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Introduction

1. The purpose of this paper is to discuss possible approaches to the lessee accounting model, taking into account feedback received on the lessee accounting proposals in the revised exposure draft on leases issued in May 2013 ("2013 ED"). The Boards and the staff obtained feedback on the lessee accounting proposals in the 2013 ED from investors and analysts ("users"), preparers, accounting practitioners, as well as others, in comment letters, at public roundtable discussions, and at private outreach meetings, including fieldwork meetings.

2. This paper does not revisit the right-of-use ("ROU") model in its entirety. All three approaches set out in this paper would require the same initial and subsequent measurement of the liability to make lease payments ("lease liability") and the same initial measurement of the ROU asset obtained by the lessee at lease commencement.

3. This paper is structured as follows:

   (a) Overview.

   (b) Background to the lessee accounting model.

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(c) Summary of feedback received on the lessee accounting model proposed in the 2013 ED.

(d) Lessee accounting approaches.

(e) Staff analysis of the proposed approaches.

(f) Other options considered but rejected.

(g) Staff views.

(h) Appendix A – Lessee lease classification guidance (2013 ED and existing IFRS/U.S. GAAP).

Overview

4. The staff are proposing three possible approaches for the Boards to consider with respect to lessee accounting:

   (a) *Approach 1* – Proposes a single approach, according to which a lessee would account for all leases as the purchase of a ROU asset on a financed basis. Accordingly, a lessee would account for all leases as Type A leases (that is, recognizing amortization of the ROU asset separately from interest on the lease liability).

   (b) *Approach 2* – Retains a dual approach, with lease classification similar to that proposed in the 2013 ED, but offers targeted simplifications and improvements to the lease classification test. A lessee would account for all leases of assets other than property as Type A leases and most property leases as Type B leases (that is, recognizing a single lease expense).

   (c) *Approach 3* – Proposes a dual approach, with the lease classification principle consistent with existing U.S. GAAP (ASC Topic 840, *Leases* – formerly Statement of Financial Accounting Standard No.13, *Accounting for Leases*) and IFRS (IAS 17 *Leases*). A lessee would account for the vast majority of existing capital (U.S. GAAP)/finance (IFRS) leases as Type A leases, and the vast majority of existing operating leases as Type B leases.

5. At a high level, the following table outlines the effect of each proposed approach as compared to existing U.S. GAAP and IFRS:

<table>
<tr><th>Existing U.S. GAAP (IFRS)</th><th>Approach 1</th><th colspan="2">Approach 2</th><th>Approach 3</th></tr>
<tr><td>Capital (Finance)</td><td>Type A</td><td colspan="2">Type A</td><td>Type A</td></tr>
<tr><td>Operating</td><td>Type A</td><td><u>Non-Property</u>

Type A</td><td><u>Property</u>

Type B</td><td>Type B</td></tr>
</table>

6. Agenda Paper 3E/FASB Memo 266, Examples—Lessee and Lessor Accounting Models illustrates the application of the possible lessee accounting approaches to particular lease scenarios.

Background to the lessee accounting model

7. In March 2009, the Boards issued a Discussion Paper entitled Leases: Preliminary Views ("2009 DP"). In the 2009 DP the Boards set out their preliminary views on lessee accounting, proposing a "right-of-use" accounting model. Feedback on the 2009 DP, including feedback from users, was generally supportive of the ROU model, in which a lessee would recognize a ROU asset and a lease liability at lease commencement. The lessee would also recognize amortization of the ROU asset separately from interest on the lease liability.

8. Nonetheless, some respondents to the 2009 DP raised some concerns about the proposed ROU model as follows:

   (a) The Boards should ensure that there is consistency between the lessee accounting model and the Conceptual Framework.

   (b) Many consider most leases to be executory contracts. These constituents expressed concern that the proposed lessee accounting model would lead to recognizing assets and liabilities for all executory contracts, including purchase orders and long-term sales and supply agreements.

(c) The existing leases guidance is well understood by both preparers and users, and the Boards should address the implementation issues relating to the existing model rather than abandon a model that is not fundamentally flawed.

(d) The ROU model is too complex and the benefits would not outweigh the costs.

9. On the basis of feedback received, the Boards published a joint Exposure Draft, Leases (“2010 ED”), in August 2010, which further developed the ROU model. Consistent with the 2009 DP, a lessee would recognize a ROU asset and a lease liability at lease commencement, and would subsequently recognize amortization of the ROU asset separately from interest on the lease liability. The typically straight-line amortization of the ROU asset, when combined with the declining interest expense on the lease liability (determined based on the effective interest method) would result in a front-loaded total lease expense recognition pattern.

10. The main feedback received included the following:

(a) There was general support for the recognition of the assets and liabilities arising from a lease by lessees.

(b) Many, including many users, supported the single model.

11. However, others disagreed with the single model, expressing the view that the single model did not reflect that different leases had differing economics. Those raising this concern generally thought that all leases (particularly leases of property) do not constitute a financing transaction, and expressed concerns about the front-loaded total lease expense effect on the income statement.

12. After considering all of the feedback received, the Boards revised the lessee accounting proposals in the 2013 ED.

13. The 2013 ED retained the core ROU model and again proposed that a lessee should recognize a ROU asset and a lease liability for all leases other than short-term leases, the recognition of which the Boards concluded is consistent with their respective Conceptual Frameworks. The ROU model continued to propose that, at

lease commencement, a lessee obtains a right to use the underlying asset for a period of time that the lessor transfers at that date.

14. The main difference from the proposals in the 2010 ED was that the 2013 ED introduced a dual approach for income statement recognition. In response to the concerns raised about the proposals in the 2010 ED, the Boards proposed a dual approach for which some leases would be accounted for in the manner proposed in the 2010 ED ("Type A leases") and, for other leases, the lessee would recognize a straight-line total lease expense ("Type B leases"). The Boards proposed a lease classification test based on the nature of the underlying asset (with specified exceptions) to determine the accounting a lessee would apply to its leases. This classification test was derived from a consumption principle that would conclude that when a lessee is expected to consume more than an insignificant portion of the underlying asset as a result of the lease, it is effectively purchasing a portion of that asset. In such a case, that purchased "portion" of the underlying asset (reflected by the ROU asset) should be accounted for no differently from the purchase of the underlying asset itself. Conversely, when the lessee is not expected to consume more than an insignificant portion of the underlying asset, the lessee is simply paying to use the underlying asset. In that case, the best reflection of the economics underlying the lease would be for the lessee to recognize a straight-line total lease expense over the lease term.

15. Specifically, the 2013 ED proposed that a lessee would:

    (a) Recognize a ROU asset and a lease liability for all leases with a maximum possible term of more than 12 months, initially measured at the present value of the lease payments.

    (b) Classify most leases of assets other than property as Type A leases, and:

        (i) Subsequently measure the lease liability at amortized cost.

        (ii) Amortize the ROU asset on a systematic basis that reflects the pattern in which the lessee expects to consume the ROU asset's future economic benefits.

(iii) Present interest on the lease liability separately from amortization of the ROU asset.

(c) Classify most leases of property as Type B leases, and:

(i) Subsequently measure the lease liability at amortized cost.

(ii) Amortize the ROU asset in each period so that the lessee would recognize the total lease cost on a straight-line basis over the lease term.

(iii) Present a single lease expense (cost) combining unwinding of the discount on the lease liability with the amortization of the ROU asset.

Summary of feedback received on the lessee accounting model proposed in the 2013 ED

16. The Boards and staff received feedback on various aspects of the proposed lessee accounting model, including the recognition of assets and liabilities for all leases other than short-term leases, the proposals with respect to measuring the ROU asset and the lease liability, as well as the proposals with respect to the income statement and statement of cash flows.

17. This paper does not revisit the recognition or measurement proposals in the 2013 ED. Each of the approaches outlined in this paper would recognize a ROU asset and a lease liability for all leases other than short-term leases and this paper does not propose any revisions to the measurement proposals in the 2013 ED (measurement will be discussed in future board papers). Accordingly, this section includes discussion of the feedback received on the proposals only with respect to the recognition of lease expenses in a lessee's income statement, as well as specific comments received on the lease classification test proposed in the 2013 ED.

Recognition of lease expenses in a lessee's income statement

Users

18. Many users consulted currently adjust a lessee's income statement for leases accounted for as operating leases under existing U.S. GAAP and IFRS. The most common technique used is to split the operating lease expense for the period into depreciation and interest using estimation techniques (for example, two-thirds of the operating lease expense as depreciation and one-third as interest).

19. Many users, including most industry-specific users, support the income statement proposals in 2013 ED for the following reasons:

    (a) Most users that provided feedback agree that there are economic differences between property leases and leases of assets other than property.

    (b) Almost all airline and transport analysts agree with the proposal to recognize and present amortization separately from interest for most leases of assets other than property because, in their view, there should be consistency in the treatment of owned and leased assets. Retail, restaurant, and hotel analysts generally support the recognition of a single lease expense for property leases, typically presented as an operating expense. They view lease expenses as an important part of the operating expenses of a retailer, hotelier, or restaurateur.

    (c) Some users who are not industry-focused also support the proposed dual model. They are of the view that a lessee's income statement should reflect what a lessee pays for consumption (depreciation) of the underlying asset separately from what it pays for financing (interest). They think the proposed dual model is a practical way to do this. Some of these users would, however, consider the lease expense for Type B leases to be a financing (interest) expense.

20. Nonetheless, many users disagree with the income statement proposals in the 2013 ED. Most of those who disagree, including two of the three major credit rating

agencies and most of the other credit analysts that provided feedback, proposed recognizing amortization expense separately from interest expense for all leases (that is, applying Type A accounting to all leases). This reflects their view that all leases create assets and "debt-like" liabilities.

21. In contrast, some other users who disagree with the income statement proposals suggest that a lessee should recognize a single, straight-line lease expense for all leases currently classified as operating leases. This reflects their view that, for these leases, the benefit to the lessee is received evenly over the lease term. The accounting would more closely align lease expense with lease payments, which these users view as preferable.

Others

22. Some other constituents, particularly lessees with property leases, support the proposed accounting in the 2013 ED for property leases. They think that the income statement lease expense recognition requirements in Topic 840 and IAS 17 work well for these leases and accurately reflect the economics of such leases. Consequently, they support a lessee recognizing a single straight-line lease expense in its income statement for most property leases.

23. However, a majority of constituents (including most preparers) disagree with the dual accounting model proposed in the 2013 ED, which is based on consumption of the underlying asset.

24. Some constituents, in particular, standard setters, accounting firms, and some preparers, disagree with having a dual lessee model for conceptual reasons. These constituents think that, if the Boards wish to require capitalization of leases by a lessee, any attempt to differentiate between those leases in the income statement is arbitrary and inconsistent with the recognition of a nonfinancial asset and a financial liability for all leases (other than short-term leases). Some of these constituents are also particularly concerned about an entity potentially having to account for leases of the same type of underlying asset in different ways depending on lease classification.

> "We believe that if the boards move forward with developing a single-model ROU approach for lessees, the approach should reflect a lease as financing the purchase of the ROU asset. The underlying concept in the ED is that when the underlying asset is delivered, the lessee has a right to use the leased asset and an obligation to make lease payments that meet the definition of an asset and a liability in the IASB's Conceptual Framework and in FASB Concepts Statement 6. Essentially, the transaction is the acquisition of a nonfinancial asset with deferred financing. Accordingly, we believe that it is appropriate to amortise the ROU asset similarly to how other purchased nonfinancial assets are amortised — that is, on a systematic basis reflecting the pattern in which the lessee is expected to consume the ROU asset's future economic benefits." – CL #262

25. These constituents and others think that any dual model perpetuates the risk of structuring to gain a particular accounting outcome and note that structuring is one of the major criticisms of the existing model in IAS 17 and Topic 840.

26. Other constituents disagree with the classification principle on which the dual accounting model is based. Most of these constituents, mainly preparers and some of the accounting firms, prefer a dual model based on the principle in IAS 17 and Topic 840 for the following reasons:

    (a) It is readily understood and has worked well in practice, as compared to the consumption principle which is new and untested. This would reduce the complexity and judgment many entities would need to apply at least initially and for a period of time after adoption of a new leases standard.

    (b) It captures economic differences between leases more accurately than the proposed consumption principle.

(c) It is closely tied to the commercial and bankruptcy laws and income tax requirements in some jurisdictions (for example, in the U.S.), unlike the consumption principle.

(d) It is a more pragmatic way to achieve the recognition of assets and liabilities for all leases on a lessee's balance sheet. Constituents with this view support the recognition of assets and liabilities on a lessee's balance sheet but acknowledge that the logical accounting consequence of that recognition (which would be a single Type A model) has been rejected by many constituents as not reflective of the underlying economics of all leases. These constituents think that the Boards introduced a dual lessee model for pragmatic reasons in response to those concerns rather than for any conceptual accounting reason and support retention of the existing lease classification line on similar pragmatic grounds.

> "...we believe the proposed classification model would not substantively improve upon the current distinctions in IAS 17. Accordingly, we recommend incorporating IAS 17's criteria into the proposed standard, instead of the consumption principle. We believe operational concerns would be significantly lessened if the current 'dividing' line in IAS 17 for distinguishing between finance and operating leases was retained for purposes of income statement classification." – CL #301

27. Some constituents criticize the consumption principle generally, noting that a ROU model should not rely on classification guidance that focuses on the nature of the underlying asset.

28. Many constituents raised concerns about the costs and complexity of the proposed dual lessee accounting model, stating that:

(a) There would be costs involved in applying any new classification guidance and in setting up the new accounting systems required for Type B accounting.

(b) The dual model is complex, particularly the judgments that need to be made in classifying leases.

> "On a pragmatic basis, we believe a standard with two types of leases will significantly increase the complexity of applying the ED. A large part of the complexity with current accounting for leases is the distinction between operating and capital leases. We expect the same or more complexity if the final document includes two types of leases. In addition to differences in judgment about whether a lease does or does not consume more than an insignificant amount of the economic benefits embedded in the underlying asset and all the confusion and non-comparability that such differences in judgment will bring to accounting for leases, consider the following complexities caused by two types of leases: (a) distinguishing between property and non-property; (b) determining whether the property or non-property asset in a single unit of account is the primary asset; and (c) the need to change from one model to another in certain situations after an impairment is recognized." – CL #99

29. Constituents also have specific concerns about the income statement profile of Type A leases. Some constituents criticize the front-loaded expense profile of Type A leases and the change from presenting rental expense to presenting interest and amortization for existing operating leases of assets other than property. Some constituents think that this change could create issues for particular transactions or in particular industries, such as:

(a) In joint arrangements.

(b) When rental expense is charged to the cost of another asset.

(c) When rental expense is used to recover costs by regulated industries or government contractors.

30. Some constituents raised concerns about the Type B income statement profile. Most of these concerns relate to the inconsistency of recognizing a financial liability without presenting any corresponding interest expense in the income statement, and recognizing a nonfinancial asset without any amortization or depreciation. Some preparers are concerned about the effects this would have on ratios used to assess their operations (for example, EBITDA).

31. Finally, although some standard setters and others agree with the consumption principle and the income statement proposals for lessees, they disagree with the Type B accounting model. They think that it is inappropriate to recognize a single, straight-line lease expense under a ROU model. Consequently, they suggest that a lessee should not recognize an asset and a liability when a lessee is expected to consume only an insignificant portion of the underlying asset.

Classification proposals

32. This sub-section of constituent feedback focuses only on comments received on specific aspects of the proposed 2013 ED lease classification guidance.

33. Some constituents support the classification guidance as proposed in the 2013 ED. These constituents think that the classification guidance appropriately offers a core principle (that is, classification on the basis of consumption of the underlying asset) and an operational way to apply that principle (that is, classification based principally on the nature of the underlying asset, with exception tests designed to more closely align application with the underlying principle).

34. Most constituents, however, are concerned about various aspects of the proposed classification guidance.

35. Most constituents expressed concern about the use of subjective phrases that would impact lease classification, including the terms “insignificant,” “major part,” and “substantially all.” These constituents think that these phrases, without any additional guidance as to their meaning, would lead to inconsistent application of the classification guidance.

36. Constituents are also concerned about aspects of the two-tiered classification test in the 2013 ED, including the application of the consumption principle on the basis of comparing the present value of lease payments to the fair value of the underlying asset and comparing the lease term to the economic life of the underlying asset. These constituents are concerned that the tests would lead to similar leases of the same underlying asset being classified differently. For example, some constituents are concerned about an entity classifying property leases as Type A leases, especially land-only leases.
37. Other constituents have concerns about the definition of property in the classification guidance. Most of these constituents think that the definition of property in the 2013 ED is too narrow.
38. Some constituents have concerns about specific aspects of the classification guidance, including the guidance relating to:
    (a) *Leases of land and buildings.* Some constituents would prefer to separate the land and building elements of these leases, while others disagree with using the remaining economic life of the building to classify the combined lease.
    (b) *Lease components with the right to use more than one asset.* Some constituents request more guidance on how to determine the "primary asset," while others disagree with the primary asset concept, particularly for leases with property and nonproperty elements.
    (c) *Economic life*. Some constituents disagree with the proposal to use the *remaining* economic life of the underlying asset for classification of property leases and the *total* economic life of the underlying asset for leases of assets other than property. Most of these constituents would prefer to use the total economic life for all underlying assets. They do not think that the classification of leases of the same underlying asset should change from Type B to Type A as the asset ages, which could be the case if classification depends on the remaining life of the underlying asset.

(d) *Fair value*. Some constituents disagree with the proposal to base the classification test on the fair value of the underlying asset because, for some assets (particularly some long-lived assets other than property), fair value is difficult to determine.

39. Constituents suggest the following various modifications to the classification guidance, if the Boards decide to retain classification guidance similar to that proposed in the 2013 ED:

    (a) Classification based solely on the underlying asset for leases of both property and assets other than property. These constituents would prefer an entity to apply the consumption principle strictly on the basis of the nature of the underlying asset (that is, classify all property leases as Type B leases and all leases of assets other than property as Type A leases).

    (b) Classification based solely on the consumption principle (that is, whether the lessee consumes more than an insignificant amount of the economic benefits embedded in the underlying asset) and not based on the nature of the underlying asset.

    (c) Changing the classification test in a way that would reduce, but not eliminate, Type A property leases and Type B leases of assets other than property.

    (d) Expanding the definition of property to incorporate the concept of "integral equipment" under existing Topic 840 or the recent IFRS Interpretations Committee's discussions on the definition of property. These constituents think that such an expanded definition should incorporate assets such as telecommunications towers, fiber-optic cables, and pipelines.

    (e) Improving the guidance with regard to terms such as "economic life," "insignificant," "major," and "substantially all."

    (f) Using numerical tests rather than terms such as "insignificant" or "major."

Lessee accounting approaches

Approach 1 – Single Type A Lessee Accounting Model

Overview of Approach 1

40. Under Approach 1, for each lease, a lessee would recognize:

    (a) A lease liability, initially measured at the present value of lease payments, and subsequently measured at amortized cost using the effective interest method.

    (b) A ROU asset, initially measured at an amount generally equal to the lease liability and subsequently measured at amortized cost. A lessee would amortize the ROU asset consistently with other nonfinancial assets, using a systematic basis that reflects the expected pattern of consumption of benefits from using the underlying asset, which typically would be straight-line.

41. Under Approach 1, the lessee's total lease expense for an individual lease would typically decrease over the lease term because (a) the interest expense is based on the liability balance, which decreases as the lessee makes payments, and (b) the ROU asset would typically be amortized on a straight-line basis.

Rationale for Approach 1

42. Approach 1 treats a lease as the acquisition of a ROU asset on a financed basis. The accounting is substantially equivalent to financing the acquisition of other nonfinancial assets, including other economically similar assets such as the rights to use particular intellectual property (for example, licenses such as franchise rights). That ROU asset is a nonfinancial asset, which Approach 1 would account for consistently with other nonfinancial assets. The lease liability is a financial liability, which Approach 1 would account for consistently with similar financial liabilities.

43. Under this approach, the components of the lease (that is, the ROU asset and the lease liability) are recognized separately—although linked on initial measurement,

they are subsequently measured independently of each other. The amortization or depreciation pattern of the ROU asset is based on the expected pattern of consumption of benefits from the asset and there is no relationship between the pattern of consumption of benefits from the ROU asset and the manner of financing.

44. Approach 1 acknowledges that service or service-like elements are often pivotal to a lessee's decision to enter into a lease (for example, to avoid the costs and effort of managing the underlying assets). Accordingly, a lessee's decision to lease is often not an attempt to finance the purchase of the underlying asset. However, Approach 1 asserts that all leases include a financing element, regardless of whether the lease represents a lease-versus-buy decision by the lessee. This is because all leases have a lease element (the right to use the underlying asset for a period of time) that is separate from any other service or service-like elements in the contract. The lessee obtains the lease element (that is, the right to control the use of an underlying asset) at lease commencement when the lessor makes the underlying asset available for the lessee's use, and the lessee generally pays for that right over the period of the lease. Absent extenuating circumstances, after lease commencement, the lessor's only performance obligation with respect to the ROU element is not to do anything that would breach the contract (that is, not to do anything that would violate the lessee's right to use the underlying asset).

Approach 2: Simplified Version of 2013 ED Lease Classification Test

Overview of Approach 2

45. Approach 2 would effectively retain the lease classification test from the 2013 ED, but with key simplifications and improvements.

46. To accomplish this, the lease classification test under Approach 2 would be as follows:

    (a) A lessee would account for leases of "property", other than short-term leases, as Type B leases unless the lease transfers control of the property to the lessee. Property would be defined as land, buildings, or "integral

equipment" (that is, any physical structure or equipment attached to land or buildings that cannot be removed and used separately without incurring significant cost) or portions thereof. The lessee would be deemed to control the underlying asset when any one of the following three criteria are met:

(i) The lease transfers ownership of the property to the lessee by the end of the lease term.

(ii) The lessee has a significant economic incentive to exercise an option to purchase the underlying asset (note: if the Boards decide to revise the notion of significant economic incentive, the staff would propose to revise this criterion accordingly).

(iii) The lessee otherwise has the ability to obtain substantially all the remaining benefits of the underlying asset as a result of the lease. The following situations, individually or in combination, would normally indicate that the lessee has the ability to obtain substantially all the remaining benefits of the underlying asset as a result of the lease:

  a. The lease term is for a major part of the remaining economic life of the underlying asset.

  b. The sum of the present value of the lease payments and any residual value guaranteed by the lessee amounts to substantially all of the fair value of the leased asset.

  c. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

In leases with land and other elements, when necessary (for example, when the lease classification of each element on its own is not otherwise clear) lessees would separate the land element(s) from the other element(s) for purposes of determining lease classification unless the land element is clearly immaterial.

(b) A lessee would account for all leases of assets other than property, other than short-term leases, as Type A leases. A lessee would also account for leases of property for which the lessee obtains control of the property as Type A leases.

47. The staff think that Approach 2 could be developed in either of the following ways:

    (a) A lessee would be *required* to apply Type B accounting to leases of property for which the lessee does not obtain control of the property.

    (b) A lessee would have the *option* to apply Type B accounting to all of its leases of property for which the lessee does not obtain control of the property. Otherwise, the lessee would apply Type A accounting to all leases, other than short-term leases.

Rationale for Approach 2

48. The rationale for Approach 2 is similar to Approach 1, in that the approach would, as a starting point, say that Type A accounting is appropriate when a lessee recognizes a ROU asset (as a nonfinancial asset) and a lease liability (as a financial liability). Approach 2 proposes that Type B accounting is inappropriate from a conceptual perspective.

49. Nonetheless, Approach 2 would either require or permit a lessee to account for the vast majority of its existing operating leases of property as Type B leases as an *exception* to the ROU model developed. The rationale for that exception is derived from the economics and pricing of leases (that is, linked to the consumption principle in the 2013 ED). The exception would permit lessees to better reflect the economics of most property leases for which the lessee is not expected to consume a very significant portion of that property over the lease term.

50. When the lessee is not expected to consume a very significant portion of the underlying asset (for example, in a 3 or 5-year lease of property), the lease payments made by the lessee would represent amounts paid to provide the lessor with a return on its total investment in the underlying asset (that is, a charge for the use of the asset by the lessee). Because of this, that return or charge would be

expected to be even, or relatively even, over the lease term. The lessor would not factor in a return of a consumed portion of the underlying asset because little, if any, of the asset is expected to be consumed during the lease term. Because of this, the lessee does not, in effect, acquire a portion of the underlying asset, but rather is paying solely for the right to use the lessor's asset, and the lease in those cases is not equivalent to the purchase of a nonfinancial asset. In many respects for such a lease, the payments made by the lessee could be viewed as somewhat similar to an entity paying interest on an interest-only loan. That is because the lessee effectively borrows the underlying asset, uses it during the lease term while paying the lessor even (or relatively even) lease payments for that use, and returns the underlying asset to the lessor with virtually the same value or service potential as it had at the commencement date.

51. In contrast, when the lessee is expected to consume more than an insignificant portion of the underlying asset during the lease term, the lessor generally would price the lease to both obtain a return on its total investment in the underlying asset and also recover an amount representing the portion of the underlying asset that the lessee is expected to consume during the lease term. In other words, the lessor would price the lease as if it were selling (and the lessee were buying) the portion of the underlying asset that the lessee is expected to consume. In that case, the lessee should account for the lease as a contract to purchase a portion of the underlying asset on a financed basis, and treat the resulting ROU asset in the same manner as other nonfinancial assets purchased on a financed basis.

52. Approach 2 retains the underlying economic rationale of the dual model proposed in the 2013 ED, but would aim to address particular concerns raised about the lease classification proposals in the 2013 ED as follows:

    (a) Many constituents expressed the view that the definition of "property" in the 2013 ED (that is, land or a building – or portion thereof) was too narrow. Approach 2 would expand that definition to include those items accounted for as "integral equipment" (for example, many

telecommunications towers and pipelines), which are presently considered to be real estate under existing U.S. GAAP.

(b) Constituents expressed concern about the complexity introduced by the "exception tests" in the 2013 ED lease classification test (that is, paragraphs A2 and A3 of Appendix A to this paper). This approach would simplify the 2013 ED proposals because it would remove the "exception" tests for leases of assets other than property proposed in the 2013 ED (paragraph A2 of Appendix A to this paper). Accordingly, a lessee would classify all leases of assets other than property as Type A leases, without any lease classification test. The staff do not expect a significant change in lease classification outcomes as a result of this simplification. This is because we would have expected most leases of assets other than property (of more than 12 months) to be classified as Type A leases in any event because assets other than property depreciate in value over time. Consequently, for such leases, a lessee would be expected to consume more than an insignificant portion of the underlying asset during the lease term. Examples of leases that a lessee would have been expected to classify as a Type B lease under the 2013 ED and would classify as a Type A lease under this approach are:

   (i) A 3-year railcar lease, when the rail car has a total economic life of 50 years.

   (ii) An 18-month ship lease, when the ship has a total economic life of 30 years.

Approach 3: Simplified and Updated IAS 17 Lease Classification Approach

Overview of Approach 3

53. Approach 3 is based on the existing lease classification principle underlying existing U.S. GAAP (Topic 840) and IFRS (IAS 17) in that a lessee would classify a lease as Type A or Type B based on whether it is effectively purchasing the underlying asset as a consequence of the lease.

> **FAS 13, paragraph 60 (Basis for Conclusions)**. "The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase."

54. Under Approach 3, a lessee would make the determination of whether the lease is effectively a purchase of the underlying asset based on whether it obtains control of the underlying asset as a result of the lease (consistent with the complementary notion of a sale in the forthcoming revenue recognition standard). The lease classification test in Approach 3 would result in the vast majority of existing capital/finance leases being classified as Type A leases and the vast majority of existing operating leases being classified as Type B leases.

55. When a lessee obtains control of the underlying asset, the lessee would account for the lease as a Type A lease. A lessee would account for all other leases, other than short-term leases, as a Type B lease.

56. A lessee would effectively obtain control of the underlying asset when any *one* of the following three criteria is met at lease commencement:

    (a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

    (b) The lessee has a significant economic incentive to exercise an option to purchase the underlying asset (note: if the Boards decide to revise the notion of significant economic incentive, the staff would propose to revise this criterion accordingly).

(c) The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease. Situations that individually or in combination would normally indicate that the lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease include:

   (i) The lease term is for a major part of the remaining economic life of the underlying asset.

   (ii) The sum of the present value of the lease payments and any residual value guaranteed by the lessee amounts to substantially all of the fair value of the leased asset.

   (iii) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

   The situations in (i) - (iii) are not always conclusive. If it is otherwise clear that the lessee will not obtain substantially all of the remaining benefits of the underlying asset during the lease term (for example, when the estimated fair value of the underlying asset is expected to appreciate over the lease term such that the remaining benefits at the end of the lease term are effectively unchanged or enhanced since lease commencement), this criteria (criteria c) would not be met.

57. Under Approach 3, land and other elements would be assessed separately for purposes of lease classification when necessary, unless the land element is clearly immaterial.

Rationale for Approach 3

58. Approach 3 is based on the view that “true leases” have a specialized role in business that neither reflect the full transfer of a nonfinancial asset (for example, the purchase of a piece of equipment), nor are equivalent to a service contract. As a consequence, the lessee’s accounting for a “true lease” does not have to conform to comparable accounting for a purchased asset or a services contract. “True leases” even differ from other “rights of use,” such as licenses of intellectual property in

terms of the rights and obligations they convey (for example, in the event of bankruptcy in the U.S., licenses of intellectual property are treated differently from existing operating leases; licenses are generally treated in the same manner as existing capital/finance leases - *the staff note that bankruptcy law varies by jurisdiction; therefore, this may or may not apply to some other jurisdictions*).

(a) A lease is not equivalent to a financed purchase of the underlying asset because the lessee does not have the same rights or obligations as a result of the lease as it would obtain from owning that underlying asset. For example, the lessee does not have the right to sell the asset nor pledge the asset as collateral. In addition, in the case of lessee bankruptcy (at least in the U.S.), the lessee's obligations with respect to a lease that would be classified as Type B under this approach are different from its obligations under a Type A lease or if the asset were purchased (either on credit from the supplier or through third-party financing).

(b) A lease is also not equivalent to a service contract because the lessor's performance with respect to the right of use is complete at lease commencement when assuming the contract will be fulfilled as promised. After making the underlying asset available for the lessee's use, the lessor's obligation with respect to the lease element only requires the lessor not to perform (for example, not pledge the leased asset as collateral or not to infringe upon the lessee's "quiet enjoyment" of its right to use the leased asset). The lessor may, however, have other obligations relating to non-lease elements in the arrangement (for example, ancillary maintenance services) that are separate from the lease element. Some constituents have expressed the view that these requirements evidence that "true leases" are "service-like"; however, these contractual requirements do not require additional performance by the lessor or the transfer of additional goods or services. This view is consistent with the Boards' conclusions in the forthcoming revenue recognition standard with respect to licenses of intellectual property. The Boards have concluded in that forthcoming standard that commitments to maintain and defend patent

rights, or to maintain exclusivity, are not performance obligations of the licensor because those actions do not transfer a promised good or service to the licensee. This view is also consistent with practice under existing U.S. GAAP revenue recognition guidance, which generally does not view either of these items as additional deliverables in a multiple-deliverable revenue arrangement. Others have suggested that, in many leases, the customer would not be required to make lease payments if the underlying asset becomes unusable (for example, if the building or the ship is destroyed by an act of nature). The staff do not think that this calls into question whether the lease element is transferred at lease commencement because this type of clause generally represents an extreme circumstance (for example, force majeure). Further, the staff think provisions of this nature in a lease are at least tangentially analogous to warranty or right of return provisions in a sale contract. For example, a lessor would typically be allowed to provide a replacement piece of equipment if the originally leased asset becomes unusable. Neither warranty, nor right of return, provisions are deemed to affect the determination as to when the seller's performance is complete with respect to transferring the promised good in a sale transaction; these generally impact allocation or measurement. Similarly, the staff do not think these types of lease clauses alter the view that the lessor's performance with respect to the right-of-use occurs at lease commencement when they make the underlying asset available for the lessee's use.

59. Based on the premise that leases are not equivalent to either purchased assets or service contracts, Approach 3 would look to the lease as the unit of account. The approach would propose that the recognition of a lessee's total lease expense should reflect the pattern in which the benefit from the lease is consumed, which is generally (but not always) straight-line over the lease term. Approach 3 presumes that this total lease expense recognition pattern would more faithfully represent the underlying economics of "true leases" to the lessee than accounting for a lease in the same manner as the purchase of the underlying asset.

60. Recognition and separate presentation of the ROU asset and the lease liability elements that result from the lease is appropriate because:

    (a) The ROU asset represents probable future economic benefits that will flow to the lessee as a result of the lease. The ROU asset arises from the lessor's past, and complete, performance of making the underlying asset available for the lessee's use at lease commencement.

    (b) The obligation to make lease payments is a present obligation arising from the past event of entering into the lease and the lessor's performance with respect to the right-of-use.

    (c) The ROU asset and the lease liability are not eligible for net presentation in the balance sheet under either U.S. GAAP or IFRS because of the nonfinancial nature of the ROU asset. U.S. GAAP and IFRS both permit offsetting only of financial assets and financial liabilities (for which a legally enforceable right of set-off exists and other criteria are met).

61. Similarly to Approach 1, Approach 3 proposes a single accounting model for all "true leases." Both Approach 1 and Approach 3 would account for those leases that are effectively purchases of the underlying asset by the lessee as purchases (that is, applying Type A accounting). Approach 1 however concludes that the ROU assets that result from "true leases" are no different from other types of acquisitions of nonfinancial assets, and therefore should be accounted for no differently. However, Approach 3 takes the view that "true leases" differ from the purchase of other nonfinancial assets. Approach 3, therefore, proposes to account for "true leases" differently from the purchase of a nonfinancial asset and also differently from those leases that are *effectively* purchases.

62. The staff have proposed Approach 3 *in lieu of* proposing that preparers simply adopt IAS 17's lease classification guidance. The staff view the adoption of IAS 17's lease classification guidance as less favorable than adopting Approach 3. This is because Approach 3 would align the concept of an effective purchase (or sale) with the principle in the forthcoming revenue recognition standard rather than the

principle for a purchase (sale) in the soon to-be superseded existing U.S. GAAP and IFRS revenue recognition guidance.

63. Type B accounting is described in the following three paragraphs. This description applies equally to Type B leases under Approach 2 as well as Approach 3.

64. A lessee would calculate the amount of the lease liability at any given point in time during the lease as the discounted value of the remaining lease payments, and would measure the liability at that amount throughout the lease. Consequently, a lessee would initially and subsequently measure all lease liabilities in exactly the same way under all three approaches in this paper (that is, the Type B lease liability is measured in the same way as the Type A lease liability, using a discount rate that typically would not change during the lease term).

65. Absent intervening events or circumstances (for example, impairment), and assuming that the lessee expects to consume the benefit from the lease evenly, a lessee would measure the ROU asset at the amount of the lease liability, adjusted for any prepaid or accrued rent if the lease payments are uneven throughout the lease term, as well as any initial direct costs and lease incentives. Accordingly, the ROU asset would equal the lease liability throughout the lease term if lease payments are even and there are no initial direct costs or lease incentives. Conversely, uneven lease payments or the presence of initial direct costs or lease incentives would result in the ROU asset not being equal to the lease liability throughout the lease term. In theory, the carrying amount of the ROU asset would represent, and approximate, the present value of the remaining benefits to the lessee at each measurement date.

66. Also in the context of measurement, regardless of the view that the lease is the unit of account, a lessee would no longer reflect a ROU asset on its balance sheet if the lease is no longer expected to provide benefit to the lessee because it would no longer meet the conceptual definition of an asset. The ROU asset would be impaired in that scenario. Conversely, a lessee would continue to recognize a ROU asset even if the lease is fully prepaid. This would reflect the future economic benefits to be derived from the ROU asset for which the lessee has paid in advance. Therefore,

in the context of either of these events, the carrying amount of the ROU asset and the lease liability also would not be equal.

Staff analysis of the proposed approaches

67. The staff evaluated each of the three approaches outlined above under three main headings—the conceptual basis, benefit for users, and costs and complexity (both on an initial and ongoing basis). In addition, the staff noted some "other considerations" that they think are relevant to determining the best path forward regarding the lessee accounting model. That analysis follows, separated by each of the key areas of evaluation.

Conceptual basis

68. The staff think that Approach 1 is the most, but not only, supportable approach on the grounds of having a sound conceptual basis. This is because Approach 1 aligns a lessee's accounting to the notion that a lessee has obtained a nonfinancial asset (the ROU asset) at lease commencement, which it typically pays for over time. Approach 1 would account for the ROU asset and the related liability in a manner consistent with the purchase of any other nonfinancial asset, as well as other similar transactions such as the financed purchase of a right to use an entity's intellectual property for a period of time (which typically receive "Type A" accounting treatment if there are noncontingent fees for the license that are paid for over time).

69. Constituents that support Approach 1 generally do so for two reasons:

    (a) Some place greater emphasis on the conceptual basis for an approach. Many of these constituents are regulators, academics, other standard setters, and most auditors and other accounting advisors (as well as some preparers). Some of those constituents note that they think it is inappropriate for the Boards to impose such a significant change to financial reporting without a strong and supportable conceptual basis.

(b) Others like the clarity and simplicity of a single model that treats ROU assets in the same way as other nonfinancial assets and lease liabilities in the same way as other similar financial liabilities.

70. Constituents that support Approach 1 generally think that Type B accounting (that is, the recognition of a nonfinancial asset without amortization or depreciation, and a financial liability without interest, in the income statement) is unsupportable from a conceptual perspective and could not be viewed as an improvement to financial reporting. They also generally think that Approach 1 appropriately reflects the economics of any transaction in which an entity purchases a nonfinancial asset and pays for that asset over time.

71. Both Approaches 2 and 3 are premised on the view that, in contrast to the view taken in Approach 1, not all leases are economically equivalent to the purchase of a nonfinancial asset that is typically paid for over time. Supporters of a dual lessee model, whether Approach 2 or Approach 3, conclude that accounting for all leases as if they *were* equivalent to the purchase of a nonfinancial asset (that is, Approach 1) would result in accounting that is *not* faithfully representative of the underlying economics of some leases. In their view, a faithful representation of the economics of leases to the lessee is more important than the individual accounting for the financial statement elements (the ROU asset and the lease liability) that result from the lease.

72. Although both dual models, Approaches 2 and 3 differ in terms of their perspective on the economics of leases. Consequently, they also differ with respect to determining which leases have attributes similar to a contract to purchase a nonfinancial asset and which do not. Broadly:

(a) Approach 2 starts from the premise that Approach 1 (Type A accounting for all leases other than short-term leases) is the *right* conceptual answer under the proposed ROU model. This is because the lessee is recognizing a ROU asset (a nonfinancial asset) and a lease liability (a financial liability). Based on this premise, Approach 2 limits any *exceptions* to Type A accounting to only those leases for which, from an economic

perspective, it might be more beneficial to present a single lease expense (rather than amortization and interest). When considering the economics of leases, Approach 2 looks to what the lessee is economically paying for as evidenced by the lessor's pricing of the lease. Approach 2 concludes that a single lease expense would provide more useful information when the lessee does not consume a very significant portion of the underlying asset. Approach 2 applies that principle for practical purposes such that a lessee would recognize a single lease expense for most property leases and amortization and interest for all other leases.

(b) Approach 3 looks to the lessee's rights and obligations resulting from the lease (that is, its right to use the underlying asset for a period of time in the contract) in determining whether the lease is, or is not, fundamentally equivalent to purchasing the underlying asset. Approach 3 concludes that when the right to use the underlying asset does not convey rights and obligations substantially equivalent to ownership of the underlying asset, the lease is not equivalent to the purchase of a nonfinancial asset. In that case, the lessee's recognition of total lease expense should mirror the pattern in which the lessee would derive benefit from the lease as the unit of account (which will generally be straight-line). Supporters of this approach think that this total lease expense recognition pattern for leases that are not equivalent to the purchase of the underlying asset most appropriately reflects the economics of these leases to the lessee. Supporters, therefore, think that Approach 3 most faithfully represents leases in a lessee's income statement.

73. Accordingly, although the staff think Approach 1 is the most supportable approach conceptually, the staff think that all three approaches can be supported. Each approach focuses on a different characteristic when determining how best to depict leases in the income statement. Approach 1 views the assets and the liabilities that arise from a lease as no different from other nonfinancial assets and financial liabilities, and depicts the income statement results accordingly. Approach 2 focuses on consumption of the underlying asset in determining what a lessee is

economically paying for in a lease. Approach 3 focuses on the rights and obligations conveyed by the lease in order to determine whether the lease is effectively a purchase of the underlying asset. The Boards have received feedback from constituents supporting the underlying rationale for each of these approaches.

74. Nonetheless, the staff acknowledge that:

    (a) Type B accounting, which would apply to most leases under Approach 3, but also most (by value) of leases under Approach 2, could be viewed as calling into question whether a lessee has obtained an asset at lease commencement. This is because the total lease expense profile and lack of recognition of interest expense on the lease liability are more consistent with the accounting for a service contract. Although the staff think that a lessee has obtained a ROU asset at lease commencement, some have interpreted the total lease expense profile resulting from Type B accounting as calling into question that conclusion.

    (b) From a conceptual standpoint, Approach 2 may be considered to confuse the unit of account from the ROU asset to the underlying asset. Approach 2 applies a different amortization method to the ROU asset based on the nature of the underlying asset rather than the nature of the right-of-use. Although the line drawn based on consumption may align closely to the economics underlying many leases, the lessee's consumption of the ROU asset is not directly affected by the nature of the underlying asset to which the right-of-use applies. A lessee consumes all of a ROU asset, regardless of the nature of the underlying asset. Determining the amortization pattern based largely on the nature of the underlying asset may lead to accounting for economically similar transactions differently (for example, a 5 year lease of a shipping container and a 5 year lease of a storage unit in a physical building).

Benefit for users

75. This section is intended to highlight how users utilize the information provided in the financial statements with respect to leases and what benefits the staff would expect each approach to provide to users.

Background

76. Users are interested in obtaining information about a lessee's leasing activities, in general, to assess the cash flows, performance and capital structure of the lessee, and to assess the lessee's ability to meet financial commitments.

77. The relative benefit of the three approaches for users can depend on the purpose for which the financial information is used— that is, whether a user is analyzing asset returns/operating performance, capital structure/enterprise value, leverage, liquidity or cash flows. The relative benefit of the approaches also depends on a particular user's view as to whether leases create "debt-like liabilities" for a lessee.

78. When assessing the operating performance of an entity or determining enterprise value, it is important to separate operating and financing elements of the financial statements. This is because:

    (a) Users wish to assess the performance of an entity, independently of the financing or ownership structure. The "R" (Return) within "ROCE" (Return on Capital Employed) or "ROIC" (Return on Invested Capital) that are commonly used when assessing an entity's performance typically excludes financing expenses.

    (b) Users assess the performance of an entity, typically in relation to the capital invested/employed in the entity. The "CE" (Capital Employed) or "IC" (Invested Capital) of "ROCE" or "ROIC" includes assets used in the operations of an entity.

79. Most of the users consulted in outreach meetings already make adjustments to a lessee's reported balance sheet to capitalize operating leases when operating leases are significant to the lessee. This reflects the fact that most of those consulted view leases as creating assets and liabilities for a lessee. They take operating leases into

account when determining enterprise value, and assessing the leverage or liquidity of a lessee (for most, operating lease commitments are added to what they consider to be "debt-like liabilities"), and also when assessing operating performance (by increasing the amount of assets used in the operations of the lessee). Many of those consulted also adjust a lessee's income statement for operating leases, estimating an allocation of the rent expense to depreciation and interest.

80. The users that we were able to access and with whom we discussed the proposals tend to be more sophisticated users. Several of those more sophisticated users, both at outreach meetings and in comment letters, noted that there are large parts of the wider investor community who do not adjust for operating leases (for example, those managing quant funds and those who screen potential investments or make investment decisions on the basis of database information, such as Bloomberg).

81. The following analysis includes information about users' views regarding a lessee's balance sheet as well as their views about the income statement. Although not directly relevant when comparing the benefits of each of the approaches (given that the lease liabilities would be measured in exactly the same way under all three approaches), we have included users' views on the balance sheet proposals because their views on the balance sheet often are an important influence on their views on a lessee's income statement.

Financial information used without adjustments

82. For those users who do not adjust the financial information reported by lessees, the proposed changes to a lessee's balance sheet under all 3 approaches would be expected to significantly improve the financial information received by those users when analyzing operating performance, enterprise value, leverage, liquidity, and cash flows. This is because it would provide information about operating leases that more closely reflects the economics of leases than using a value of zero —that is, it would increase the operating assets of the lessee to include leased assets used in operations and it would increase liabilities to include a lessee's contractual commitments for leases. Regarding the income statement, there would also be benefits from recognizing amortization of the ROU asset separately from interest on

the lease liability—and thus separating the operating component of lease expense (amortization) from the financing component (interest). This would create greater comparability in the income statement between entities that borrow and buy assets versus those who lease assets used in their operations. Separating amortization and interest would also provide coherency between the lessee's balance sheet and income statement (that is, an interest expense that corresponds to the lease liability presented as a financial liability). This is beneficial for users who rely on reported information, without adjustments, in their analyses. Consequently, we are of the view that Approach 1 would provide the most useful information to these users.

Credit analysts, including analysts at the credit rating agencies

83. Credit analysts are of the view that operating leases create assets and "debt-like" liabilities. All three approaches would provide significantly improved information when these analysts are assessing the liquidity, contractual commitments, and leverage of lessees. Because they view leases as creating assets and "debt-like" liabilities, credit analysts generally see benefit in applying Type A accounting to operating leases (and recognizing amortization of the ROU asset separately from interest on the lease liability). Many of those analysts adjust a lessee's income statement for all operating leases today to estimate an allocation of rent expense between depreciation and interest. Those users noted that they would continue to adjust the income statement for Type B leases to estimate that allocation of rent expense for those lessees that have a significant amount of Type B leases. Consequently, most of the credit analysts consulted, including some of those who provide funding to nonpublic entities in the U.S., would prefer Approach 1.

84. A few credit analysts consulted, including some retail and hotel credit analysts, supported the income statement outcomes under Approach 2. The retail and hotel credit analysts indicated that:

    (a) They view leases as creating "debt-like" liabilities and, thus, would treat leases liabilities under the proposals as "debt-like" liabilities when analyzing a lessee.

(b) They use, and would continue to use, "EBITDAR" (Earnings Before Interest, Taxes, Depreciation, Amortization and Rent) when analyzing a lessee, presumably to get more comparable information between entities that borrow and buy assets versus those that lease assets.

For those users, the information provided under any of the 3 approaches would satisfy their information needs.

85. A few credit analysts of nonpublic entities in the U.S. expressed support for the results that would be achieved under Approach 3. These analysts generally were not focused on the income statement, but thought of lease expense as operating in nature and generally viewed closer alignment between lease expense and lease payments to be preferable.

Equity Analysts

86. The views of equity analysts regarding the lessee accounting proposals were more mixed, largely because their analysis is often focused primarily on assessing the operating performance of a lessee (although assessing leverage and liquidity is still important in their analyses). In addition, although a majority of equity analysts consulted view leases as creating "debt-like" liabilities, some do not.

87. When assessing operating performance, most equity analysts indicated that they capitalize operating leases to try to obtain a more comparable operating asset base between entities that borrow and buy assets versus those that lease assets. Consequently, many equity analysts (and in particular those who follow entities that lease longer-lived assets—for example, airlines and retailers) indicated that they would continue to adjust a lessee's balance sheet to get to a "whole asset" or perpetual commitments number when assessing operating performance. Many of those analysts, however, indicated that the balance sheet information provided under any of the three approaches would provide useful information when assessing liquidity and contractual obligations, and would provide a much better starting point for their analyses than operating lease accounting today. In addition, some of those analysts noted that they expect to use the reported information when assessing operating performance. This is because the assets and liabilities recognized would

be expected to be "close enough" to whole asset information for shorter-lived assets (such as trucks and vans) such that no further adjustments would be required.

88. Almost all industrials/airlines/transportation/telecom analysts consulted view leases as creating "debt-like" liabilities. Consequently, they support the recognition of amortization and interest separately in a lessee's income statement for at least all leases of assets other than property. They noted that treating leased assets and owned assets in a similar way in the income statement would be beneficial to their analyses.

89. Almost all retail/hotel/restaurant equity analysts supported the recognition of operating lease expense on a straight-line basis within operating expense, similarly to operating lease accounting today. Nonetheless, their views can be categorized as follows:

    (a) Some of the retail/hotel/restaurant equity analysts view leases as creating "debt-like" liabilities. Those analysts generally either use EBITDAR when analyzing a lessee or estimate an allocation of rent expense between depreciation and interest. They noted that they are comfortable with receiving the same information about property lease expenses as they do for operating leases today because they have no issue with continuing to make the same adjustments to the income statement amounts as they do today. For these analysts, the information provided under any of the 3 approaches would satisfy their information needs and, arguably for those who estimate the split between depreciation and interest, Approach 1 would provide the most useful information.

    (b) Some of the retail/hotel/restaurant equity analysts either view existing operating leases as creating operating (rather than debt-like) liabilities or as executory contracts. For those analysts, the information provided under approaches 2 or 3 would satisfy their needs. Those analysts are likely to adjust the income statement information that they would receive under Approach 1.

90. Some equity analysts, principally in the U.S., adjust for operating leases in the balance sheet of the entities they follow, but think that the corresponding lease expense is an operating expense (and that lease payments are operating in nature). They do not view leases as creating "debt-like" liabilities. These analysts would prefer to obtain income statement information for lessees in-line with existing U.S. GAAP and IFRS (in other words, Approach 3), which they view as providing useful information because the rent expense for existing operating leases often is a close reflection of actual cash payments.

91. Other users, mainly some who take a "whole asset" view of leases, support Approach 2. For these users when assessing the operating performance of a lessee, it is important to split the lease payments between amounts paid for the portion of the underlying asset consumed (an operating expense) and those amounts paid for interest (a financing expense). When there is little or no consumption of the underlying asset (for example, for many property leases), these users view the entire lease payment as interest and, thus, would use the single lease expense amount for Type B leases in their analyses (even if not characterized as interest in a lessee's income statement).

Summary of benefits to users of the approaches

92. Taking into account all of the feedback received from users, the staff think that Approach 1 would provide the most useful information for the broadest range of users. This view largely reflects that most users consulted, and the views expressed in most user comment letters, is that leases create "debt-like" liabilities. On that basis, there is benefit for those users in recognizing amortization of the ROU asset (an operating expense) separately from interest on the lease liability (a financing expense). This is particularly the case for less sophisticated users that use reported information for their analyses without making further adjustments. In addition, although retail/hotel/restaurant analysts expressed support for a single lease expense for property leases, many of them use EBITDAR or split rent expense into depreciation and interest today in their analyses. Consequently, Approach 1 would still provide those analysts with information that is useful for their analyses.

93. The staff have identified six preparers (two airlines and four retailers) that already report non-GAAP financial information in their Management Discussion and Analysis, adjusted to capitalize operating leases. Arguably, these preparers do so to provide information requested by their users. All of those preparers include operating leases as part of their reported debt. They also adjust the income statement amounts to add back at least some of the operating lease expense to the earnings measure that they use to assess operating performance. Three of the four retailers impute interest on operating lease liabilities, and estimate an allocation of operating lease expense between depreciation and interest. They then add back the interest element to the earnings measure used to assess operating performance. One of the retailers adds back the entire operating lease expense to the earnings measure used to assess operating performance. One of the retailers notes the following in its financial statement to explain the adjustments made:

> "When assessing Return on Invested Capital ("ROIC"), the Company adjusts its results to reflect its operating leases as if they qualified for capital lease treatment. Operating leases are the primary financing vehicle used to fund store expansion and, therefore, we believe that the presentation of these leases as capital leases is appropriate."

94. For many of the same reasons as noted above for Approach 1, the staff thinks that Approach 2 would provide more useful information for users than Approach 3. The main difference between Approaches 2 and 3 is that a lessee would recognize amortization separately from interest for existing operating leases of assets other than property under Approach 2, whereas it would not under Approach 3. Feedback from industrials/airline/transport analysts suggests that there is benefit in recognizing amortization and interest separately (and similarly to owned assets) for leases of assets other than property.

95. In preparing outreach materials to discuss with users, the staff modelled the effects that the proposals would have on two different airlines, both with similar operations except that one airline held 30 percent of its aircraft fleet on operating leases and the other held 70 percent of its aircraft fleet on operating leases. For the airline with

70 percent of its aircraft fleet on operating leases, our modelling suggests the following difference between applying Type A accounting (Approach 2) compared to Type B accounting (Approach 3) to the airline's aircraft leases:

	Approach 2	**Approach 3**
Operating profit/EBIT	298	136
Financing expenses	(217)	(83)

96. For the airline with 30 percent of its aircraft fleet on operating leases, operating profit/EBIT would be 244 (under Approach 3) and 294 (under Approach 2), which also creates a significant difference in the amounts reported.

97. The effect of separating amortization and interest on leases of assets other than property is likely to be more significant for an airline than for entities in other industries, including those industries within which entities typically have a more consistent leased versus owned asset portfolio. This is because aircraft operating leases (which typically have 7-12 year lease terms) are longer than many other leases of assets other than property. This results in larger interest components for aircraft leases than is likely to be the case for other leases of assets other than property. Nonetheless, this modelling suggests that there could be significant differences in the operating and financing expense split under Approach 2 versus Approach 3, which (without being adjusted) could have an important influence on the analyses performed by some users.

Costs and complexity

98. A significant number of constituents expressed concerns about costs and complexity. This paper addresses only those costs and complexity concerns that directly relate to the lessee accounting model—that is, concerns relating to the lease classification test and the effects of the proposed lessee model on systems and process changes (generally as compared to lease accounting under existing U.S. GAAP or IFRS). Constituents also raised concerns about the costs associated with other proposals in the 2013 ED, which we intend to address later during

redeliberations. In particular, constituents highlighted the following areas of expected costs for lessees:

(a) The costs relating to the core recognition and measurement proposals. The staff expect this area of expected cost to be influenced mainly by a lessee's volume of leasing activity. The staff expect that most lessees would incur incremental costs in recognizing their leases on the balance sheet. Agenda Paper 3C/FASB Memo 264 addresses the application of the core recognition and measurement proposals to "small-ticket" leases.

(b) The ongoing costs of reassessing the lease liability for changes in lease term, discount rate, and variable lease payments linked to an index or a rate.

(c) The costs involved in separating lease and non-lease components in a single contract.

(d) The ongoing costs of the increased qualitative and quantitative disclosure requirements.

(e) The modified retrospective transition method.

Areas of costs and complexity relating to the lessee accounting model

99. The main areas of costs and complexity relating to the lessee accounting model are as follows:

	Initial costs	**Ongoing costs**
Lease classification	√	√
Transition and effects of change for existing leases	√	X
IT systems / process changes	√	√

100. Each of these topics are discussed in the following paragraphs.

101. In addition, feedback from preparers indicates the following when considering the costs and complexity of changing existing lessee accounting requirements:
    (a) Many preparers indicate that the management of leases is very often decentralized within each operating location or subsidiary, unlike for example pension schemes or hedging transactions, which are often managed centrally for the entire reporting group.
    (b) Any aspect of the requirements that cannot be automated and requires human intervention (for example, the application of judgment) is often viewed as being more costly to apply in the long-term than any requirements that can be automated.

102. Many of the comments regarding costs and complexity indicate that, in the respondent's view, the costs of implementing the proposals would be very significant. Although some comment letters provide more detailed information about the drivers of those costs, many comment letters do not provide extensive detail to understand exactly which aspects of the proposed requirements would create the costs and complexity and, thus, which of the possible approaches would be the least costly to implement.

Lease classification

103. The staff analysis of complexity relating to the lessee accounting model focuses on the lease classification test (that is, how much judgment would be required to apply the test and how much revised or new information would the lessee be required to accumulate and/or take into account when classifying leases?)

104. Regarding lease classification, preparers' views are quite mixed about the amount of cost associated with lease classification. Many preparers view the complexity involved in classifying leases in the 2013 ED as a major area of concern. In particular, many question how to interpret terms such as "insignificant," "major part," and "substantially all." Other areas of concern relate to distinguishing between property and non-property assets and determining the economic life.

105. Some preparers view the costs and complexity associated with lease classification, both initially and on an ongoing basis, as being so significant that they would propose a single lessee accounting model. A number mentioned the decentralized management of leases as being an important driver of complexity in this respect because the assessment of lease classification would be done at each location/subsidiary within the group. Many of these preparers would prefer any single lessee accounting model over any dual model. They note that the application of judgment can lead to differences in application, and some were concerned about a lack of comparability within particular industry sectors.

106. Others preparers disagree and support a dual model. They think any cost associated with lease classification is more than outweighed by the benefit of better reflecting the differing economics of leases by having a dual model. They also indicate that they do not expect costs associated with lease classification to be excessive, often because they would implement internal accounting policies that would reduce the judgment that could be applied at individual locations/subsidiaries.

Staff analysis

107. A lessee would account for all leases in the same manner under Approach 1. Approach 1 is, therefore, the least complex of the possible approaches, both initially and on an ongoing basis. Because all leases would be classified in the same manner, lessees would not have to apply any judgment, nor would they need any specific information (such as the economic life or the fair value of the underlying asset) in order to determine lease classification.

108. Approaches 2 and 3 are dual models, and therefore, require a lease classification analysis. Although there is clearly a cost associated with classifying leases, the staff consider the lease classification tests to be applied under both of those Approaches to be substantially less complex than the lease classification tests proposed in the 2013 ED. This is because neither approach requires a lessee to apply a new term, “insignificant,” when classifying leases. Approach 3 retains lease classification that is familiar to IFRS preparers, and very similar to the lease classification test already applied by U.S. GAAP preparers. Approach 2 requires the identification of property

and non-property leases, but does not require any classification test of leases of assets other than property.

109. On an ongoing basis, the lease classification test under Approach 2 provides simpler lease classification requirements than the IAS 17-like test that would be applied under Approach 3. This is because Approach 2 classifies all leases of assets other than property as Type A leases without any further analysis. This reduces judgment and enhances comparability. A lessee would generally classify property leases in the same manner under Approaches 2 and 3. Therefore, there is likely to be little difference with respect to complexity for leases of property between those two approaches.

110. However, *some* of the simplification that would result from the default classification of all leases of assets other than property under Approach 2 would likely be offset by the requirement under that approach to assess the nature of the underlying asset as property or other-than-property. In general, a lessee would consider land and buildings (or portions thereof) to be property and most other assets to be other-than-property. However, a lessee would also consider "integral equipment" to be property under Approach 2. The assessment of whether a particular asset is "integral equipment" is not always straight-forward, and may require estimates and judgments by the lessee. Therefore, for leases with land and/or building elements as well as equipment, a lessee would be required to establish whether the equipment meets the definition of property.

111. The staff think that, initially, Approach 3 may be easier to apply than Approach 2 because the vast majority of leases would be classified as they are today (that is, capital/finance leases as Type A and operating leases as Type B). In addition, despite the complexities that exist under both existing U.S. GAAP and IFRS, we understand that most leases are classified easily without detailed analysis.

112. Additionally, some staff are not convinced that the lease classification test under Approaches 2 or 3 would involve significant costs for lessees. Based on field visits with some lessees, we think at least some lessees would establish policies that take a significant portion of the judgment aspect out of the lease classification process

(for example, some lessees have indicated that they would apply reasonable quantitative thresholds as a matter of accounting policy to terms such as "major part" or "substantially all").

Transition and the effects of change for existing leases

113. Assuming a transition approach that is similar to that proposed in the 2013 ED, the staff think that Approach 3 is likely to provide some significant cost savings with respect to transitioning existing leases to the new model as compared to the other two possible approaches. This analysis is based on the following points:

    (a) Approach 3 would retain existing income statement and statement of cash flows results for the vast majority of leases. Therefore, most lessees would not need to restate their operating results as part of transition and could probably retain the lease classification outcomes for their existing leases.

    (b) Based on the Boards' current tentative decisions, all Type B leases would be eligible for a simplified retrospective method whereby the ROU asset would typically be measured at an amount equal to the lease liability (measured at the present value of the remaining lease payments at the date of initial application). Approach 3 would classify the vast majority of existing operating leases as Type B leases. Consequently, this simplified transition method would apply to almost all leases that were not previously capitalized as capital (finance) leases. Practically, the information necessary to capitalize these leases in retrospective balance sheets should exist from the information the lessee had to compile to meet existing lease disclosure requirements (the table of lease commitments) and the information the lessee had to track in order to account for any prepaid or accrued rents.

    (c) In some jurisdictions, existing lease accounting aligns to income tax reporting. Approach 3 would produce transitional savings because lessees would generally not have to revisit their existing deferred income tax accounting.

114. Approach 1 would require a more complex transition method for all leases and Approach 2 for most leases of assets other than property under the Boards' current tentative decisions. For Type A leases, the ROU asset at initial application is a derived figure requiring a separate calculation from that performed for the lease liability. In addition, both of these approaches would require a lessee to restate the income statement and statement of cash flows for retrospective periods. When combined with potentially complex transition for the new revenue recognition standard, as well as for financial instruments and insurance for some entities, a simpler transition for leases would reduce the burden on scarce resources and the need to incur additional costs (such as for external consultants, etc.).

115. In some jurisdictions, existing lease accounting aligns to other nonfinancial (for example, regulatory) reporting as well as income tax reporting. It is unknown whether those jurisdictions would update the income tax and other nonfinancial reporting requirements to align to the new leases accounting guidance. In the event that those requirements are not updated, or are not updated in the near-term, Approach 3 would generally provide cost savings to lessees in those affected jurisdictions by not requiring separate tax or other reporting based on requirements that differ from the new leases guidance.

116. Nonetheless, many of the transition costs associated with Approaches 1 and 2 noted above could be addressed by changing the transition requirements. For example, the Boards could decide to amend the transition requirements similarly to the revenue recognition proposals to *not* require the restatement of comparative periods. Under Approach 2, given that the majority (by value) of leases are expected to be Type B leases, the Boards could decide to permit a lessee to apply the simplified measurement of the ROU asset to Type A leases as well as Type B leases. In addition, some of the transition concerns raised could be addressed by permitting sufficient time between publication of the final standard and the effective date to allow preparers to stagger major implementation projects. Fieldwork participants indicated that the timing of the effective date could have a significant effect on the costs of transition.

IT systems and accounting processes

117. In comment letters and at outreach meetings, a significant number of preparers mentioned the need to implement new IT systems as a significant cost driver. However, there is very little detail provided about how preparers would plan to implement the requirements and, thus, little detail on which to assess the relative systems costs of each of the approaches. This is largely because most software providers have yet to develop new IT systems that could be used to apply any new lessee model. Nonetheless, the staff has spoken to a number of software providers and consultants in order to better assess the relative costs of systems changes required for each of the approaches.

118. Most lessees are likely to require incremental system requirements because of the volume of their leasing activity, regardless of the lessee accounting approach selected in this paper. The most significant systems costs are likely to be associated with recognizing leases on a lessee's balance sheet and reassessing the measurement of the lease liability, as opposed to how those leases are accounted for in the income statement. For example, although most lessees are likely to have processes in place to account for existing capital/finance leases, those processes may be largely manual or unsophisticated because we understand that most lessees do not have a significant volume of existing capital/finance leases. To the extent that a lessee already has a sophisticated system for its existing capital/finance leases that is capable of handling a significantly increased volume of leasing activity, that lessee's systems costs would be expected to be relatively small, particularly under Approach 1.

119. The staff think that a single model for all leases (that is, Approach 1) would require the least system requirements because it would negate any need for multiple system requirements and processes for dealing with different types of leases. Accordingly, it would be the least costly from a systems perspective. The significance of the cost reduction compared to the other approaches, however, is difficult to assess. Meetings with systems providers indicate that the cost reduction related specifically to the IT systems would not be expected to be very significant compared to

Approach 2 or Approach 3. This is because Type A accounting and Type B accounting are very similar (that is, the Type A and Type B lease liabilities are measured in the same way both initially and subsequently; the Type A and Type B ROU assets are measured in the same way at lease commencement and both are amortized; the only difference relates to the amortization method). Because of this, there is not much difference in Type A accounting and Type B accounting from a software architecture perspective. One fieldwork participant estimated a cost reduction from a systems development perspective of 14% if the boards were to propose a single Type A model, rather than the dual model proposed in the 2013 ED. A consultancy with whom the staff engaged indicated that somewhere between 90-95% of the coding in its software tool would remain constant regardless of whether the Boards adopted a single Type A model, a model roughly equivalent to the 2013 ED, or a model that resulted in all leases being accounted for as Type B leases.

Effects of changing existing lease requirements on tax and other reporting requirements

120. In some jurisdictions, income and other tax accounting related to leases is based on existing U.S. GAAP or IFRS. To the extent those jurisdictions do not update or adjust their tax regulations for a final leases standard, Approach 3 is likely to have the least effect on a lessee's tax accounting and reporting, including accounting for deferred taxes in the U.S. GAAP or IFRS financial statements. This is because Approach 3 effectively retains the existing income statement treatment for leases.

121. Approach 3 would also solve some regulatory accounting and reporting issues in some jurisdictions. For example, some U.S. government contractors have expressed concern with obtaining reimbursement for lease costs characterized as interest in the income statement. Income statement results that are in-line with existing lease accounting will likely alleviate that issue.

Other costs

122. Particularly to the extent that a lessee has complex or non-standard leases, there can be incremental costs associated with a dual lessee model resulting from the need to provide evidence and explanations about the accounting conclusions reached. This could include disclosures in the notes to the financial statements. In addition, a dual model would require entities to maintain effective internal controls over the lease classification process (and have them audited). Approach 1 would not require these costs, and therefore would be the least costly approach in this respect.

Other considerations—the effect of Type A leases on a lessee's income statement and equity

123. Many preparers have expressed concerns about the Type A lease expense profile (that is, the front-loaded total lease expense effect of an individual lease). They think that this total lease expense profile would not reflect the economics of most leases for which the benefit of the contract is consumed by the lessee evenly over the lease term.

124. Nonetheless, it is important to note that the front-loaded expense effect from Type A accounting would only affect a lessee's net income. The front-loaded effect would not affect other important GAAP and non-GAAP measures such as operating income, EBIT, EBITDA, or EBITDAR because interest expense on the lease liability would be excluded from those measures.

125. In addition, the staff think that the reducing lease expense recognition profile included in net income would likely not be significant in many circumstances because of the effect of holding a portfolio of leases that begin and end at different times. One constituent that participated in the public roundtables discussed having over 1,000 leases, with 50 or 60 lease renewals or extensions every month. The staff find it hard to imagine that there would be any significant front-loaded effect on a portfolio of leases of this nature.

126. In addition, if a lessee is regularly entering into lease renewals or extensions, even in a steady state leasing environment, the lease expense under Type B accounting

would not be "straight-line" between periods if those renewals or extensions include changes in lease payments (for example, for inflation or for other market-based rental factors). The total lease expense would also not be equal between periods if leases include variable lease payments.

127. Nonetheless, Type A accounting does have an effect on the equity of a lessee, even when a lessee has a portfolio of leases. This is because the carrying amount of the ROU asset would typically be lower than the carrying amount of the lease liability at every reporting date between lease commencement and the end of the lease. As a consequence, Type A accounting would result in a reduction in reported equity when compared to existing operating lease accounting and Type B accounting. The actual effect on a lessee's reported equity of applying Type A accounting to leases classified as operating leases would depend on the lessee's leverage, and on the ratio of the lease liability to equity. This in turn depends on the proportion of assets the lessee owns, the proportion of assets leased and how the lessee finances its operations.

128. Further information about the effects of applying Type A accounting on a lessee's income statement (including the portfolio effect) and reported equity is included in the IASB's 2013 ED Basis for Conclusions, Appendices B and C.

Other options considered but rejected

129. The staff considered, but ultimately rejected, two additional approaches:

    (a) Retention of the dual-approach proposed in the 2013 ED.

    (b) Accounting for all leases as Type B leases (that is, a lessee would recognize a single lease expense for all leases).

Option (a)

130. The staff rejected option (a)—retaining the dual approach proposed in the 2013 ED. This is because this option would have applied the same concept as Approach 2 in

this paper, but the staff viewed the adjustments made to the 2013 ED lease classification test in Approach 2 as improvements to the proposals in the 2013 ED. Those improvements would address some of the main concerns raised by constituents in response to the 2013 ED. Consequently, the staff concluded that it would not be worthwhile to propose retention of the lease classification test as proposed in the 2013 ED as a possible approach.

Option (b)

131. The staff rejected option (b)—applying Type B accounting to all leases. This is because the staff think that accounting for *all* leases as Type B leases (including those classified as capital/finance leases under existing U.S. GAAP/IFRS) would not appropriately reflect the economics of those leases. Even most constituents (users *and* preparers) that expressed a preference for the results under Type B lessee accounting acknowledge that some leases are effectively purchases of the underlying asset. Most of those constituents accept applying existing capital (finance) lease accounting to those leases.

132. In addition, the staff think that option (b) would provide inappropriate opportunities for structuring. For example, an entity could structure the purchase of a piece of equipment with a 10 year economic life as a "lease" of that equipment for 10 years, resulting in substantially different accounting from a comparable entity that bought the same piece of equipment with supplier or third-party financing. The lessee in this example would recognize a single (typically straight-line) total lease expense over the lease term, while the comparable entity would recognize depreciation of the purchased equipment and interest expense on the financing obtained to purchase the equipment.

133. The staff think that Approach 3 appropriately presents the Boards with an alternative to account for all "true leases" in accordance with what many view as the underlying economics of those transactions. At the same time, Approach 3 appropriately accounts for leases for which the lessee obtains control of the underlying asset in the same manner as a financed purchase.

Staff Views

Single model versus dual model

134. The staff, like much of the Boards' constituency, is split on whether the Boards should adopt a single Type A lessee accounting model (that is, Approach 1) or adopt a dual model (that is, either Approach 2 or Approach 3).

135. Those staff members that support Approach 1 think that this approach would be the simplest (that is, least costly and complex) to apply in the long-term, would provide the most useful information to users, and is the most conceptually supportable. These staff members recall the opposition to FAS 13 when it was published, and think that there would continue to be vocal opposition to any new leases guidance that proposes to recognize leases on a lessee's balance sheet, regardless of how a lessee depicts the lease in the income statement. These staff are of the view that the principal opposition to Approach 1, that of the front-loaded expense effect, is both overstated and potentially overly influenced by the view of leases perpetuated by the longstanding FAS 13 (Topic 840) and IAS 17 standards. These staff members think that a ROU model is best expressed through a single Type A lessee model.

136. Those staff members supportive of a dual model think that not all leases are the same, and that many, if not most, leases are not the same economically as a purchase of the underlying asset or the purchase of other nonfinancial assets. These staff also recall that a single Type A model was previously exposed twice (that is, in the 2009 DP and the 2010 ED), and that a large proportion of comment letters expressed the view that this model would not appropriately reflect the economics of all leases. Those staff members preferring a dual lessee model as their first choice support Approach 3 for the reasons outlined in the next sub-section.

Dual model approach

137. If the Boards conclude that a dual lessee model should be retained, the staff remain split between Approaches 2 and 3.

138. Those that support Approach 2 generally support Approach 1 as their first choice (however, not all staff that support Approach 1 as their first choice, support Approach 2 as their second choice). Their support for Approach 2 as compared to Approach 3, therefore, is at least partially influenced by the fact that a majority of leases (numerically, not by value) would retain Type A lessee accounting under Approach 2. These staff members think that applying Type A accounting (that is, presenting amortization of the ROU asset separately from interest on the lease liability) to leases of assets other than property provides useful information to users. These staff members also generally think Approach 2 will be easier to apply than Approach 3 in the long-term because Approach 2 would not require any lease classification for leases of assets other than property. This would remove the complexity of lease classification for the majority (by number) of leases.

139. Those staff that support Approach 3 over Approach 2 do so largely because they think that Approach 3 best reflects the economics of leases based on the rights and obligations conferred as a result of the lease. They also remain unconvinced that consumption of the underlying asset equates to a partial purchase of the underlying asset that is equivalent to the purchase of that entire asset or any other nonfinancial asset. Therefore, distinguishing between those leases that are, in substance, purchases of the underlying asset and those that do not convey similar rights and obligations to the lessee is, in their view, the most appropriate lessee accounting approach. These staff also think that Approach 3 would be less costly than Approach 2 (as well as Approach 1) in transition, and would remain less costly to apply than Approach 2 over the long-term for the reasons outlined earlier in the paper.

Questions: Lessee Accounting Model
Question #1 – Do the Boards have any questions on the proposed approaches? Question #2 – Are there any other approaches that the Boards think the staff should explore?

APPENDIX A: Lessee Lease Classification Guidance (2013 ED and Existing IFRS/U.S. GAAP)

The following paragraphs set out the lease classification proposals from the 2013 ED:

A1. At the commencement date, an entity shall classify a lease as either a Type A lease or a Type B lease. An entity shall not reassess the classification after the commencement date.

A2. If the underlying asset is not property, an entity shall classify a lease as a Type A lease unless one of the following two criteria is met:

(a) the lease term is for an insignificant part of the total economic life of the underlying asset; or (b) the present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type B lease.

A3. If the underlying asset is property, an entity shall classify a lease as a Type B lease unless one of the following two criteria is met:

(a) the lease term is for the major part of the remaining economic life of the underlying asset; or

(b) the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type A lease.

A4. Notwithstanding the requirements in paragraphs A2-A3, a lease is classified as a Type A lease if a lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

A5. If a lease component contains the right to use more than one asset, an entity shall determine the nature of the underlying asset on the basis of the nature of the primary asset within the lease component. An entity shall regard the economic life of the primary asset to be the economic life of the underlying asset when applying the classification criteria in paragraphs A2-A3.

A6. Notwithstanding the requirements in paragraph A5, if a lease component contains both land and a building, an entity shall regard the economic life of the building to be the economic life of the underlying asset when applying the classification criteria in paragraph A3.

Classification of leases (IAS 17)

A7. The following paragraphs set out the lease classification guidance from IAS 17:

> 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.

13. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7-12 if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

14-15 [Deleted]

15A When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7-13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.

16. Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

17. For a lease of land and buildings in which the amount that would initially be recognised for the land element, in accordance

with paragraph 20, is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification and classified as a finance or operating lease in accordance with paragraphs 7-13. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.

18. Separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted. Detailed calculations are required for this assessment only if the classification of one or both elements is otherwise uncertain.

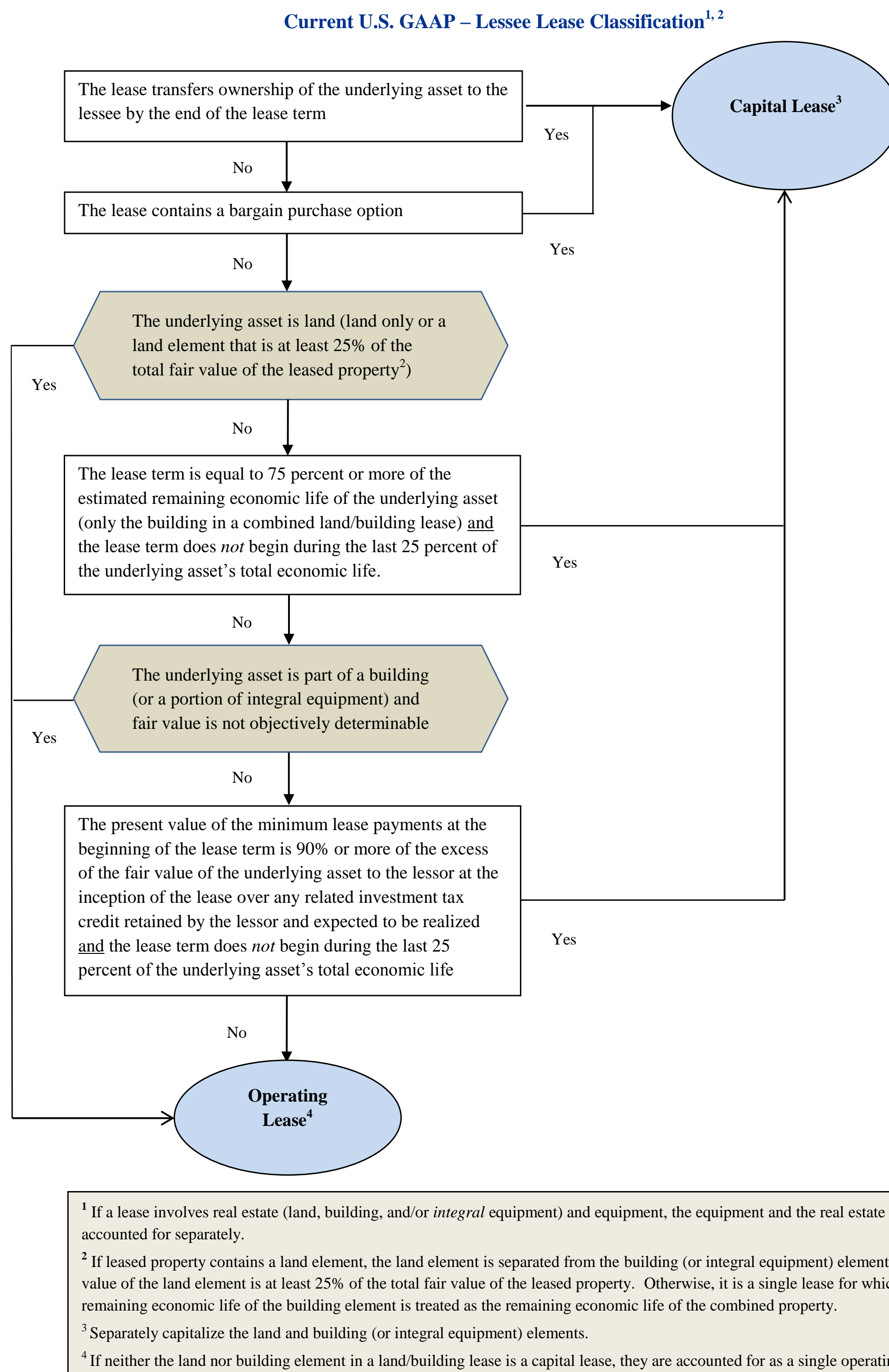
19. In accordance with IAS 40, it is possible for a lessee to classify a property interest held under an operating lease as an investment property. If it does, the property interest is accounted for as if it was a finance lease and, in addition, the fair value model is used for the asset recognised. The lessee shall continue to account for the lease as a finance lease, even if a subsequent event changes the nature of the lessee's property interest so that it is no longer classified as investment property. This will be the case if, for example, the lessee:

(a) occupies the property, which is then transferred to owner-occupied property at a deemed cost equal to its fair value at the date of change in use; or

(b) grants a sublease that transfers substantially all of the risks and rewards incidental to ownership of the interest to an unrelated third party. Such a sublease is accounted for by the lessee as a finance lease to the third party, although it may be accounted for as an operating lease by the third party.

Classification of leases (Current U.S. GAAP)

A8. The following chart sets out the classification guidance from ASC Topic 840:



[1] If a lease involves real estate (land, building, and/or *integral* equipment) and equipment, the equipment and the real estate elements are accounted for separately.

[2] If leased property contains a land element, the land element is separated from the building (or integral equipment) element if the fair value of the land element is at least 25% of the total fair value of the leased property. Otherwise, it is a single lease for which the remaining economic life of the building element is treated as the remaining economic life of the combined property.

[3] Separately capitalize the land and building (or integral equipment) elements.

[4] If neither the land nor building element in a land/building lease is a capital lease, they are accounted for as a single operating lease.