Staff Paper

IASB Education Session April 6, 2011
FASB Education Session April 7, 2011

Project	**Leases**
Topic	**Determining a lease to be a finance lease or an other-than-finance lease**

Background

1. In the February 2011 Joint Board Meetings, the Boards tentatively decided to identify a new approach for the lessee and lessor to distinguish between two types of leases, a finance lease and an other-than-finance lease. A finance lease is represented by a financing profit or loss recognition pattern and an other-than-finance lease by a recognition pattern over the lease term. The Boards directed the staff to perform targeted outreach on this new approach.

2. Based on the feedback from targeted outreach, the staff recommends that the lessee and the lessor use the same guidance and determine whether the lease is a finance lease or an other-than-finance lease in a transaction based on the business purpose for the lease transaction *and* an assessment of the transfer of substantially all of the risks and rewards of ownership, using new guidance outlined in paragraphs 17 and 18 in this paper.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

3. This paper is structured as follows:

   (a) Overview

   (b) Approach A – IAS 17, paragraphs 7-12

   (c) Approach B – Targeted outreach approach

   (d) Approach C – Consumption approach

   (e) Appendix A – Targeted outreach approach, marked for feedback

   (f) Appendix B – Feedback and rationale for changes marked in Appendix A

Overview

4. There are three approaches for determining whether a lessee and a lessor should account for a lease as a finance lease or an other-than-finance lease:

   (a) **Approach A**: Determination based on the transfer of substantially all of the risks and rewards of ownership, using the IFRS guidance as outlined in IAS 17, paragraphs 7-12;

   (b) **Approach B**: Determination based on the business purpose for the lease transaction *and* the transfer of substantially all of the risks and rewards of ownership, using new guidance (the targeted outreach approach); or

   (c) **Approach C**: Determination based on the extent the right to use consumes the underlying asset (the consumption approach).

5. Other approaches that the staff considered but did not develop include:

   (a) Alignment with the revenue recognition project: the staff received feedback from auditors and preparers in response to targeted outreach and the ED that the distinction for the lessor between two types of leases should be consistent with the concept of control in the *Revenue Recognition* project. However, the staff rejected this as an approach due to the difficulty in aligning lessor accounting with the revenue recognition project due to the uniqueness of lease contracts and thinks

that the arguments made in paragraph 31 of AP 1F/Memo 160 apply in this paper as well.

(b) Topic 840 (FAS 13) criteria for the lessee and the lessor: the staff quickly rejected these criteria as an approach due to the frequent criticism of the bright-line tests (principally the 90% and 75% tests) as the reason to improve lease accounting. The staff continues to think the concepts underlying the criteria from Topic 840 are relevant to this discussion and instead incorporated them into the guidance of Approach B.

(c) Exposure draft (ED) guidance for the lessor: the staff rejected developing further, for both the lessee and the lessor, the guidance proposed in the ED to distinguish between lessor approaches because the guidance did not offer significant improvement over current guidance to justify including it as a possible approach. This and other criticisms were common in comment letter feedback, discussion of which can be found in Appendix A of AP 1F/Memo 160. The staff thinks that the concepts underlying this guidance are relevant and instead incorporated them into the guidance in Approach B.

6. The staff acknowledges that both parties in a lease contract would look to similar elements of the transaction to evaluate its substance and purpose. Therefore, the same guidance should be used by both the lessee and the lessor to determine whether a lease is a finance lease or an other-than-finance lease. Approaches A, B, and C are all considered with the lessee and the lessor aligned.

7. However, the staff notes that, while each approach is aligned in the evaluation that is necessary for the lessor and the lessee, this does not mean that the *result* of the evaluation of a lease as a finance lease or an other-than-finance lease will always be symmetrical. If nothing else besides their differences as lessor and lessee, the two parties may have asymmetrical information (for example, knowledge of a lessor third party residual value guarantee) or may apply different levels of judgment in determining the substance of the transaction and

applying the indicators (for example, the extent to which the lessors' business model influences which accounting approach to apply).

Approach A: IAS 17, paragraphs 7-12

8. Under Approach A, the transfer of substantially all of the risks and rewards of ownership is determinative of whether a lease is, and whether the pattern of profit or loss recognition is reflected as, a finance lease or an other-than-finance lease. That is, the transfer of substantially all of the risks and rewards of ownership in the lease transaction is consistent with a finance lease transaction. While an other-than-finance lease transaction does not involve the transfer of substantially all of the risks and rewards of ownership.

9. As this is the same principle articulated in IAS 17 (specifically, paragraph 8 of IAS 17) to distinguish between a finance lease and an operating lease, Approach A uses the IFRS guidance as outlined in paragraphs 7-12 of IAS 17 as the best method to distinguish between a finance lease and an other-than-finance lease that is based on the transfer of substantially all of the risks and rewards of ownership. Paragraphs 7-12 of IAS 17 are provided below:

> **Classification of leases**
>
> 7. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.
>
> **8. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.**
>
> 9. Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

> 10. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
>
> (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
>
> (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
>
> (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
>
> (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
>
> (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.
>
> 11. Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:
>
> (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
>
> (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
>
> (c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
>
> 12. The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

Staff analysis and feedback from targeted outreach

10. Approach A has the following advantages for distinguishing between a finance lease and an other-than-finance lease for both the lessee and the lessor:

(a) Promotes a smoother transition between the current accounting and the proposed lease model, specifically if the intent of the Boards is to maintain a 'line' that is relatively consistent with that applied in current practice;

(b) Known in practice and therefore familiar to most (predominantly IFRS) constituents, as noted by user, preparer, and accounting firm participants in targeted outreach;

(c) Most practice issues relating to applying the guidance have already been identified and practice has evolved to ensure consistency in application;

(d) Adopts the principles underlying current US GAAP under FAS 13, without the bright-line tests; and

(e) Favorable cost/benefit analysis for those currently applying IFRS to a lease portfolio, as those entities had previously used IAS 17 to distinguish between operating and finance leases.

11. Some preparers and most accounting firm participants in targeted outreach noted that the guidance in IAS 17 properly distinguishes between a finance lease and an operating lease in current practice and could do the same for finance leases and other-than-finance leases in the new leases guidance. They noted that the transfer of substantially all of the risks and rewards of ownership draws an appropriate "line" between a finance lease and an operating lease today and if the intent of the Boards is to retain a similar "line" between a finance lease and an other-than-finance lease, they proposed retaining the current guidance in IAS 17 from a cost/benefit perspective.

12. The disadvantages of using the IAS 17 guidance and Approach A are as follows:

(a) The guidance in IAS 17 was used for an entirely different purpose, namely, to differentiate between one on-balance sheet accounting model (finance lease) and one off-balance sheet accounting model (operating lease). Therefore, the method in IAS 17 for distinguishing between types of leases may not be appropriate for establishing the

distinction between types of leases in the Boards' proposed right-of-use model.

(b) While the IAS 17 indicators do not cite bright-line tests, they are generally consistent with Topic 840 (formerly FAS 13) criteria for distinguishing a capital lease from an operating lease. As a result, practice has adopted the bright-line tests as a guide to applying the IAS 17 indicators, especially the test used to indicate whether the present value of the minimum lease payments represents "at least substantially all of the fair value of the leased asset" in paragraph 10(d) of IAS 17.

(c) The guidance in IAS 17 may not appropriately capture all of the Boards' reasoning for determining that a finance lease and an other-than-finance lease exist, outlined in Agenda Paper 1F/Memo 160.

(d) In current practice, particularly under U.S. GAAP, a lease is considered to be an operating lease unless it meets the criteria in FAS 13 to be a capital/financing lease; the default lease type in current U.S. GAAP is an operating lease. However, the staff does not think a default lease type is appropriate; the determination should be made as to which type of lease a lessee or a lessor enters into instead of whether the lease meets certain criteria or a threshold to be considered a different type of lease than the default.

13. The staff recognizes that some may support Approach A and the guidance in IAS 17 after certain indicators have been modified. It is not the staff's intention to preclude these considerations. Some may suggest to modify the IAS indicators by:

(a) deleting certain indicators (for example, the fair value indicator based upon the present value of the minimum lease payments) which is deleted in Approach B and favorable feedback was received in the targeted outreach; or

(b) adding certain indicators (for example, an indicator including the business model of the lessor).

Approach B: Targeted outreach approach

14. In the February 2011 Joint Board Meeting, the staff proposed a new approach/set of indicators for distinguishing between a finance lease and an other-than-finance lease that drew from concepts underlying the IAS 17 indicators (see Approach A), the criteria in Topic 840 (FAS 13), the ED lessor indicators, and feedback from constituents regarding the different business reasons for engaging in leasing activities. The Boards suggested improvements to the approach and directed the staff to perform targeted outreach on its effectiveness. Some of those improvements suggested in the February 2011 joint meeting included:

    (a) Have one set of indicators of a finance lease and another set of indicators of an other-than-finance lease, but avoid using strictly "reverse" indicators for other-than-finance leases;

    (b) Consider using some indicators in the reverse instead of as proposed in AP 5F/Memo 134, as they may be more effective written as such;

    (c) Avoid defining a finance lease and writing a set of indicators of when that definition is met;

    (d) Emphasize that all indicators should be considered together instead of individually in a checklist or as with bright lines.

15. The staff addressed these improvements and proposed an approach to participants as part of the targeted outreach conducted in March and April 2011. The staff asked the participants for feedback on this approach. Based on this feedback, the staff made changes and presents the modified approach as Approach B in this paper to determine which type of lease, and which pattern of recognition in profit or loss, is appropriate.

Principle for determining whether a lease is a finance lease or an other-than-finance lease

16. Under Approach B, the difference between a finance lease and an other-than-finance lease and the pattern of profit or loss recognition for each involves more than just the transfer of substantially all of the risks and rewards of ownership. Paragraphs 33 to 36 and 42 to 45 in AP 1F/Memo 160 properly

summarize a finance lease and an other-than-finance lease and how they differ for the lessee, principally:

(a) The business purpose for entering into a finance lease transaction is different than the purpose for entering into an other-than-finance lease transaction; and

(b) Substantially all of the risks and rewards of ownership are transferred in a finance lease transaction, but not in an other-than-finance lease transaction.

17. To properly articulate its rationale for continuing with a finance lease and an other-than-finance lease, the staff developed the principle in 1 below to better describe and define a finance lease and an other-than-finance lease:

1. **At the date of inception of a lease the lessee and the lessor shall identify the lease as either a finance lease or an other-than-finance lease. This determination shall be made based on the substance of the transaction regardless of contractual terms, and shall include:**

   a. **an evaluation of the business purpose of a contract.**

      The purpose of a finance lease is for the lessor to finance the lessee's right to use an underlying asset in a contract and the financing element is significant.

      The purpose of an other-than-finance lease is for the lessor to provide the lessee any one or more of the following: (i) to avoid the inflexibilities of ownership; (ii) to mitigate the risk of ownership (for example, technological obsolescence); or (iii) to outsource significant activities principally relating to maintenance and administration of an asset. The underlying asset in the contract is *not* significantly consumed or depleted during the lease term.

   b. **a review of all available evidence, including, but not necessarily limited to, the non-exhaustive list of indicators set out in paragraphs A2 and A3. No single indicator shall be individually conclusive.**

Supporting indicators of a finance lease and an other-than-finance lease

18. To assist in distinguishing between a finance lease and an other-than-finance lease using the principles and descriptions provided in A1 above, Approach B provides a set of indicators in 2 and 3 below:

2. The following indicators may identify a finance lease. Some of these indicators may not be applicable to both lessors and lessees in every lease contract.

a. *Lessor business model* – The business model of the lessor in the contract is to provide direct financing or is as a manufacturer/dealer. There is no significant, continuing involvement after the date of commencement of the lease other than credit risk in the collection of lease payments.

b. *Residual asset* – The risks and rewards of the residual asset are transferred from the lessor to the lessee, including the effect of any residual value guarantee (including those provided by an unrelated third party).

c. *Potential ownership transfer* – The underlying asset transfers ownership from the lessor to the lessee at the end of the lease term or there is a bargain purchase option that the lessee may exercise at the end of the lease term.

d. *Length of lease term* – The duration of the term of the lease is significant in relation to the economic useful life of the underlying asset.

e. *Underlying asset* – The underlying asset is specialized and/or customized.

3. The following indicators may identify an other-than-finance lease. Some of these indicators may not be applicable to both lessors and lessees in every lease contract.

a. *Rent characteristics* – The rent payments are benchmarked to, or priced by the lessor with reference to, market-based rates.

b. *Underlying asset* – The underlying asset is not available to be purchased by the lessee or sold by the lessor.

c. *Embedded or integral services* – The contract contains significant integral or embedded services.

d. *Variable rent* – The contract contains significant variable (contingent) rent during the lease term that is based on the use or performance of the underlying asset.

19. Appendix A lays out a marked-up version of 1-3. The marks show the differences between what was proposed to participants in targeted outreach and what is proposed to the Boards as Approach B in paragraphs 17 and 18 in this paper. Appendix B explains some of the more significant marks and revisions that were made in Appendix A using feedback from targeted outreach, including the staff's rationale.

Staff analysis and feedback from targeted outreach

20. Approach B notes that the principles in IAS 17 and criteria in Topic 840 (FAS 13) were created for, and are used for, a different purpose than what is being proposed in the new leases guidance. In addition, Approach B notes that the "baggage" of the current guidance will be carried forward unless substantive

changes are made to the words used to describe the difference between finance leases and other-than-finance leases. An advantage of Approach B is that it addresses the concerns over carrying forward the guidance in IAS 17 as described in paragraph 12 of this paper.

21. While Approach B also distinguishes between a finance lease and an other-than-finance lease, in part, based on the transfer of substantially all of the risks and rewards of ownership, Approach B includes the following improvements over IAS 17 and Approach A:

    (a) Provides a substantive description of an other-than-finance lease in paragraph 17 and a unique set of indicators of an other-than-finance lease in paragraph 18. This is not the case in IAS 17, where an operating/other-than-finance lease is defined as the inverse of a finance lease in paragraph 8 of IAS 17 and only indicators of a finance lease are provided.

    (b) Does not include a comparison of the present value of the lease payments to the fair value of the underlying asset as an indicator, eliminating one of the most distinctive bright lines currently used in practice under FAS 13 and IAS 17 (i.e., the 90% test) and commonly cited as one of the most significant problems in the current accounting for leases.

    (c) Incorporates the lessor's business model as an explicit differentiator between a finance lease and an other-than-finance lease for both lessors and lessees (to the extent the lessee can assess the lessor's business model).

    (d) Recognizes the importance of the business purpose for entering into a lease transaction as a determinant of whether it is a finance lease or an other-than-finance lease that the lessor or lessee has entered into and should account for.

    (e) Both (c) and (d) above are consistent with arguments made in paragraphs 33-36 and 42-45 for the staff recommendation in Agenda Paper 1F/Memo 160YY.

22. Disadvantages of Approach B, identified also by auditor participants in targeted outreach, are similar to the advantages of Approach A (continuing with the principle and indicators in IAS 17) discussed in paragraph 10 in this paper and therefore, maintaining the guidance in IAS 17 would be the most pragmatic solution for distinguishing between a finance lease and an other-than-finance lease.

Approach C – Consumption approach

23. Under Approach C, the determination of whether a lease should be accounted for as a finance lease or an other-than-finance lease would be based on the extent that the right to use consumes the underlying asset during the term of the lease. An assessment of the consumption by the right to use the underlying asset would largely be based on the comparison of the lease term to the economic useful life of the underlying asset and the type of underlying asset.

24. Applying Approach C would lead to contracts for the right to use an underlying asset that consume the underlying asset during the term of the lease (for example, a 5-year lease of a computer) being accounted for as a finance lease.

25. In contrast, applying Approach C to a contract where it is determined that the right to use would not consume the underlying asset over the lease term (for example, the right to use a floor in a building for 5 years, assuming the floor is appropriately maintained over the lease term) would typically lead to the transaction being accounted for as an other-than-finance lease.

Staff analysis and feedback from targeted outreach

26. The main advantage of applying Approach C is that most real estate leases would be accounted for as other-than-finance leases. This would be consistent with the feedback from many preparer and user participants in targeted outreach who expressed support for:

(a) an accounting approach that reflects that real estate leases are frequently not entered into as an alternative to acquiring the underlying asset;

(b) recognizing profit or loss for real estate leases on a straight-line basis; and

(c) presenting expenses relating to real estate leases as operating expense, rather than as interest and amortization.

27. The main disadvantages of Approach C are that:

(a) Applying the principle may be viewed as 'industry-specific' guidance as it would likely focus on accounting for real estate transactions as other-than-finance leases;

(b) Application guidance would need to be developed relating to the point at which the right of use is determined to consume enough of the underlying asset for the transaction to be accounted for as a finance lease (for example, would a 50-year lease of a building be determined to consume the benefits of the underlying building?); and

(c) There are/may be other lease contracts that do not reflect significant financings and should not be accounted for as finance leases and that the approaches in Approaches A and B provide a better method of distinguishing an other-than-finance lease from a finance lease.

(d) The approach is mostly inconsistent with arguments made in paragraphs 33-36 and 42-45 that two types of leases exist in Agenda Paper 1F/Memo 160.

28. Approach C may not have a strong conceptual premise, but it may result in a practical basis for distinguishing leases of real estate and other leases with a shorter term as other-than-finance leases, while other leases would be accounted for as finance leases.

29. Approach C could also be amended to mandate that leases of real estate are other-than-finance leases and leases of other assets are finance leases. However, the staff notes that this amended approach would create concerns in

determining an appropriate definition of real estate that could be applied by both Boards and may be perceived to be an industry-specific approach.

Staff recommendation

30. Some of the staff recommends Approach B; that the determination of whether a lease is a finance lease or an other-than-finance lease be made based on the business purpose for the lease transaction *and* the transfer of substantially all of the risks and rewards of ownership, using the new guidance outlined in paragraphs 17 and 18 in this paper.

31. These staff members think that different business models of the lessor and different business purposes for entering into lease transactions are key reasons for deciding that different types of leases exist. Therefore, they should be included in the assessment, along with the transfer of substantially all of the risks and rewards of ownership, to determine whether a lease is a finance lease or an other-than-finance lease.

32. These staff members think that the distinction between a finance lease and an other-than-finance lease is probably similar to the distinction in current practice between a finance lease and an operating lease under IAS 17 (Approach A). However, these staff members do not want to risk carrying forward certain practices in use today to interpret and apply the indicators in IAS 17 (and thus, the classification criteria in FAS 13). At a minimum, the new principle in paragraph 17 and set of indicators in paragraph 18 in Approach B provide a fresh start and new descriptions and ideas behind a finance lease and an other-than-finance lease such that the substance and purpose of the lease transaction will be better evaluated to determine whether the lessee or the lessor has entered into a finance lease or an other-than-finance lease, rather than a set of indicators (or bright lines) as a checklist to determine if the lease meets certain criteria or a threshold to be considered a different type of lease than the default.

33. However, other staff members question whether the benefits of a significant change from the guidance currently used in IAS 17 exceed the costs if the objective of the Boards is to retain a distinction between a finance lease and an

other-than-finance lease that is largely consistent with current practice. If this is the objective of the Boards, these staff members would recommend Approach A.

Question 1: Determining the type of lease by the lessee
Some staff members recommend that in the final leases standard, both lessees and lessors determine the profit or loss recognition pattern for a lease transaction based on the business purpose for the transaction *and* an assessment of the transfer of substantially all of the risks and rewards of ownership, using new guidance outlined in paragraphs 17 and 18 in the this paper as Approach B. However, if the objective of the Boards is to retain a distinction between a finance lease and an other-than-finance lease that is largely consistent with current practice, other staff members recommend that in the final leases standard, both lessees and lessors determine the profit or loss recognition pattern for a lease transaction based on an assessment of the transfer of substantially all of the risks and rewards of ownership, using Approach A. Do the Boards agree with Approach A or Approach B?

Appendix A – Targeted outreach approach, marked for feedback

The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards reach decisions about how to distinguish between two types of leases. The Boards have not yet made decisions about the views reflected in this appendix, and therefore, the wording is subject to change. This appendix shows marked changes from what was originally proposed to participants of targeted outreach. Marked changes where the staff would like to discuss its rationale are numbered in superscript and addressed in Appendix B.

A1. **At the date of inception of a lease the lessee and the lessor shall identify the lease as either a finance lease or an other-than-finance lease. This determination shall be made based on the substance of the transaction regardless of contractual terms, and shall include:**

(a) **an evaluation of the business purpose of a contract~~; and~~**

The purpose of a finance lease is for the lessor to finance the lessee's right to use an underlying asset in ~~an arrangement~~ a contract and the financing element is significant.[1]

The purpose of an other-than-finance lease is for the lessor to provide the lessee any one or more of the following: (i) to ~~create flexibility~~ avoid the inflexibilities of ownership; (ii) to mitigate the risk of ownership (for example, technological obsolescence); or (iii) to outsource significant activities principally relating to maintenance and administration of an asset. The underlying asset in the contract is *not* significantly consumed or depleted during the lease term. [2]

(b) **a review of all available evidence, including, but not necessarily limited to, the non-exhaustive list of indicators set out in paragraphs A2 and A3. No single indicator shall be individually conclusive.**

A2. The following indicators may identify a finance lease. Some of these indicators may not be applicable to both lessors and lessees in every lease contract.

a) *Lessor business model* – The business model of the lessor in the contract is to provide direct financing or is as a manufacturer/dealer. There is no significant, continuing involvement after the date of commencement of the lease other than credit risk in the collection of lease payments. [3]

b) *Residual asset* – The ~~residual asset risks and~~ ~~benefits~~ risks and rewards of the residual asset [4] are transferred from the lessor to the lessee, including the effect of any residual value guarantee (including those provided by an unrelated third party).

c) *Potential ownership transfer* – The underlying asset transfers ownership from the lessor to the lessee at the end of the lease term or there is a bargain purchase option that the lessee may exercise at the end of the lease term.

d) *Length of lease term* – The duration of the term of the lease is significant in relation to the ~~remaining~~ economic [5] useful life of the underlying asset.

~~e) *Rent characteristics* – The rent payments are designed to compensate the lessor for its investment in the underlying asset plus a fair return on the use of funds invested based on an evaluation of the lessee's credit and other risk factors.~~ [6]

f) *Underlying asset* – The underlying asset is specialized and/or customized.

A3. The following indicators may identify an other-than-finance lease. Some of these indicators may not be applicable to both lessors and lessees in every lease contract.

~~a) *Length of lease term* – The duration of the term of the lease is not significant in relation to the remaining economic useful life of the underlying asset and it could be expected that the underlying asset would be re-leased by the lessor.~~ [7]

b) *Rent characteristics* – The rent payments are benchmarked to, or priced by the lessor with reference to, market-based rates.

c) *Underlying asset* – The underlying asset is not available to be purchased by the lessee or sold by the lessor ~~(for example, a retail space in an airport)~~. [8]

d) *Embedded or integral services* – The ~~arrangement~~ contract contains significant integral or embedded services.

e) *Variable rent* – The ~~arrangement~~ contract contains significant variable (contingent) rent during the lease term that is based on the use or performance of the underlying asset.

Appendix B – Feedback and rationale for changes marked in Appendix A

B1. [1] The staff thinks that the description of a finance lease and the business purpose for entering into a contract for a finance lease should be driving principles to evaluate the substance of the transaction. Financing is the predominant element of a finance lease.

B2. [2] The staff thinks that the description of an other-than-finance lease and the business purpose for entering into a contract for an other-than-finance lease should be driving principles to evaluate the substance of the transaction. Unlike a finance lease, the underlying asset subject to an other-than-finance lease is not significantly consumed, as outlined in Approach C, and the lessee (lessor) enters into the contract for elements besides financing (to provide elements besides financing).

B3. [3] The staff thinks that, consistent with significant comment letter and targeted outreach feedback, the lessor's business model is relevant to the evaluation of the substance of the transaction – as it has been in APB 27 and paragraph 60 of FAS 13 – and whether the lease should be classified as finance or other-than-finance. The staff thinks that this will mostly be a factor to the evaluation by the lessor, but, to the extent the lessee can assess the lessor's business model, it also should be a factor in the evaluation by the lessee.

B4. [4] The staff notes that the term "risks and rewards" is more consistent with other projects of the Boards.

B5. [5] The staff received considerable feedback from users, standard-setters, and preparers in targeted outreach that a term of the lease that is significant in relation to the *economic* useful life of the underlying asset is a stronger indicator of a finance lease than when the significance of the term is compared to the *remaining* useful life of the asset.

This issue was also discussed by the Boards in the February 2011 Joint Board Meeting as to whether a term of the lease that is significant in relation to the useful life of the asset if it was purchased is a stronger indicator of a finance lease. The staff thinks that the comparison to the *economic* useful life may

address this (i.e., the *economic* useful life may be the same as the useful life of the asset if it was purchased).

B6. [6] The staff received significant feedback from preparers in targeted outreach that the rent characteristics indicator in paragraph A2(e) is not indicative of a finance lease; one could argue that rent payments are always designed to compensate the lessor for its investment in the underlying asset, etc.

However, the staff continues to think that the "reverse" of the indicator is indicative of an other-than-finance lease (paragraph A3(b)), such as in the case of real estate leases.

B7. [7] The staff received feedback from preparers that the expectation that the asset could be re-leased by the lessor in paragraph A3(a) was not indicative of an other-than-finance lease because it is not uncommon for a lessor in a finance lease (e.g., a car lease) to sell the asset at the end of the term. However, the staff thinks that once this is removed from the indicator, it just the "reverse" of the length of lease term indicator in paragraph A2(d) and is not useful to evaluating a lease as other-than-finance.

B8. [8] The staff does think it is appropriate to include an example as a part of a set of indicators.