Analyst Representative Group | Agenda reference **6A**

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Project **Leases**

Topic **Leases Board Paper - Two types of leases**

Introduction

1. On January 19, 2011, the Boards discussed feedback received through outreach activities and comment letter responses to the *Leases* exposure draft (ED). Among the items highlighted by the staff at the January 2011 joint Board meeting, the Boards specifically discussed whether there should be more than one lease model for both lessees and lessors, and specifically, the profit or loss effects of the proposed right-of-use model for both lessees and lessors.

2. For lessees, this paper assumes that the Boards will reconfirm the right-of-use model that requires recognition of a right-of-use asset and a liability to make lease payments, for all leases, measured at the present value of the lease payments in accordance with the ED. The staff will ask the Boards to reaffirm this tentative decision in a separate paper presented at a future meeting.

3. This paper examines the following three topics:

    I. Are there different types of leases?

    II. If there are different types of leases, should all leases have the same profit or loss recognition pattern or should there be differences in profit or loss recognition?

    III. If there are different types of leases, what are the indicators that distinguish one type from another?

This paper has been prepared for discussion at a public meeting of the Analyst Representative Group of the IASB.

The views expressed in this paper are those of the authors.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Purpose

4. The staff are seeking the Boards' approval to proceed with additional efforts to explore Topic I (Are there different types of leases?) and thereby acknowledging that there may be different types of leases (which is different from the ED, but in some respects more consistent with current US GAAP/IFRS).

5. In order to establish the approach to be developed further (the Approach), the staff seeks tentative decisions on the two follow-on topics (Topics II and III). If tentative decisions are reached in Topics II and III in addition to the other matters outlined in Topic IV, the staff thinks a sufficient approach could be established to perform additional targeted outreach. This targeted outreach would focus on whether the Approach would address constituent concerns on the profit and loss recognition pattern proposed in the ED and the cost/benefits of applying the ED without changing the proposed requirement to recognize lease assets and lease liabilities on all lessees' balance sheets and a lease receivable on all lessors' balance sheets.

6. The staff thinks further information from additional targeted outreach efforts on the Approach will be essential to enable the staff to make a final recommendation to the Boards on whether the final standard should acknowledge two types of leases.

Staff recommendations

7. Topic I – The staff recommends the Boards tentatively acknowledge that there are different types of leases. Additionally, the staff recommends establishing an Approach to be used in targeted outreach as discussed below in Topics II, III and IV. Finally, the staff recommends the results of this targeted outreach be presented to the Boards at a future date with a staff recommendation on whether the Boards should confirm the tentative decisions made in this memo.

8. Topic II – The staff recommends that if there are different types of leases, that each type has a different profit or loss recognition pattern for both the lessee and lessor. Specifically there is a lease that is:

   a) A ***finance lease*** that is akin to an installment purchase/sale in which the financing element is significant and should be reflected in the pattern of profit or loss recognition of both lessees and lessors. The profit or loss of a finance lease has a profit or loss pattern consistent with the proposals in the ED and includes interest

expense/income (using the effective interest method), and would usually reflect the lessee consuming the right-of-use asset on a straight-line basis; or

b) An ***other-than-finance lease*** that is a lease transaction in which the financing element is not considered significant. The profit or loss pattern of an other-than-finance lease is characterized by straight-line recognition consistent with today's US GAAP/IFRS operating lease accounting.

9. Topic III – The staff recommends the following indicators to make a determination between the two proposed types of leases. Additional detail is provided in paragraph 65 on each of these indicators.

   a) Residual asset

   b) Potential ownership transfer

   c) Length of lease term

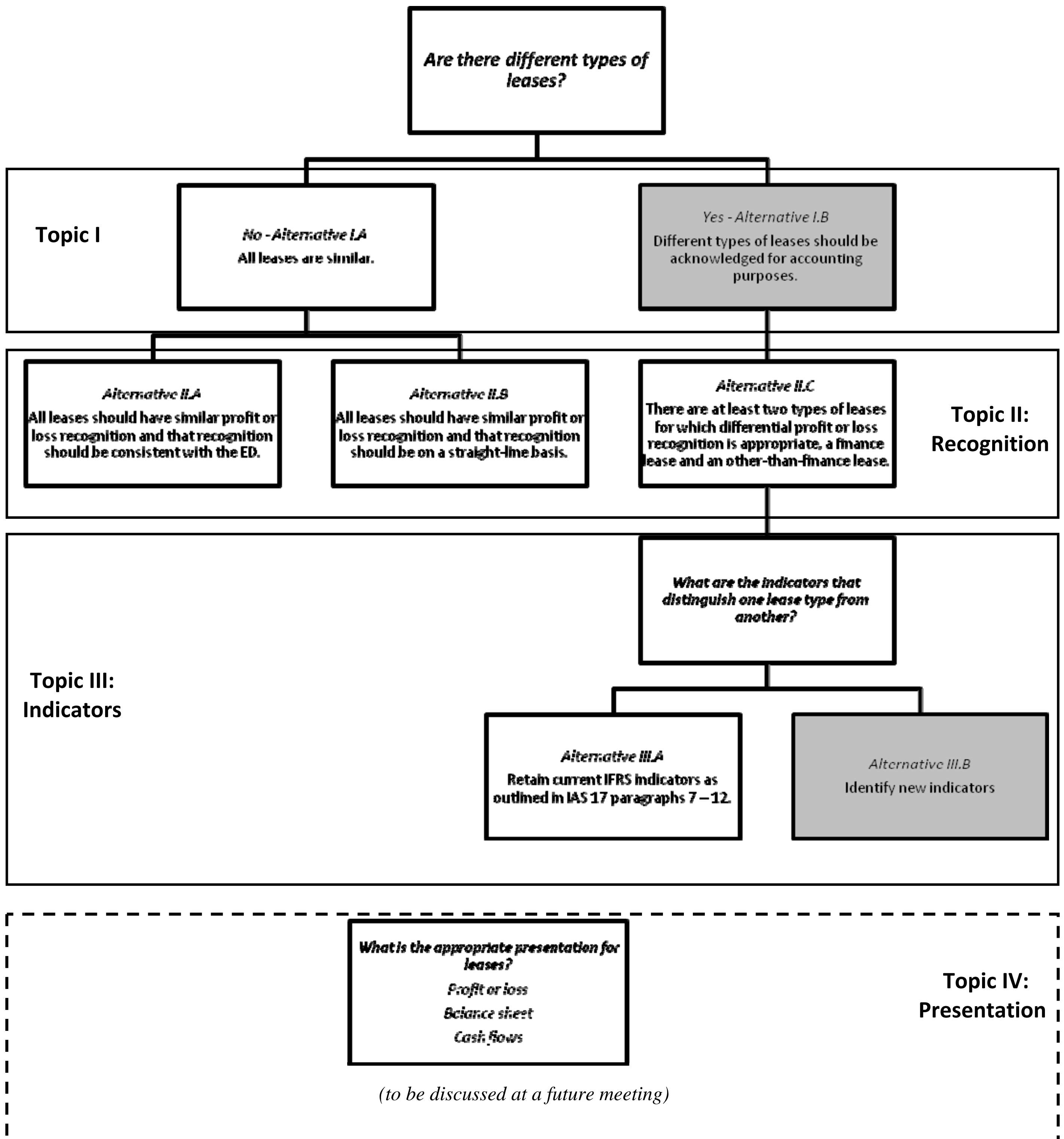
   d) Rent characteristics

   e) Underlying asset

   f) Embedded or integral services

   g) Variable rent

Structure of the Paper and Staff Recommendations



Structure of the Paper

10. The structure of the paper is as follows:

    a) Summary of ED proposals (paragraphs 11 – 14)

    b) Summary of feedback (paragraphs 15 – 24)

    c) Alternatives and staff analysis

        (1) Topic I – Are there different types of leases? (paragraphs 25 – 38)

        (2) Topic II - If there are different types of leases, should all leases have the same profit or loss recognition pattern or should there be differences in profit or loss recognition? (paragraphs 39 – 56)

        (3) Topic III – If there are different types of leases, what are the indicators that distinguish one type from another? (paragraphs 57 – 69, Appendices A, B and D)

        (4) Topic IV – Other matters to consider (paragraphs 70 – 73)

    d) Private company considerations (paragraph 24 and 74)

    e) Appendix A – Topic 840 – Lease classification criteria

    f) Appendix B – Excerpts from ED – When to apply the performance obligation or derecognition approach

    g) Appendix C – Illustrative examples

    h) Appendix D – A comparison of potential indicators

Summary of ED Proposals

11. The ED proposes a new accounting model for leases in which:

    a) A lessee would recognize an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments. The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

b) A lessor would apply either the performance obligation approach, or a derecognition approach, to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during, or after, the expected term of the lease.

12. The ED proposes that a lessee shall recognize, among other items, the following items in the income statement (statement of comprehensive income), except to the extent that another Topic (IFRS) requires or permits its inclusion in the cost of an asset:

    a) Interest expense on the liability to make lease payments.

    b) Amortization of the right-of-use asset.

13. The ED proposes that a lessor shall recognize, among other items, interest income on the right to receive lease payments in the income statement (statement of comprehensive income), using the (effective) interest method.

14. The ED proposals will change both the recognition and presentation of amounts in profit or loss for those lease transactions currently classified as operating leases.

Summary of Feedback

General feedback

15. The Invitation to Comment includes specific questions regarding profit or loss recognition as follows:

    Question 1(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

    Question 2(b) Do you agree with the Boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

16. The staff presented agenda paper 5A/FASB memo 123 at the January 2011 joint meeting which summarized feedback received on the ED. Specifically, paragraph 62 of that memo states that many respondents expressed some level of concern with the proposals relating to whether:

a) One lessee accounting model can be applied to all lease contracts;

b) All leases should be considered as being similar to financing the acquisition of an asset, rather than being operational in nature;

c) The Boards have clearly articulated why a lease contract should be accounted for in a manner that is different to the accounting for executory contracts (e.g. employment and utility contracts);

d) The Boards' objectives could be better achieved through either revising the bright lines that exist in present lease accounting standards or through enhancing disclosures.

17. Paragraph 67 of that memo goes on to state that respondents had mixed views on the Boards' rationale that the profit or loss recognition pattern for the combination of (i) amortization of the right-of-use asset and (ii) interest expense from the liability to make lease payments for lessees, should be consistent with the pattern that would arise from financing an acquisition of an asset, with:

a) Some respondents, specifically those from accounting firms and standard-setters supporting the proposals in the ED; and

b) Others, specifically the leasing industry, some users and preparers supporting applying annuity-based or a mortgage-based, amortization of the right-of-use asset. Under this approach, the combination of amortization and interest expense would be recognized on a straight-line basis, resulting in a profit or loss pattern for lease expense, similar to current operating lease accounting.

18. A representative preparer comment letter (#501) presents the following argument:

> T believes it is important to distinguish between *financing* and *other than financing* arrangements for both lessees and lessors. As mentioned within the ED, leasing is an important source of financing to businesses. The Boards have also acknowledged that not all arrangements within the scope of the current guidance are entered into for the purpose of financing from a lessor perspective, but are silent from a lessee perspective. For lessors, the Boards have proposed differing accounting approaches (performance obligation or derecognition approaches) based on retention of significant risks and rewards. Similarly, T believes that *differing accounting approaches for other than financing arrangements should equally apply for lessees.*
>
> T is strongly concerned that the *standard as proposed does not reflect the economic reality of other than financing arrangements with respect to timing of revenue and expense recognition.* …This does not reflect how the annual revenue is earned by the lessor or how the annual expense is incurred by the

> lessee. …Therefore, the front loaded revenue profile for lessors or expense profile for lessees under mortgage based amortization accounting is misleading and not representative of the economic reality of the other than financing arrangements with respect to timing of revenue and expense recognition.
>
> *The Boards appear to have sacrificed appropriate timing of revenue and expense recognition for other than financing arrangements in order to bring lease obligations on the balance sheet.* (Emphasis added)

19. Feedback on the lessor accounting model indicated that many think that the lessor model is not currently broken and the different profit or loss patterns created by operating leases and financing leases in accordance with current US GAAP/IFRS meet the needs of users and appropriately present the economics of a lessor's business.

20. Finally, paragraph 68 of that memo states that respondents that disagreed with the profit and loss pattern proposed in the ED noted that the proposals create:

    a) Higher lease expenses in earlier periods than later periods for all current operating leases;

    b) Significant deferred tax assets for lessees;

    c) Inconsistency with the accounting for purchasing the underlying asset with financing, because a purchase is unlikely to be 100% debt financed; and

    d) Further divergence from the cash payments made for the lease contract (e.g. the expense recognized by a lessee in the final year of a lease is significantly different to the expense recognized by the same lessee in the first year of a replacement lease).

User feedback

21. A majority of users that submitted comment letters disagreed with the Boards' tentative decisions for lessee profit or loss recognition. A representative user comment letter (#593) states the following:

> Since the *right-of-use asset and the lease obligation are linked* (i.e., the asset would not exist without the liability and vice versa), we are concerned that the proposed model would *cause confusion for investors because this linkage is not apparent in the income statement in the way the right-of-use asset and obligation to pay rent are measured subsequent to lease inception.* Accordingly, we propose that the right-of-use asset be amortized on the same basis as the lease payment liability. *Tying the amortization of the right-of-use asset to the periodic reduction of the lease liability would provide for greater operational simplicity as well as better transparency for users* of financial statements, as the sum of the amortization of the asset and the interest expense on the liability would result in a *better proxy for cash rental payments* than the

> proposed accounting. …Therefore, we ask the Boards to reconsider this alternative in its redeliberations. (Emphasis added)

22. Additionally, in the roundtables and other outreach activities, users discussed the adjustments made for operating leases in current financial statements. Typically, users adjust the statement of financial position for lessees but indicated that fewer adjustments are made to lessees' profit or loss. When users do make adjustments to profit or loss of lessees with operating leases, these adjustments are to break out the actual recorded operating lease expense (e.g. into two components such as 1/3 interest and 2/3 depreciation), rather than adjusting the total amount of operating lease expense recognized in a certain period. Additionally, users did not generally indicate that significant adjustments are currently made to lessor financial statements.

23. However, there was some user support for the Boards' proposals in the ED which is aligned with today's capital/finance lease profit or loss accounting, for example, comment letter (#748) states the following:

> We agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments. This is consistent with our long-held view that payments under operating leases should be recharacterized from rent expense to an amortization (depreciation) component and an interest expense component. We believe amortization treatment for the decrease in the value of the right-of-use asset is more appropriate than treatment as rent expense, given the concept that a right-of-use asset is created under the model. Amortization treatment would be consistent with how the carrying value of fixed and intangible assets is reduced in the financial statements over time.

Private company feedback

24. Many private companies providing feedback expressed similar disagreement with the Boards' tentative decisions for profit or loss recognition. A representative private company comment letter (#221) states the following:

> The proposed standard results in an acceleration of expenses in the initial periods of a lease. *The recognition of higher expenses related to leasing in the early periods distorts the economics of the lease.* The proposed standard also results in right of use assets valued at less than their payment liabilities for the early periods of the lease. If the Boards determine that a capitalization and amortization model must apply to all leases, the amortization should be structured to balance the recognition of expense over the term, and to ensure that lease assets and liabilities are in balance in the absence of impairment.
>
> In addition to higher volatility, the proposed standard decreases the visibility of leasing expenses relative to the current operating lease model. The current

> operating lease expense reflects the "pay as you go" economics for many operational assets. *The proposed standard separates expenses into an amortization component and an interest component, occupying separate areas of the income statement. Users of financial statements will likely need to make proforma adjustments to bring lease expenses into operating cash flow and EBITA.* (Emphasis added)

Alternatives and Staff Analysis

TOPIC I – Are there different types of leases?

25. Topic I examines whether under the Boards' right-of-use model there is more than one type of lease for lessees/lessors for which different recognition and presentation in profit or loss may be appropriate.

Alternative A – No, all leases are similar.

26. Alternative A is similar to the ED proposals for lessees, specifically all lease contracts include an element of financing and therefore all resulting profit or loss should recognize the financing element (interest expense) and amortization of the right-of-use asset (usually on a straight-line basis).

27. Similarly, in both of the ED proposed lessor approaches (performance obligation and derecognition) there is recognition of a finance element represented by the requirement to record interest income over the lease term by the lessor.

28. Those that support Alternative A think that **all** leases are a source of financing as the lessee makes payments over the lease term to the lessor and a lease transaction is always similar to a lessee financing the acquisition of an asset from the lessor. Therefore, there is an element of time value in **all** lease arrangements in the payments made/received.

29. Many respondents, including supporters of Alternative A, supported the Boards' decision to require recognition of a liability to make lease payments (lessee) or lease receivable (lessor) measured as the present value of the future lease payments for **all** lease arrangements. Supporters of Alternative A think the **only** conceptually supportable method of profit or loss recognition is accretion of the liability/receivable which gives rise to interest expense/income.

30. Additionally, supporters of Alternative A note the following in support of the statement that all leases are similar:

    a) Additional complexity is added if there are two separate models to apply which is a common criticism of current guidance.

    b) Additional structuring opportunities are provided if there are discrete models for different types of leases.

Alternative B – Yes, different types of leases should be acknowledged for accounting purposes.

31. Under Alternative B, it would be acknowledged that there are different types of leases. In principle, there are certain leases for which the financing element is significant because the transaction is similar to the lessee financing the acquisition of an asset. However, there is another type of lease for which the financing element is not significant because the lessee enters in to a rental transaction to use the asset, rather than a transaction that is similar to financing the acquisition of the asset.

32. Supporters of Alternative B agree with the Boards that there are some leases for which the economics and business purpose align with the Boards proposals, and an entity is financing an otherwise purchase/sale transaction. In such cases, supporters of Alternative B agree with the Boards' proposals in the ED. However, supporters of Alternative B view another subset of lease arrangements as significantly different from this "finance" notion required for all lessees and lessors in the ED.

33. Supporters of Alternative B argue there are key differences in lease arrangements and not all leases are entered into for the purpose of financing. In some cases the purpose of a lease is to create flexibility, mitigate the risk of ownership (for example, technological obsolescence), and/or outsource significant activities principally related to maintenance and administration of an asset. These key differences are compelling to supporters of Alternative B. Supporters acknowledge there is a financing element present in lease arrangements; however, supporters of Alternative B think the predominance of the finance element varies, which indicates that there are different types of leases.

34. Additionally, leases have varying levels of ancillary services combined in the arrangement. Supporters of Alternative B argue that increased levels of service incorporated into the

lease contract may differentiate that lease from another type of lease.[1] Also, certain supporters of Alternative B cite specific circumstances where purchase of the underlying asset is not a viable option (for example, retail space in an airport, cell phone towers, satellites, etc.) as a result such leases are not the same as an installment purchase/sale.

35. The Boards' stated purpose "that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities" is not compromised by identifying two types of leases. In fact, supporters of Alternative B argue that to not recognize differences in lease arrangements would be inappropriate.

36. Finally, supporters of Alternative B also cite the Boards' tentative decision in the ED for lessors that acknowledges that there are two different types of leases. Alternative B supporters agree with the differentiation in the lessor model and think the lessee model should similarly acknowledge differences in leases.

37. This Approach, should the Boards support Alternative B, is further explored in Topics II and III in this paper.

Staff Recommendation

38. The staff agrees with many respondents that there are compelling business reasons, in addition to financing considerations, that entities use lease arrangements. As a result, the staff recommends that the Boards pursue a model that identifies two types of leases: (1) finance leases and (2) other-than-finance leases. Additionally, the staff recommends that these two types of leases have different profit or loss recognition (discussed in Topic II) and presentation (to be discussed in a future meeting).

Question for the Boards

Question 1 – Are there different types of leases?
The staff recommends (Alternative B) that the Boards acknowledge there are differences in leases and recommend that additional targeted outreach is performed to support this recommendation. Do the Boards agree with the staff recommendation? Why or why not?

[1] The staff plans to present a more detailed analysis of this matter (i.e. bundled arrangement that contain both leases and services) in a future meeting.

Topic II – If there are different types of leases, should all leases have the same profit or loss recognition pattern?

39. Topic II explores whether all leases should have the same profit or loss recognition pattern.

    If the Boards conclude under Topic I that there is only one type of lease, then profit or loss recognition of that lease must be determined. The staff has outlined two alternatives for recognition: (A) profit or loss recognition consistent with the ED or (B) straight-line profit or loss recognition.

    If, however, the Boards agree with the staff recommendation and conclude under Topic II that there is more than one type of lease, then the Boards must determine how to differentiate one type of lease from another (explored in Topic III) and determine the profit or loss recognition for each type of lease identified. The staff has developed a proposal for profit or loss recognition for the two types of leases in Alternative C below.

Alternative A – Yes, all leases should have the same profit or loss recognition and that recognition should be consistent with the ED, including the recognition of interest expense/income.

40. Alternative A would require all lease contracts to have the same profit or loss recognition; therefore, supporters of Alternative A agree with Topic I – Alternative A. In Alternative A the recognition pattern should be consistent for all lessees and lessors and should align with the lessee proposals in the ED (e.g. lessee right-of-use model which is outlined above and includes recognition of interest and results in a profit or loss pattern that is higher in the earlier years of a lease for **all** leases).

41. Most, if not all, agree that leases are a source of financing and there is an element of time value in the payments made/received in a lease contract. Therefore, supporters of Alternative A think the resulting profit or loss should acknowledge the financing element which results in interest expense (lessee) or interest income (lessor) being recognized. As described in the ED, supporters of Alternative A argue the inclusion of interest is conceptually correct and to exclude the time value of money from the accounting would be erroneous.

42. Supporters of Alternative A also think that a lessee should amortize the right-of-use asset on a systematic basis, noting that this systematic basis would usually be on a straight-line,

rather than annuity, basis. They note that this is consistent with how amortization of other intangible and tangible assets is recognized, including those where the asset is purchased using financing, and do not think that the amortization pattern for a right-of-use asset should be different.

43. The proposals in the ED are simple with respect to this element – that is, if an arrangement is a lease it requires consistent profit or loss accounting. If there is more than one profit or loss recognition pattern a new level of complexity is introduced which will require additional analysis and could therefore increase the cost to comply. Additionally, the single model reduces the opportunity to structure transactions to achieve a desired accounting result. Finally, one of the key elements in issuing the ED was the removal of the arbitrary distinction between operating and capital/finance leases. Any alternative that adds a distinction between types of leases would add another arbitrary distinction.

44. Additionally, supporters of Alternative A suggest that if the scope of leases is defined correctly and services can be appropriately separated from the lease elements of a contract, then the accounting proposed in the ED is correct and the arrangement should include interest expense/income and, for the lessee, amortization of the right-of-use asset on a basis that is consistent with the accounting for other assets acquired through financing.

Alternative B – Yes, all leases should have similar profit or loss recognition and that recognition should be on a straight-line basis similar to today's operating leases.

45. Under Alternative B, all leases would present similar profit or loss recognition and that recognition would be on a straight-line basis similar to today's operating leases.

46. Supporters of Alternative B agree that there should only be one type of profit or loss recognition for lease arrangements; therefore, Alternative B supporters also agree with Topic I – Alternative A. However, in contrast to Alternative A, supporters of Alternative B think that the benefits of a lease transaction are passed from the lessor to the lessee, and consumed by the lessee, in a consistent manner over the lease term. As a result, the profit or loss pattern should account for this delivery of benefits over time by recording straight-line expense/income.

47. Constituents supporting this approach argue that:

    (a) The accounting model proposed is based on the accounting for a lease contract, rather than accounting for the separate components within a lease contract. The

accounting for lease assets and lease liabilities is linked at inception of the contract and should be maintained throughout. Supporters point out that these two elements are linked as they arise from the same contract and are inter-dependent. This is the 'linked approach' discussed in BC8–BC11 of the ED. A respondent in CL#14 notes the following:

> *But I think that a lease contract is unique in that the asset and liability are linked.* … The ROU asset should be amortized at the same rate as the capitalized lease liability, except for impairment and initial direct costs. *This would recognize the accounting for the lease contract and not its components. Using straight line amortization of the ROU asset makes the lease contract appear to be "under water" immediately*, since the book value of the asset amortizes more quickly that the liability. *The Boards have decided that the unit of account is the contract, not its components. The asset and liability in a lease contract are inextricably linked.* The Boards' view at lease inception is that the best proxy for fair value of the asset and liability is the same (the PV of the lease payments). That relationship should hold true in subsequent accounting periods, absent impairment and initial direct costs, and would give the user of financials better information regarding the value of the lease contract on the balance sheet and costs in the P&L statement. (Emphasis added)

(b) As proposed in the ED, interest expense/income should be recognized on an effective rate of interest basis. However, amortization of the right-of-use asset by a lessee should also reflect the time value of money to reflect the discounting of the value of the right acquired by the lessee. A respondent in CL#122 states:

> When one acquires a property, plant or equipment (either through obtaining title to that asset or through a lease that is in substance a purchase), one obtains the right to use that asset for its entire life. When one pays upfront for that asset (eg when one pays for the asset on acquiring title to the asset) one is paying in advance for the future right of use and the price paid for that asset represents the present value of those future rights – i.e. it is the value of those rights discounted to reflect the time value of money. As with any payment in advance, the accounting ought to reflect the reversal of that discount.
>
> In the case of leasing, instead of paying upfront for the right-of-use, one generally pays for that right-of-use at the same time as one consumes that right (as noted in paragraph BC9). Consequently, current operating lease accounting is not subject to the same flaw regarding not recognising the time value of money – at least as regards the income statement.

(c) Recognition on a straight-line basis, rather than in accordance with a financing recognition pattern may better reflect a lessors' performance obligation relating to certain lease contracts (e.g. when significant service components are included within the contract).

48. Supporters of Alternative B also argue that, similar to Alternative A, because all leases are accounted for uniformly this method is simple to apply and would reduce structuring opportunities compared to current accounting.

49. Those that argue against Alternative B state that this approach of straight-line recognition is conceptually inaccurate and inconsistent with other areas of US GAAP/IFRS. Also, straight-line recognition may also dismiss the financing element that is present in all leases.

Alternative C – No, the profit or loss pattern should not be consistent for all leases. There are at least two types of leases for which different profit or loss recognition is appropriate, a finance lease and an other-than-finance lease.

50. Alternative C aligns with the conclusion in Topic I that there **are** different types of leases (Alternative B). Supporters of Alternative C cite the arguments in paragraphs 33 and 34, specifically the purpose of a lease is to create flexibility, mitigate the risk of ownership, outsource significant activities or the underlying asset is not available for purchased (retail location in an airport). As such, supporters of Alternative C reaffirm the conclusion in Topic I that there are different types of leases.

51. Supporters of Alternative C think there is merit in some of the arguments of both Alternative A and Alternative B. As such, Alternative C acknowledges that it is necessary to differentiate between types of lease agreements in order to appropriately recognize different profit or loss patterns, specifically there is a:

    a) A ***finance lease*** that is similar to an installment purchase/sale in which the financing element is significant and should be reflected in the pattern of profit or loss recognition of both lessees and lessors. A finance lease is characterized by a profit or loss pattern consistent with the proposals in the ED and includes interest expense (lessee) or interest income (lessor) (using the effective interest method) and would usually reflect the lessee consuming the right-of-use asset on a straight-line basis; and

    b) An ***other-than-finance lease*** is a lease arrangement in which the financing element is not considered significant. An other-than-finance lease is characterized by straight-line expense/income consistent with today's US GAAP/IFRS operating lease accounting.

52. Supporters of Alternative C hold the same view as described above in Topic I – Alternative B and think there should be a distinction between lease types in order to appropriately recognize different profit or loss recognition patterns. Additionally, supporters of

Alternative C agree with the support outlined above for Alternative A and Alternative B but view certain lease arrangements to be aligned with Alternative A (finance leases) and others aligned with Alternative B (other-than-finance leases).

53. The staff collected feedback from a number of users who consistently requested that the profit and loss recognition pattern for leases be consistent with the cash payments made under lease arrangements. As a result, some users prefer for some leases the current straight-line profit or loss recognition pattern (more closely aligned with cash lease payments) to the approach proposed in the ED. Additionally, as stated above in paragraph 22, users may adjust the categorization of the recorded expense, but typically do not change the amounts recorded. As a result, most users for today's operating leases do not adjust the straight-line lease profit or loss recognition pattern presented in accordance with current US GAAP and IFRS. Other users make adjustments only to reflect operating leases on the balance sheet but do not make any corresponding profit or loss adjustments.

54. Those who argue against Alternative C cite the Boards' rationale in the Exposure Draft and Discussion Paper. Specifically, the Boards tentatively decided to reject this Alternative C for the following reasons:

   a) Alternative C requires the lessee to differentiate between two types of leases, which creates complexity as decisions and judgments are required to assess lease arrangements between two models. Additionally, when there is more than one model the opportunity to structure between the two models increases. Proponents cite specific concerns with "drawing a line" between types of leases and think that any line will be arbitrary.

   b) Although the right-of-use asset and the liability to make lease payments are clearly linked at inception of the lease, this is not necessarily the case after inception (for example, impairment, revaluation and prepaid/deferred rent).

   c) There is no conceptual rationale to make a distinction in profit or loss patterns between leases.

Staff recommendation

55. The staff thinks that there should be different profit or loss recognition for finance leases as compared to other-than-finance leases. Specifically, a finance lease should align with the proposals in the ED and include interest expense/income (using the effective interest

method), and would usually reflect the lessee consuming the right-of-use asset on a straight-line basis. An other-than-finance lease would be characterized by straight-line expense/income consistent with today's US GAAP/IFRS operating lease accounting.

56. Similar to the support above for Alternative C, the staff finds the different reasons entities engage in lease transactions as described above in paragraphs 33 and 34 compelling and different enough from other types of leases that are principally financing the acquisition of an asset. Additionally, the staff weighs heavily the views from a majority of users that think the current operating lease profit or loss pattern is sufficient and more consistent with cash payments.

Question for the Boards

Question 2 – Should all leases have the same profit or loss recognition pattern or should there be differences?
The staff recommends (Alternative C) that, if the Boards acknowledge different types of leases, then, not all leases should have the same profit or loss recognition pattern. The staff recommends establishing: (a) a finance lease that is characterized by a profit and loss pattern consistent with the ED proposals; and (b) an other-than-finance lease that is characterized by a straight-line profit or loss pattern generally consistent with today's operating leases. Do the Boards agree with the staff recommendation? Why or why not?

Topic III – If there are different types of leases, what are the indicators that distinguish one type from another?

57. Topic III explores the guidance that would be used to differentiate one type of lease from another in the Boards' proposed right-of-use model. This Topic would be relevant if the Boards agreed with the staff recommendation in Topic I and II that there are different types of leases. To reiterate, the staff thinks an other-than-finance lease exists principally as a result of the arguments in paragraphs 33 and 34, specifically to create flexibility, mitigate the risk of ownership, outsource significant activities or the underlying asset is not available for purchased (retail location in an airport).

58. A potential alternative would be the Topic 840 (FAS 13) criteria; however, the staff quickly rejected these criteria due to the frequent criticism of the bright-line tests

(principally the 90% and 75% tests) as the reason to improve lease accounting. The Topic 840 (FAS 13) criteria are presented in Appendix A to this paper as reference material as the staff continues to think the concepts in Topic 840 are relevant to the discussion.

59. Additionally, the staff reviewed the ED indicators used to determine whether a lessor accounts for a lease in accordance with the performance obligation approach or the derecognition approach. These indicators are included in Appendix B.

Alternative A – Retain current IFRS indicators as outlined in IAS 17 paragraphs 7 – 12.

60. Under Alternative A, the indicators for determining which type of lease, and which recognition method is appropriate would be similar to the current guidance in IAS 17 that states:

> **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.

61. Supporters of Alternative A cite the following advantages of using current IAS 17 indicators:

    a) The IAS 17 indicators are known in practice and therefore familiar to most (predominantly IRFS) constituents (users, preparers and auditors).

    b) As the IAS 17 indicators are currently utilized, supporters think most practice issues have already been identified and practice has evolved to ensure consistency in application.

    c) Supporters also think it would promote a smoother transition between the current accounting and the proposed lease model. Finally, supporters cite a cost/benefit analysis for those currently applying IFRS to a lease portfolio as these entities had previously used the IFRS indicators to distinguish between operating and finance leases. Therefore, supporters identify some synergies between the prior analysis and the new required analysis.

62. Those against using the IAS 17 indicators cite three predominant reasons:

a) The IAS 17 indicators were used for an entirely different purpose, namely, to differentiate between two significantly different accounting models (on-balance sheet finance leases and off-balance sheet operating leases). Therefore, the IAS 17 indicators are not appropriate to establish different profit or loss recognition patterns 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.

c) These indicators may not appropriately capture all of the Boards' reasoning for determining that two types of leases exist.

Alternative B – Identify new indicators

63. Supporters of identifying new indicators note that the indicators in IAS 17 and Topic 840 (FAS 13) were created for, and are used for, a different purpose. In addition, supporters of Alternative B think the "baggage" of the past indicators will be carried forward unless substantive changes are made to the words used to describe the difference between finance and other-than-finance leases. The staff thinks that the substance of the transaction should always prevail regardless of any indicators outlined in the accounting guidance. All indicators should be reviewed with reference to each lease arrangement and no single indicator should be conclusive.

64. The staff reviewed the IAS 17 indicators (see Alternative A), the Topic 840 indicators (see Appendix A) and the ED lessor indicators (see Appendix B) as well as feedback from constituents regarding the different business reasons for engaging in leasing activities and have developed a new listing of indicators. Appendix D is a bridge and comparison between three sets of indicators (Proposed staff indicators, IAS 17 indicators and Topic 840 indicators). The staff has also noted below if a Proposed staff indicator was included in IAS 17 or Topic 840.

65. The staff thinks the following indicators may identify a finance lease:

a) *Residual asset* – When the benefits of a significant change in the value of the residual asset are provided to the entity, including the effect that any residual value guarantee

(including those provided by an unrelated third party) may have on the entity's exposure. [IAS17]

b) *Potential ownership transfer* – When the lease transfers ownership of the asset by the end of the lease term or there is a bargain purchase option. [IAS 17 & Topic 840][2]

c) *Length of lease term* – The duration of the lease is significant in relation to the remaining useful life of the underlying asset. [IAS 17 & Topic 840]

d) *Rent characteristics* – The rent payments charged by the lessor are fixed amounts sufficient to return the lessor's investment in the asset under the lease plus a fair return, and not benchmarked to, or priced by, the lessor in reference to competitive, market based rates.

e) *Underlying asset* –

(1) The underlying asset is specialized and/or customized. [IAS 17]

(2) The underlying asset is available to be purchased/sold.

f) *Embedded or integral services* – The arrangement does not contain significant integral and/or embedded services that are not separable from the lease component of a contract.

g) *Variable rent* – The lack of significant variable rent during the lease term that is based on the use or performance of the underlying asset.

66. The ED proposals for lessor accounting included principles of many of the above indicators. Specifically, the *length of lease term* (c) indicator above includes the wording from the ED (see Appendix B) and the principles in indicators (f) *embedded or integral services*, (g) *variable rent* and (a) *residual asset* are all present in the ED proposals.

67. Indicators (e)(2) *underlying asset* and (d) *rent characteristics* are drawn from the arguments above for why there are different types of leases and different profit or loss patterns. For underlying asset, the staff thinks that certain assets, such as a retail location in an airport or a certain cell phone tower, are unavailable for the lessee to purchase and in

[2] The staff acknowledge paragraph 8 of the ED that excludes from scope contracts that represent a purchase or sale of the underlying asset. Additional guidance is outlined in paragraphs B9 (title transfer) and B10 (bargain purchase option). The staff plans to discuss this topic more thoroughly in a future meeting; however, the staff think the indicator identified above may be relevant to the discussion despite this tentative conclusion to exclude such leases from the scope of the guidance.

these situations it may indicate the lessee is entering into the arrangement for a reason other than financing.

68. One indicator in both IAS 17 and Topic 840 that was not carried forward by the Boards in the ED or recommended to be included in the above list is the "90% test" (IAS 17 paragraph 10(d) and ASC 840-10-25-1(d), formerly FAS 13 paragraph 7(d)) which compares the minimum lease payments in the lease to the fair value of the underlying asset.

Staff recommendation

69. The staff thinks that the current indicators in IAS 17 and Topic 840 are insufficient for identifying characteristics of finance and other-than-finance leases and a new listing of indicators drawing from the outreach feedback and the concepts in the ED, IAS 17 and Topic 840 should be established. The staff thinks the arguments outlined above against retaining IAS 17 are compelling. Also, the staff note and agree with the Boards tentative decision to reject both IAS 17 and Topic 840 indicators in the development of the ED lessor model. The staff thinks it is more important to align the indicators with the currently proposed model rather than retaining old guidance.

Question for the Boards

Question 3 – What are the indicators that distinguish one type of lease from another?
The staffs recommends (Alternative B) that, if the Boards acknowledge different types of leases and recognize differences in profit or loss recognition patterns, as recommended by the staff, then the indicators outlined in paragraph 65 should be used as a framework to distinguish one lease type from another. Do the Boards agree with the staff recommendation? Why or why not?

Topic IV – Other matters to consider

70. The staff has identified the following additional topics that are critical in the development of the Approach. The staff plans to bring these items to the Boards in a future meeting.

71. ***Profit or loss presentation*** – The staff plan to discuss if (i) there is more than one type of lease (finance or other-than-finance) and (ii) more than one recognition pattern (effective interest based ED method or straight-line), then do all leases continue to present a line item entitled interest expense/income or should rent expense or lease income be presented.

72. ***Balance sheet recognition and presentation*** – The staff tentatively recommend that **all** lessees comply with the proposals in the ED and record and present a right-of-use asset and liability to make lease payments in the balance sheet. Feedback on the lessor model will be considered and certain provisional recommendations on recognition and presentation will be developed.

73. ***Cash flow statement presentation*** – The staff will evaluate feedback on the proposals and statement of cash flow presentation specifically concerns regarding classifying all cash outflows of lessees as financing activities.

Private Company Considerations

74. The staff does not think there are significant differences with respect to this topic between public entities and private entities. See representative comment letter included in paragraph 24.

Appendix A – Topic 840 Lease Classification Criteria

TOPIC 840 - Leases

Topic 840-10
Lease Classification Criteria
25-1 A lessee and a lessor shall consider whether a lease meets any of the following four criteria as part of classifying the lease at its inception under the guidance in the Lessees Subsection of this Section (for the lessee) and the Lessors Subsection of this Section (for the lessor):

- a. Transfer of ownership. The lease transfers ownership of the property to the lessee by the end of the lease term. This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title.
- b. Bargain purchase option. The lease contains a bargain purchase option.
- c. Lease term. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.
- d. Minimum lease payments. The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at lease inception over any related investment tax credit retained by the lessor and expected to be realized by the lessor. If the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

25-42 A lessor shall consider all four lease classification criteria in paragraph 840-10-25-1 and both of the following incremental criteria:

- a. Collectibility of the minimum lease payments is reasonably predictable. A lessor shall not be precluded from classifying a lease as a sales-type lease, a direct financing lease, or a leveraged lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables.

- b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs such as insurance, maintenance, and taxes to be paid by the lessor (see paragraph 840-30-30-6[a]) shall not by itself constitute an important uncertainty as referred to herein. If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at lease inception, the classification criterion in this paragraph shall be applied by the lessor at the date that construction of the property is completed or the property is acquired by the lessor.

Appendix B – Exposure Draft: Leases

When to apply the performance obligation or derecognition approach

28. At the date of inception of the lease, a lessor shall assess whether a lease is accounted for in accordance with the performance obligation approach or the derecognition approach on the basis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset either:

(a) during the expected term of the lease; or

(b) after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or selling the underlying asset.

(see paragraphs B22-B27)

29. If a lessor retains exposure to significant risks or benefits associated with an underlying asset, the lessor shall apply the performance obligation approach to the lease. If a lessor does not retain exposure to significant risks or benefits associated with an underlying asset, the lessor shall apply the derecognition approach to the lease. A lessor shall not change the lessor accounting approach after the date of inception of the lease.

Lessor: when to apply the performance obligation or derecognition approach (paragraphs 28 and 29)

B22. A lessor shall consider the following factors in assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the current lease:

(a) significant contingent rentals during the lease term that are based on the use or performance of the underlying asset.

(b) options to extend or terminate the lease.

(c) material non-distinct services provided under the current lease.

B23. [**IASB only**] The existence of material non-distinct services may expose the lessor to a significant risk that the lessee will terminate the lease early because of the non-provision of those services. When the risk that the lessee will terminate the lease early is significant, the lessor is likely to be exposed to significant risks or benefits associated with the underlying asset during the term of the lease.

B24. A lessor shall consider the following factors when determining whether it retains exposure to significant risks or benefits associated with the underlying asset after the expected term of the current lease:

(a) whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset.

(b) whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making that assessment, the lessor shall consider:

(i) the present value of the underlying asset at the end of the lease term, and

(ii) the effect that any residual value guarantees (including those provided by an unrelated third party) may have on the lessor's exposure to risks or benefits.

B25. In general, a residual value guarantee will reduce a lessor's exposure to downside risk but may give the lessor the potential to benefit from

Appendix C – Illustrative examples

1. The following schedule outlines the differing profit or loss recognition and presentation alternatives for a lessee in addition to current accounting under US GAAP/IFRS for operating and capital/finance leases.

2. The key terms include the following:

    a) Lease term is 10 years; rental payments are CU 1,000 (where CU = currency units) and the rate charged in the lease is 5.7%.

    b) Underlying asset value is CU 11,500 at inception of the lease and residual value is expected to be CU 7,000 at the end of the lease.

    c) For simplicity purposes, assume only for classification, recognition and presentation of the capital/finance lease under US GAAP/IFRS, that there is a bargain purchase option included in the lease contract.

ABC Company									
CU (currency units)	Statement of Income								
	For the year ended 20X1 (YEAR 1)								
	LESSEE								
	Current US GAAP/IFRS				(c)				(d)
					Finance Lease	Other-than-finance Lease			
	Operating		Capital/ Finance		Alternative A (ED)	S/L w/ int & amort			S/L w/ rent expense
Net Sales	55,000		55,000		55,000	55,000			55,000
Cost of Sales	30,500		30,500		30,500	30,500			30,500
Selling, General & Adminstrative	12,040	**(a)**	11,040	**(b)**	11,040	11,040	**(e)**		12,040
Depreciation & amortization	5,400		6,147	**(b)**	6,147	5,975	**(e)**		5,400
Operating Income	7,060		7,313		7,313	7,485			7,060
	12.8%		*13.3%*		*13.3%*	*13.6%*			*12.8%*
Interest expense	1,500		1,925	**(b)**	1,925	1,925	**(e)**		1,500
Interest income	(800)		(800)		(800)	(800)			(800)
Other income, net	(350)		(350)		(350)	(350)			(350)
Income before taxes	6,710		6,538		6,538	6,710			6,710
	12.2%		*11.9%*		*11.9%*	*12.2%*			*12.2%*
Income taxes	2,342		2,282		2,282	2,342			2,342
Net Income	4,368		4,256		4,256	4,368			4,368
	7.9%		*7.7%*		*7.7%*	*7.9%*			*7.9%*
EBIT	7,410		7,663		7,663	7,835			7,410
EBITDA	12,810		13,810		13,810	13,810			12,810

(a) Includes CU 1,000 rent expense

(b) SG&A does not include rent expense, includes CU 747 of depreciation expense and includes interest expense of CU 425

(c) The exposure draft is consistent with Capital/Finance lease in current accounting.

(d) Alternative C produces the same income statement impact as current accounting for Operating leases.

(e) Alternative B (the "linked approach") includes interest expense of CU 425 and amortization of CU 575 and no rent expense.

Appendix D – A comparison of potential indicators

Staff Indicators		**IAS 17**	**ASC 840**
a)	Residual asset	**x**	
b)	Potential ownership transfer	**x**	**x**
c)	Length of lease term	**x**	**x**
d)	Rent characteristics		
e)	Underlying asset	**x**	
f)	Embedded or integral services		
g)	Variable rent		

IAS 17			
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.	**Indicator not carried forward**	
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)**
(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;		**b)**
(c)	the **lease term is for the major part of the economic life** of the asset even if title is not transferred;		**c)**
(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	**Indicator not carried forward**	
(e)	the leased assets are of such a **specialised nature** that only the lessee can use them without major modifications.		**e)**
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;	**Indicator not carried forward**	
(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		**a)**
(c)	the lessee has the **ability to continue the lease for a secondary period at a rent that is substantially lower than market rent**.		**c)**
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 Indicators		IAS 17	ASC 840
a)	Residual asset	x	
b)	Potential ownership transfer	x	x
c)	Length of lease term	x	x
d)	Rent characteristics		
e)	Underlying asset	x	
f)	Embedded or integral services		
g)	Variable rent		

Topic 840 (formerly FAS 13)			
> Lease Classification Criteria			
840-10-25-1	*A lessee and a lessor shall consider whether a lease meets any of the following four criteria as part of classifying the lease at its inception under the guidance in the Lessees Subsection of this Section (for the lessee) and the Lessors Subsection of this Section (for the lessor):*		
a.	**Transfer of ownership**. The lease transfers ownership of the property to the lessee by the end of the lease term. This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title.		**b)**
b.	**Bargain purchase option**. The lease contains a bargain purchase option.		**b)**
c.	Lease term. The **lease term is equal to 75 percent or more of the estimated economic life** of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.		**c)**
d.	Minimum lease payments. The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at lease inception over any related investment tax credit retained by the lessor and expected to be realized by the lessor. If the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.	**Indicator not carried forward**	
840-10-25-42	*A lessor shall consider all four lease classification criteria in paragraph 840-10-25-1 and both of the following incremental criteria:*	**TBD determined on further deliberations into lessor accounting**	
a.	Collectibility of the minimum lease payments is reasonably predictable. A lessor shall not be precluded from classifying a lease as a sales-type lease, a direct financing lease, or a leveraged lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables.		
b.	No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs such as insurance, maintenance, and taxes to be paid by the lessor (see paragraph 840-30-30-6[a]) shall not by itself constitute an important uncertainty as referred to herein. If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at lease inception, the classification criterion in this paragraph shall be applied by the lessor at the date that construction of the property is completed or the property is acquired by the lessor.		