, FASB and IASB Take Divergent Paths on Key Aspects of Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network. 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] FASB meeting on August 27, 2014.

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sale recognition in the new revenue recognition standard, (b) the leaseback by itself would not preclude the transaction from qualifying for sale recognition, and (c) a lease in a sale-leaseback transaction would be accounted for in the same manner as any other lease when the transaction qualifies for sale accounting.[3] However, they did not agree on (a) the circumstances that would preclude sale accounting under the new revenue recognition standard's requirements, or (b) how to measure (1) any gain on the transaction or (2) the lessee's right-of-use asset, when the transaction is accounted for as a sale.

The Boards reached generally converged decisions about:

- ***Definition of a Lease.*** The Boards agreed to clarify that the definition of a lease generally requires a customer to have the right to direct how and for what purpose the underlying asset is used throughout the period of use. The Boards directed their staff to provide additional analysis about whether the definition of a lease also should require a customer to either have the capability to operate the asset itself or have access to other readily available operators other than the supplier who have the capability to operate the asset.
- ***Lessor Disclosures.*** The Boards agreed to retain substantially all of the existing lessor disclosure requirements under both U.S. GAAP and IFRS. In addition, they agreed to expand the existing lessor disclosures to provide financial statement users more information about the amount, timing, and uncertainty of cash flows arising from lessor's leases.

The FASB reached decisions about the following U.S. GAAP-specific proposals:

- ***Leveraged Leases.*** The FASB decided to eliminate leveraged lease accounting prospectively but to allow existing leveraged leases to be grandfathered from application of the new lease accounting requirements.
- ***Nonpublic Lessee Discount Rates.*** The FASB decided to retain the proposed accounting policy election in its ED that would permit nonpublic lessees to use a risk-free discount rate to determine the initial and subsequent measurement of all lease liabilities.
- ***Related Party Leasing Transactions.*** The FASB decided to retain the proposal in its ED that leases between related parties would be accounted for based on their contractual terms, even if those terms do not reflect the substance of the arrangement.

Key Impacts

- Purchase options retained by the seller-lessee generally will preclude sale accounting in sale-leaseback transactions, which may affect many equipment sale-leaseback transactions. Gains recognized on sale-leaseback transactions that qualify for sale accounting will be smaller (often significantly) under IFRS than under U.S. GAAP, with a corresponding reduction of the lessee's right-of-use asset and related amortization expense recognized over the lease term.

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

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- The definition of a lease will exclude some contracts in which the customer obtains all of the output or utility of an identified asset, regardless of the price the customer pays for the output, unlike current GAAP. Depending on the outcome of the Boards' future discussions about the impact of a customer's ability to derive the benefits from directing the use of an identified asset, the definition of a lease also may exclude arrangements in which the supplier provides operations services that the customer is not capable of performing on its own or purchasing separately.
- Lessor accounting will remain unconverged for existing leveraged leases that are grandfathered under U.S. GAAP, making it difficult for financial statement users to compare the financial statements of these lessors to those of other lessors prepared under U.S. GAAP and IFRS.
- While the alternative for nonpublic lessees to use a risk-free discount rate in measuring their lease liabilities should decrease costs and complexity for some reporting entities, when applied it will result in overstated lease liabilities that may not reflect the economics of these transactions and may increase the costs of analysis for financial statement users.
- Lessors and lessees applying U.S. GAAP will no longer be required to evaluate whether the contractual terms of related party leases are consistent with the substance of the arrangements to determine the appropriate accounting.

Background

When the FASB and the IASB began the leases project their primary objectives included reducing complexity in lease accounting, eliminating arbitrary accounting distinctions for transactions that are economically similar, requiring lessees to recognize all leases on-balance sheet, and developing converged lease accounting requirements. Based on the current state of the Boards' decisions, the project will meet the objective for lessees to recognize leases on-balance sheet. However, it appears unlikely that the Boards will achieve their other objectives.

Leases Project Timeline

- **2009 – Discussion Paper**
- **2010 – Exposure Draft**
- **May 2013 – Revised Exposure Draft**
- **Sept 2013 – Comment Period Ended (>630 comment letters received)**
- **2013-Present – Joint Redeliberations**

Earlier this year, the Boards reached significantly different decisions about lessee accounting. The FASB decided to retain a dual model approach similar to that proposed in the EDs. Under the dual model approach, a lessee would recognize a right-of-use (ROU) asset and a lease liability for its obligation to make lease payments for all leases other than short-term leases. Subsequent accounting for the ROU asset and presentation of lease expense, however, would depend on whether the lease is classified as Type A (most capital leases under current U.S. GAAP) or Type B (most operating leases under current U.S. GAAP). For Type A leases, the lessee generally would recognize a front-loaded pattern of total lease expense comprising interest on the lease liability and amortization of the ROU asset, similar to today's accounting for capital leases. For Type B leases, the lessee would recognize a single lease expense amount on a straight-line basis over the lease term, similar to today's accounting for operating leases. The amortization of the ROU asset for Type B leases would be determined as a "plug" to achieve straight-line total lease expense. Conversely,

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the IASB decided on a single model approach in which lessees would account for all leases other than short-term leases as Type A leases.

On lessor accounting, the Boards reached a converged decision to abandon the proposals in their EDs. Specifically, the Boards decided there was no need for lessors to characterize leasing transactions in the same way as lessees for financial reporting purposes. Instead, the Boards decided to keep the key aspects of lessor accounting substantially unchanged from existing guidance. As a result, lessors will account for most leases as executory contracts (i.e., as operating leases).

Although the Boards have publicly expressed an intention to minimize further divergence between their respective final lease accounting standards, they have reached different conclusions on a number of issues in addition to the basic lessee accounting model. Additional areas in which the Boards' proposals have diverged include lessee reassessments of variable lease payments, accounting for subleases, accounting for leases between related parties, financial statement presentation for lessees, and sale-leaseback transactions. In addition, discussion to date suggests that their proposals will also diverge on the accounting for "small-ticket" leases (i.e., leases of assets that are small in value). These disparate approaches may cause significant differences between the financial reporting by companies applying U.S. GAAP and companies applying IFRS, making comparisons by their financial statement users more difficult than under current GAAP. This may compel some financial statement users to reverse the impacts of lease accounting so that the users can perform an analysis using their own models. Although it is possible that the Boards may yet be able to converge their decisions in some of these areas, their plan for the remaining redeliberations does not include revisiting their divergent decisions on the fundamental aspects of lessee accounting.

The Boards expect to discuss other remaining issues before finalizing their respective standards, including:

- The impact, if any, of a customer's ability to derive the benefits from directing the use of an identified asset on the definition of a lease;
- Small-ticket leases;
- Lessee disclosure requirements;
- Transition and effective date;
- Cost-benefit considerations; and
- Consequential amendments.

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Sale-Leaseback Transactions

The Boards jointly discussed the accounting for sale-leaseback transactions at their July meeting. The FASB also separately discussed the accounting for sale-leaseback transactions at its August meeting.

Determining whether a Sale has Occurred. The Boards agreed that a sale would be recognized in a sale-leaseback transaction that meets the requirements for sale recognition in the new revenue recognition standard. They also agreed that the leaseback itself would not automatically preclude the transaction from qualifying for sale recognition under the new revenue recognition standard. Examples of circumstances that would preclude sale accounting under the new revenue recognition standard include a repurchase option held by the seller and a put option that the buyer has a significant economic incentive to exercise. The Boards agreed that sale-leaseback transactions that do not qualify for sale accounting would be accounted for as financing transactions by the seller-lessee and the buyer-lessor.

The Boards did not agree on whether certain repurchase options held by the seller-lessee would preclude sale accounting under the new revenue recognition standard's requirements. The FASB decided that a repurchase option with a strike price that is the fair value of the underlying asset at the option exercise date would *not* preclude sale accounting in a sale-leaseback transaction if the underlying asset is non-specialized and readily available in the marketplace. The FASB concluded that in this situation the buyer-lessor would be entitled to obtain substantially all of the remaining benefits of the underlying asset and/or obtain a substantially equivalent asset with its repurchase option proceeds. Therefore, these repurchase options would not prevent the buyer-lessor from obtaining control of the underlying asset under the new revenue recognition standard's transfer of control requirements. Conversely, the IASB decided that any substantive repurchase option held by the seller-lessee would preclude sale accounting in a sale-leaseback transaction, and that a strike price that is the fair value of the underlying asset at the option exercise date would not cause the option to be non-substantive.

The FASB also decided to preclude recognition of a sale in a sale-leaseback transaction if the leaseback would be classified as a Type A lease by the seller-lessee. The FASB concluded that in a Type A leaseback the seller-lessee would be essentially retaining control of the underlying asset under the new revenue recognition standard's provisions. The IASB decided that Type A lease classification by the seller-lessee would not preclude sale accounting as lessees would account for all leases as Type A leases under the IASB's proposals.

Accounting for a Sale/Purchase. The Boards disagreed on how to measure a gain in a sale-leaseback transaction that qualifies for sale accounting. The FASB decided that a seller-lessee would measure a gain on sale as the amount by which the selling price of the underlying asset exceeds its carrying amount, consistent with the guidance that would apply to any other sale (i.e., recognize the full gain). This is because the FASB concluded that in a sale-leaseback transaction the seller-lessee transfers control of the entire underlying asset and obtains a different asset (the ROU asset) as a consequence of the leaseback. The IASB decided that the seller-lessee would limit the measurement of any gain on sale to the amount of the difference between the selling price and the carrying amount of the underlying asset that relates to the buyer-lessor's

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residual interest in the underlying asset at the end of the leaseback. In essence, the IASB concluded that the seller-lessee retains the portion of the underlying asset represented by its ROU asset and, therefore, only sells the portion of the underlying asset represented by the buyer-lessor's residual interest, rather than the entire underlying asset. Accordingly, the IASB concluded that it would be inappropriate for the seller-lessee to recognize the portion of the total gain related to the ROU asset. Both Boards decided that the total gain should be subject to revision when the transaction contains off-market terms as discussed in further detail below.

KPMG Observations

Because the Boards have decided that the leaseback in a sale-leaseback transaction does not by itself preclude sale accounting under their new revenue recognition guidance, it will continue to be possible to structure sales as sale-leaseback transactions to recognize revenue earlier than the new revenue recognition standard would otherwise permit. Consider the following example:

> Seller A sells machines with a five-year remaining economic life to Customer B. Seller A and Customer B agree that Seller A will not deliver the machines for two years. Until delivery of the machines, Seller A is free to use them if it wants to, and Customer B will receive a refund of part of the purchase price from Seller A during the two-year period. The present value of the refund is equal to half the sales price.

Under the guidance in the revenue recognition standard, Customer B must obtain control of the machines (including the ability to receive substantially all of their remaining benefits) for Seller A to recognize a sale. In this example, Customer B does not meet that requirement at the date of the sale because (among other reasons) Customer B does not obtain substantially all of the remaining benefits from the machines. However, if the arrangement was structured as a sale-leaseback rather than a bill-and-hold transaction, Seller A would be *required* to recognize a sale and a leaseback upon entering into the transaction because Seller A does not retain substantially all of the remaining benefits from the machines. The Boards' decisions on sale-leaseback accounting along with their decision not to exclude leases of inventory from the scope of the leases standard offer companies flexibility to determine the timing of revenue recognition without actually delivering goods to customers simply by structuring transactions that will be in the scope of the leases standard. Moreover, companies will be able to structure the lease term to achieve off-balance sheet accounting for the leaseback.

Sale Recognition

Under current U.S. GAAP, repurchase options held by the seller-lessee do not preclude recognition of a sale in a sale-leaseback transaction involving assets other than real estate. Under current IFRS, repurchase options held by the seller-lessee do not preclude recognition of a sale in a sale-leaseback involving any type of asset (including real estate). The Boards' decision to require sale-leaseback transactions to qualify for sale accounting under their new revenue recognition standard means that repurchase options retained by the seller-lessee generally will preclude sale accounting. This could be a major change for many equipment sale-leaseback transactions for companies applying U.S. GAAP and more generally for companies applying IFRS.

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Gain Measurement

The differences in the Boards' decisions on measurement of a gain to be recognized in a sale-leaseback transaction will affect not only the income statement at the date of the transaction, but also the measurement of the seller-lessee's ROU asset and the subsequent expense recognized over the term of the leaseback. Gains recognized on sale-leaseback transactions that qualify for sale accounting will be smaller (often significantly) under IFRS than under U.S. GAAP, with a corresponding reduction of the seller-lessee's ROU asset and related amortization expense recognized over the lease term.

It is important to note that the IASB has not proposed any adjustment to the buyer-lessor's accounting due to the restriction on the measurement of the seller-lessee's gain in a sale-leaseback transaction that qualifies for sale accounting. The buyer-lessor would recognize the entire underlying asset at its purchase price (subject to revision when the transaction contains off-market terms as discussed in further detail below).

Example 1 and the diagram that follows illustrate the Boards' differing decisions on the seller-lessee's accounting for a sale-leaseback transaction that qualifies for sale accounting.

Example 1: Gain Recognized By a Seller-Lessee in a Sale-Leaseback Transaction

A seller-lessee sells a building with a carrying amount of $1,500,000 for $2,500,000, which is the observable market value of the building on the date of the sale (i.e., "at-market" terms). The seller-lessee leases the building for 4 years at $325,000 per year (paid in arrears) and the seller-lessee's incremental borrowing rate is 10%. The seller-lessee would account for the transaction as follows:

	FASB	**IASB**
	Dr. (Cr.)	Dr. (Cr.)
Cash	2,500,000	2,500,000
Building	(1,500,000)	(1,500,000)
Gain on sale	(1,000,000)	(588,000)[A]
ROU asset	1,030,000[C]	618,000[B]
Lease liability	(1,030,000)[D]	(1,030,000)

Under U.S. GAAP, the seller-lessee would recognize a gain on the sale of $1,000,000, consistent with any other gain resulting from the sale of a nonfinancial asset. The seller-lessee would recognize a ROU asset and lease liability of $1,030,000, consistent with the measurement of a lease in a non-sale-leaseback transaction.

Conversely, under IFRS the gain recognized by the seller-lessee would be limited to $588,000, which is the portion of the gain related to the buyer-lessor's residual interest in the underlying asset. The seller-lessee would measure its ROU asset at $618,000, which is the portion of the previous carrying amount of the building ($1,500,000) related to the ROU asset.

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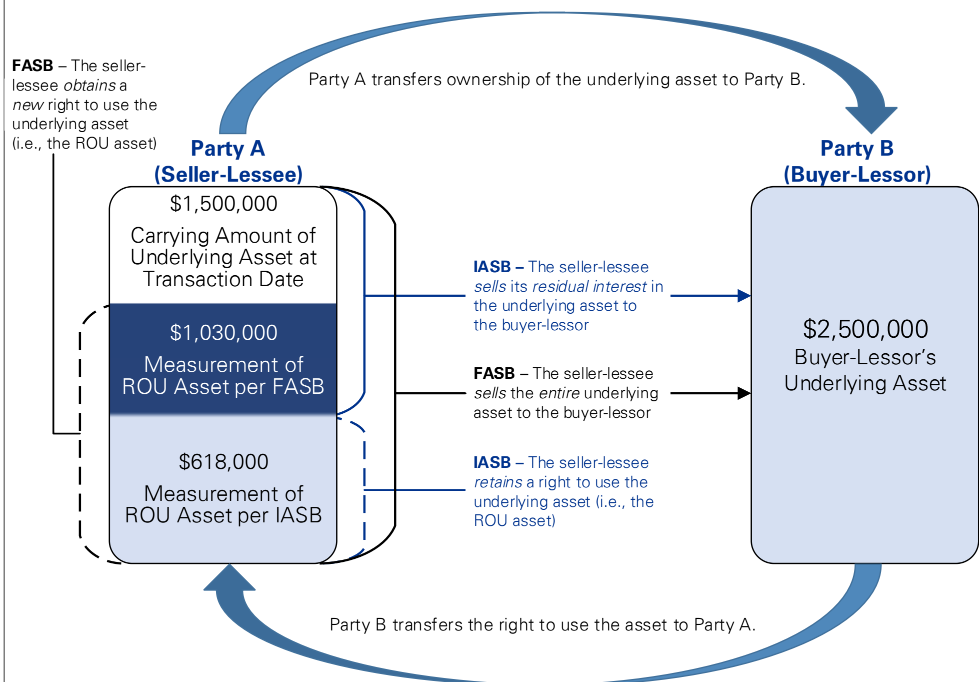
Example 1: Gain Recognized By a Seller-Lessee in a Sale-Leaseback Transaction

[A] Portion of gain related to buyer-lessor's residual interest in underlying asset = total gain × (fair value of underlying asset – present value of lease payments) ÷ fair value of underlying asset = $1,000,000 × ($2,500,000 - $1,030,000) ÷ $2,500,000 = $588,000

[B] ROU asset under IFRS = present value of lease payments – total gain + gain recognized = $1,030,000 – $1,000,000 + $588,000 = $618,000

[C] ROU asset = lease liability + prepaid rent + initial direct costs – lease incentives = $1,030,000

[D] Lease liability = 4 payments of $325,000 discounted at 10% = $1,030,000



Accounting for "Off-Market" Terms. The Boards agreed that the accounting for a sale-leaseback transaction would be adjusted when the terms of the transaction are not at market. The amount of the "off-market" adjustment would be the more readily determinable of:

- The difference between the sales price and the fair value of the underlying asset, or
- The difference between the present value of the contractual lease payments and the present value of fair market value lease payments.

The Boards agreed that if the terms of the transaction are below market (e.g., the sales price of the underlying asset is less than its fair value), the deficiency would be accounted for as a prepayment of rent from the seller-lessee to the buyer-lessor. If the terms of the transaction are above market (e.g., the sales price of the underlying asset is greater than its fair value), the excess would be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

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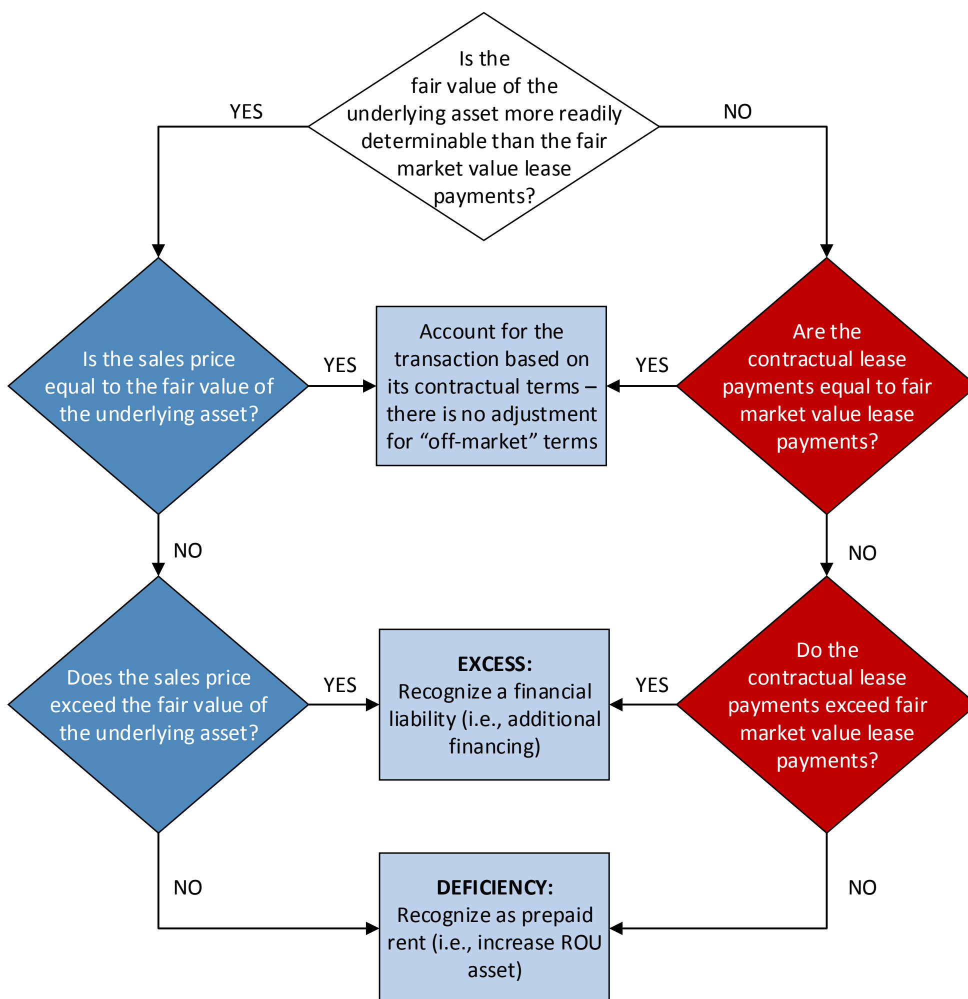
Accounting for "Off-Market" Terms



KPMG Observations

In a sale-leaseback transaction, the difference between the sales price and fair value of the underlying asset may not necessarily equal the difference between the present value of the contractual lease payments and the present value of fair market value lease payments. The Boards decided that either comparison would be an acceptable way to identify whether the accounting for the transaction needs to be adjusted due to the presence of off-market terms.

Example 2 illustrates the accounting for a sale-leaseback transaction with above market terms using both a comparison of the sales price to the fair value of the underlying asset and a comparison of the contractual lease payments to the fair market value lease payments.

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Example 2: Accounting for a Sale-Leaseback Transaction with "Off-Market" Terms

Assume the same facts as Example 1 except that the building's observable market value on the date of the sale is $2,000,000 (i.e., the sales price exceeds the building's fair value by $500,000), and fair market value lease payments are $198,800 per year (i.e., the present value of the contractual lease payments exceeds the present value of fair market value lease payments by $400,000). (Note that although both a comparison of the sales price to the underlying asset's fair value and the contractual lease payments to fair market value lease payments are provided for illustrative purposes, only the more readily determinable comparison would be required under the Boards' decisions.) For ease of illustration, the buyer-lessor's discount rate is assumed to be 10%.

As the terms of the transaction are above market, both parties would need to record an adjustment to recognize the transaction at fair value as follows:

	FASB		IASB	
	More Readily Determinable		More Readily Determinable	
	Fair Value of Underlying Asset	Fair Market Value Lease Payments	Fair Value of Underlying Asset	Fair Market Value Lease Payments
	Dr. (Cr.)	Dr. (Cr.)	Dr. (Cr.)	Dr. (Cr.)
Seller-Lessee				
Cash	2,500,000	2,500,000	2,500,000	2,500,000
Building	(1,500,000)	(1,500,000)	(1,500,000)	(1,500,000)
Gain on sale	(500,000)[A]	(600,000)	(367,500)[F]	(420,000)[H]
ROU asset	530,000	630,000	397,500[G]	450,000[I]
Lease liability	(530,000)[B]	(630,000)[D]	(530,000)[B]	(630,000)[D]
Financial liability	(500,000)[C]	(400,000)[E]	(500,000)[C]	(400,000)[E]

	Converged	
	More Readily Determinable	
	Fair Value of Underlying Asset	Fair Market Value Lease Payments
	Dr. (Cr.)	Dr. (Cr.)
Buyer-Lessor		
Building	2,000,000[J]	2,100,000[L]
Financial Asset	500,000[K]	400,000[E]
Cash	(2,500,000)	(2,500,000)

[A] $2,000,000 (fair value of underlying asset) – $1,500,000 (carrying amount of underlying asset)

[B] Present value of contractual lease payments (4 annual payments of $325,000, discounted at 10%) – $500,000 ("off-market" adjustment)

[C] "Off-market" adjustment: $2,500,000 (sales price) – $2,000,000 (fair value of underlying asset)

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Example 2: Accounting for a Sale-Leaseback Transaction with "Off-Market" Terms

D Present value of contractual lease payments at market (4 annual payments of $198,800, discounted at 10%)

E "Off-market" adjustment: present value of 4 annual payments of $126,200 ($325,000 – $198,800), discounted at 10%

F Portion of gain related to buyer-lessor's residual interest in underlying asset = total gain × (fair value of underlying asset – present value of lease payments) ÷ fair value of underlying asset = ($2,000,000 - $1,500,000) × ($2,000,000 - $530,000) ÷ $2,000,000 = $367,500

G ROU asset under IFRS = present value of lease payments – total gain + gain recognized = $530,000 – $500,000 + $367,500 = $397,500

H Portion of gain related to buyer-lessor's residual interest in underlying asset = total gain × (fair value of underlying asset – present value of lease payments) ÷ fair value of underlying asset = ($2,100,000 - $1,500,000) × ($2,100,000 - $630,000) ÷ $2,100,000 = $420,000

I ROU asset under IFRS = present value of lease payments – total gain + gain recognized = $630,000 – $600,000 + $420,000 = $450,000

J Fair value of underlying asset

K "Off-market" adjustment: $2,500,000 (purchase price) – $2,000,000 (fair value of underlying asset)

L $2,500,000 (purchase price) – $400,000 ("off-market" adjustment)

Definition of a Lease

The Boards agreed 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. To control the use of an identified asset a customer must obtain the right to:

- Direct the use of the identified asset; and
- Obtain substantially all of the economic benefits from directing the use of the identified asset.

The Boards agreed to clarify that for a customer to have the right to direct the use of an identified asset it must have the right to direct (including the right to *change*) how and for what purpose the asset is used throughout the period of use. The Boards also agreed that if neither the customer nor the supplier controls how and for what purpose the asset is used throughout the period of use, the customer would nevertheless have the right to control the use of the asset if:

- The customer has the right to operate the asset or to direct others to operate it in a manner the customer determines (and the supplier has no right to change those operating instructions); or
- The customer designed the asset, or caused it to be designed, in a way that predetermines during the period of use (a) how and for what purpose it will be used, or (b) how it will be operated.

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KPMG Observations

The clarifications of the definition of a lease do not represent a significant change from the proposals in the EDs. The new definition will exclude some contracts in which the customer obtains all of the output or utility of an identified asset, regardless of the price the customer pays for the output, unlike current GAAP as illustrated in Example 3.

Example 3: Outsourcing Arrangement

Auto Manufacturer enters into a 25-year agreement for Parts Supplier to build a parts facility adjacent to Auto Manufacturer's manufacturing plant. Auto Manufacturer will make an equity investment in the entity formed by Parts Supplier to own the facility but does not participate in the design of the facility.

Auto Manufacturer and Parts Supplier agree that the parts facility will produce constant-velocity (CV) joints for Auto Manufacturer. The initial capacity of the facility will be used to produce only CV joints and Auto Manufacturer will purchase all of the CV joints produced by the facility. The price paid by Auto Manufacturer will be determined based on Parts Supplier's actual operating costs plus a profit margin. Parts Supplier has the right to expand the facility in the future if it wishes to produce other parts (but does not expect to do so) and has the right to make all operating decisions for the facility.

Based on the Boards' decisions, the arrangement would not contain a lease. Auto Manufacturer does not have a right to direct the use of the facility during the 25-year term of the agreement because it cannot direct how and for what purpose the facility is used throughout the term. Even though Parts Supplier built the facility for the express purpose of supplying parts to Auto Manufacturer, Auto Manufacturer has no right to *change* how the facility is used or what it produces. In addition, Auto Manufacturer does not have the right to operate the facility or direct Parts Supplier to operate it in a manner that Auto Manufacturer determines. Auto Manufacturer also did not design the facility or cause it to be designed in a way that predetermines during the period of use (a) how and for what purpose the facility will be used, or (b) how the facility will be operated. Consequently, Auto Manufacturer would account for the arrangement as the acquisition of inventory as CV joints are delivered. Auto Manufacturer would be required to separately evaluate whether to consolidate the entity that owns the facility and, if it is required to consolidate the entity, the inventory acquisition accounting would be eliminated in Auto Manufacturer's consolidated financial statements.

Alternatively, if Auto Manufacturer had the right to change the parts produced by Parts Supplier during the term of the agreement (e.g., to require that Parts Supplier produce axles rather than, or in addition to, CV joints), then Auto Manufacturer would have the right to direct the use of the facility based on the Boards' decisions because it could *change* what the facility produces and the arrangement would contain a lease.

Under current GAAP the arrangement would contain a lease because Auto Manufacturer is expected to obtain substantially all of the facility's output during the term of the arrangement for a price that is not fixed per unit of output or equal to the market price per unit of output at the time it is delivered.

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The Boards also discussed whether the right to obtain substantially all of the economic benefits from directing the use of an identified asset requires a customer to have the ability, using its own resources or other readily available resources, to derive the benefits from directing the use of the asset. This additional condition would exclude from the definition of a lease arrangements in which the supplier operates the identified asset if the customer does not have the requisite skills to operate the asset on its own and there are no other readily available operators with that skill. The Boards directed their staff to provide additional analysis about this issue for consideration at a future meeting.

KPMG Observations

The Boards' staff did not identify any examples of arrangements in which the customer does not have the requisite skills to operate the asset on its own and there are no other readily available operators with that skill. Although the staff suggested that there should be very few such arrangements, most FASB members seemed inclined to include the condition in the definition of a lease because they viewed it as an important aspect of determining whether the customer controls the use of an identified asset. Most IASB members seemed inclined to exclude the condition from the definition of a lease either because they considered it irrelevant or because they thought it would create additional complexity and invite inappropriate transaction structuring to achieve off-balance sheet accounting. Members of both Boards expressed concern that the term "readily available" was not sufficiently clear to be applied consistently in practice.

Lessor Disclosures

The Boards agreed to retain substantially all of the existing lessor disclosure requirements under U.S. GAAP and IFRS. They also agreed that a lessor would be required to disclose for all leases:

- Information about the nature of its leases and significant judgments and assumptions made in accounting for leases;
- A table of lease income during the reporting period; and
- Information about how it manages risks of the residual interests in its leased assets.

For Type A leases, the Boards decided that a lessor would be required to disclose:

- A maturity analysis of the undiscounted cash flows comprising the lessor's lease receivables for each of the first five years following the reporting date and in total for years thereafter that is reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes (both Boards agreed);
- An explanation of significant changes in the components of the lessor's net investment in Type A leases other than lease receivables during the reporting period (FASB only – the FASB decided to consider disclosures

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related to Type A lease receivables in its project on accounting for impairment of financial instruments);

- A qualitative and quantitative explanation of the significant changes in the lessor's net investment in Type A leases during the reporting period (IASB only).

For Type B leases, the Boards agreed that a lessor would be required to disclose:

- General property, plant, and equipment disclosures for assets subject to Type B leases by significant class of underlying asset separately from those disclosures for the lessor's other owned assets; and
- A maturity analysis of the undiscounted future lease payments to be received for each of the first five years following the reporting date and in total for years thereafter.

KPMG Observations

Although the Boards decided not to substantially change lessor accounting, their decision to expand the required lessor disclosures is intended to provide financial statement users more information about the risks to which the lessor is exposed (e.g., collectibility of lease receivables and risks related to the lessor's residual interest in its leased assets). In response to feedback from financial statement users, the Boards also decided to require lessors to provide a table of lease income recognized during the period. Example 4 provides an illustration of this reconciliation.

Example 4: Lessor Table of Lease Income	
Lease income – Type A leases	
Profit at lease commencement	XXX
Interest income on lease receivables	XX
Interest income from accretion of residual assets	XX[1]
Subtotal	**XXXX**
Lease income – Type B leases	XXX
Lease income from variable lease payments	X
Total lease income	**XXXX**

[1] Interest income on the lessor's net investment in Type A leases may be presented either in aggregate or separately (as shown) for each component of the net investment in the lease.

U.S. GAAP-Specific Proposals

The FASB reached decisions about U.S. GAAP-specific proposals on leveraged leases, nonpublic lessee discount rates, and related party leasing transactions. Refer to the Summary of Decisions Reached in Redeliberations for a description

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of the FASB's decisions on nonpublic lessee discount rates and related party leasing transactions.

The FASB decided to eliminate leveraged lease accounting under U.S. GAAP for leases that commence after the effective date of the new lease accounting standard. A lessor would account for all leases subject to the requirements of the new standard as either Type A (financing) or Type B (operating) leases. The Board decided that leveraged leases in existence at the effective date of the new lease accounting standard would not be subject to its requirements (i.e., leveraged lease accounting would continue for those transactions).

KPMG Observations

Leveraged leasing transactions typically provide significant tax and financial reporting benefits for lessors applying U.S. GAAP. Leveraged leases usually involve capital intensive assets such as airplanes and power plants that are leased for extended periods (e.g., 25 years or more). However, these transactions have become more infrequent in recent years due to changes in interest rates and investment tax incentives. The FASB's decision to eliminate leveraged lease accounting is intended to reduce complexity in the lessor accounting requirements and to converge with IFRS, which has no specialized accounting for leveraged leases. The FASB decided to grandfather existing leveraged leases from the requirements of the new lease accounting standard because it determined that there are relatively few existing leveraged leases and the cost for lessors to "unwind" the accounting for those transactions would exceed the benefit to financial statement users. This decision will require lessors with leveraged leases to retain their existing systems and controls for those transactions until the leases are terminated, which may be several decades. Lessor accounting will remain unconverged for grandfathered leveraged leases, making it difficult for financial statement users to compare the financial statements of these lessors to those of other lessors prepared under U.S. GAAP and IFRS.

"We prefer a single measurement approach [for lessee accounting] which would be consistent with the theme around reducing complexity and creating more simple financial statements that users can understand."

– Jonathan Nus, IAC Member

Other Developments

FASB Investor Advisory Committee Feedback. On August 26, 2014, the FASB met with its Investor Advisory Committee (IAC) to discuss the leases project.[4]

- The IAC expressed support for on-balance sheet accounting by lessees, noting that it would benefit the majority of financial statement users.
- A majority of the IAC members expressed a preference for the IASB single Type A lessee accounting model rather than the FASB dual model because in their view the single Type A model better represents the economics of leasing transactions and increases financial statement comparability.
- The IAC emphasized the importance of disclosures and recommended that the FASB focus on relevance, rather than volume. The committee expressed

[4] The IAC is a standing committee that works closely with the FASB in an advisory capacity to ensure that investor perspectives are effectively communicated to the FASB on a timely basis in connection with the development of financial accounting standards.

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a desire for disclosures that would explain management's critical judgments and assumptions (e.g., when determining whether to include renewal or purchase options in the measurement of lease payments). The committee also highlighted the need for disclosures that would enable users to reconcile between the lessee accounting under U.S. GAAP and IFRS.

EFRAG and European Standard Setters Leases Consultation. During July and August, the European Financial Reporting Advisory Group (EFRAG)[5] and the National Standard Setters of France, Germany, Italy, and the UK jointly solicited public comment on two aspects of the proposals in the leases project:

a) Examples of transactions that would be considered leases under the Boards' proposed definition but that respondents believe are in-substance services for which off-balance sheet accounting should apply; and

b) Which approach to lessee accounting (the FASB dual model approach or the IASB single model approach) respondents considered more appropriate and/or less costly to apply.

Examples of transactions preparers identified that they believe are in-substance services for which off-balance sheet accounting should apply included:

a) Time charters of vessels;

b) IT storage contracts; and

c) "Wet" leases of aircraft in which the supplier of the aircraft also provides the personnel, maintenance, and insurance needed to operate it.

A majority of preparers that participated in the outreach expressed a preference to keep or improve existing lease accounting requirements as compared to either the FASB or IASB proposals. In addition, of those preparers that responded, more preferred the IASB single model approach to lessee accounting than the FASB dual model approach.

Most financial statement users that participated in the outreach expressed support for on-balance sheet recognition of leases by lessees. In addition, a majority of financial statement users indicated a preference for the IASB single model approach to lessee accounting rather than the FASB dual model approach.

[5] EFRAG provides advice to the European Commission (EC) on all issues relating to the application of IFRS in the European Union (EU). Its primary objective is to influence the international debate on accounting matters from a European perspective. EFRAG is the primary technical advisor to the EC with respect to the EC's consideration of whether to endorse IFRS for use in the EU. Additional information is available at www.efrag.org.

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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</td><td colspan="2">• 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, or neither the customer nor the supplier controls the use of the identified asset throughout the period of use and:
▪ The customer has the right to operate the asset or to direct others to operate it in a manner the customer determines (and the supplier has no right to change those operating instructions); or
▪ The customer designed the asset, or caused it to be designed, in a way that predetermines during the period of use (a) how and for what purpose it will be used, or (b) how it will be operated</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 with a lease term as determined under the revised proposals ≤ 12 months
• 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
• Lease classification test based on IAS 17 classification criteria[6]
• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability
– Type A leases would be treated as the purchase of an asset on a financed basis
– Type B leases generally would have straight-line recognition of total lease expense</td><td>• Single lease accounting model
• No lease classification test
• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability
– Treated as the purchase of an asset on a financed basis</td></tr>
</table>

[6] IAS 17, Leases.

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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="3">Lessor Accounting Model</td><td colspan="2">• Dual lease accounting model
• Lease classification test based on IAS 17 classification criteria
• Type B accounting model based on IAS 17 operating lease accounting
• 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>
<tr><td>– Selling profit would not be recognized on commencement of leases that qualify for Type A classification solely 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>• Existing leveraged leases would be grandfathered from application of the new standard</td><td>• N/A – leveraged lease accounting does not exist under IFRS</td></tr>
<tr><td>Related Party Leasing Transactions</td><td>• Account for leases between related parties based on their contractual terms, even if they differ from the substance of the arrangement</td><td>• N/A – the IASB did not address related party leasing transactions in its proposals</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
• 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
• 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
• Lessees would include initial direct costs in the initial measurement of the ROU asset and amortize the costs over the lease term
• 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
• Lessors would include initial direct costs for Type A leases
– In the initial measurement of the lease receivable if no selling profit is recognized at lease commencement</td></tr>
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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">– In expense at lease commencement if selling profit is recognized at lease commencement
• 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
– The value used to determine the lessee’s incremental borrowing rate would be the cost of the ROU asset
• Lessees would reassess the discount rate when there is
– 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
– A lease modification</td></tr>
<tr><td></td><td>• Nonpublic business entity lessees would be permitted to elect as an accounting policy to use a risk-free discount rate</td><td>• N/A – no unique guidance for nonpublic business entities</td></tr>
<tr><td></td><td colspan="2">• The lessor’s discount rate would be the rate implicit in the lease (i.e., the implicit rate)
– 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
• Lessors would reassess the discount rate when there is a lease modification</td></tr>
<tr><td>Variable Lease Payments</td><td colspan="2">• Lease payments used in the initial measurement of lease assets and liabilities would include
– Variable payments based on an index or rate using prevailing (spot) rates or indices at lease commencement; and
– Variable payments that represent in-substance fixed payments (consistent with current practice)
• No reassessment of variable lease payments by lessors
• 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</td></tr>
<tr><td></td><td>• Lessees would reassess variable lease payments based on an index or rate only when lease</td><td>• Lessees would reassess variable lease payments based on an</td></tr>
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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td>payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)</td><td>index or rate when:
– Lease payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)
– 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)</td></tr>
<tr><td>Arrangements with Lease and Non-lease Components; Contract Combinations</td><td colspan="2">• 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
• 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)
– Reallocate consideration when there is a contract modification that is not accounted for as a separate, additional lease
• Lessees would choose an accounting policy by class of underlying asset to either:
– Separate lease and non-lease components and allocate consideration based on relative standalone prices of components, maximizing the use of observable information
▪ 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
– Account for lease and non-lease components together as a single lease component
• Two or more contracts entered into at or near the same time would be combined as a single transaction if:
– The contracts are negotiated as a package with a single commercial objective; or
– 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
• 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</td></tr>
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Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	that ROU is priced commensurate with its standalone price in the context of that particular contract • For lessees, when a modification is not considered a separate, additional lease: – 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 – 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 • For lessors, when a modification is not considered a separate, additional lease: – 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 – Type A lease modifications would be accounted for under the financial instruments requirements in U.S. GAAP or IFRS as applicable	
Subleases	• A lessee-sublessor would account for the head lease and the sublease as two separate contracts unless those contracts meet the contract combinations guidance – The head lease would be accounted for in accordance with the lessee accounting proposals – The sublease would be accounted for in accordance with the lessor accounting proposals • 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 • 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)[7]	
	• A sublessor would consider the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease	• A sublessor would consider the ROU asset to be the leased asset in determining the classification of the sublease

[7] 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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Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
Sale-Leaseback Transactions	*Determining Whether a Sale has Occurred* • A sale and leaseback of the underlying asset would be recognized if the requirements for sale recognition in the new revenue recognition standard are met. The existence of the leaseback would not, on its own, result in a conclusion that control of the asset had not been conveyed to the buyer-lessor.	
	• If the leaseback would be classified as a Type A lease by the seller-lessee, then sale recognition would be precluded • A repurchase option held by the seller-lessee in a sale and leaseback transaction would preclude sale recognition unless: – The strike price to repurchase the asset is its fair market value at the date of option exercise; and – The underlying asset is readily available and non-specialized	• N/A – single model approach for lessee accounting • If the seller-lessee has a substantive repurchase option with respect to the underlying asset, sale recognition would be precluded
	• Both the seller-lessee and the buyer-lessor would account for a sale-leaseback transaction that does not qualify for sale accounting as a financing transaction	
	Accounting for a Sale/Purchase • A buyer-lessor would account for the purchase of an asset in a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that would apply to the purchase of a nonfinancial asset • A seller-lessee would account for any loss on a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that applies to any other sale	
	• Any gain recognized by a seller-lessee on a sale-leaseback transaction that qualifies for sale accounting would be measured consistent with the guidance that applies to any other sale, subject to any adjustment for "off-market" terms	• Any gain recognized by a seller-lessee on a sale-leaseback transaction that qualifies for sale accounting would be restricted to the amount that relates to the buyer-lessor's residual interest in the underlying asset, subject to any adjustment for "off-market" terms

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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">Accounting for the Leaseback
• If a sale-leaseback transaction qualifies for sale accounting, the leaseback would be accounted for in the same manner as any other lease</td></tr>
<tr><td></td><td colspan="2">Accounting for "Off-Market" Terms
• Any potential "off-market" adjustment would be measured as the more readily determinable of:
– The difference between the fair value of the underlying asset and the sales price, or
– The difference between the present value of fair market value lease payments and the present value of the contractual lease payments
• A deficiency in the transaction terms versus market terms would be accounted for as a prepayment of rent
• An excess in the transaction terms versus market terms would be accounted for as additional financing provided by the buyer-lessor to the seller-lessee</td></tr>
<tr><td>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
– If not separately presented on the balance sheet lessees would:
▪ Present Type A ROU assets on the balance sheet as if the underlying asset were owned
▪ 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></td><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
– 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>

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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Lessee Presentation – Statement of Cash Flows</td><td>• Lessees would classify cash paid for:
– Principal on Type A lease liabilities as financing activities
– Interest on Type A lease liabilities as operating activities
– 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:
– Principal on lease liabilities as financing activities
– Interest on lease liabilities as either operating or financing activities based on the lessee's accounting policy choice under IAS 7[8]
– Variable lease payments and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities
• 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
• Lessors would classify all cash inflows from leases as operating activities in the statement of cash flows</td></tr>
<tr><td>Lessor Disclosures</td><td colspan="2">General
• A lessor would disclose the following information about its leases:
– A general description of its leases;
– The basis, and terms and conditions, on which variable lease payments are determined;
– The existence, and terms and conditions, of options to extend or terminate the lease;
– The existence, and terms and conditions, of options for a lessee to purchase the underlying asset;
– Information about the significant assumptions and judgments made in accounting for its leases, which may include:
▪ The determination of whether a contract contains a lease;
▪ The allocation of the consideration in contracts that contain a lease between lease and non-lease components;
▪ The initial measurement of the residual asset; and</td></tr>
</table>

[8] IAS 7, Statement of Cash Flows.

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<tr><td rowspan="2"></td><td colspan="2">▪ Information about managing the risk associated with the residual asset
– A table of lease income received during the reporting period
– A maturity analysis of a) the undiscounted cash flows comprising a lessor’s lease receivables (for Type A leases) and b) the undiscounted future lease payments (for Type B leases) for each of the first five years and a total of the amounts thereafter. For Type A leases, the amounts included in the maturity analysis would be reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes.
Type B Leases
• General property, plant, and equipment disclosures for assets subject to Type B leases by significant class of underlying asset separately from those disclosures for the lessor’s other owned assets
Type A Leases</td></tr>
<tr><td>• An explanation of the significant changes in the components of net investment in Type A leases other than the lease receivable during the reporting period</td><td>• A qualitative and quantitative explanation of the significant changes in the net investment in Type A leases during the reporting period</td></tr>
</table>

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