STAFF PAPER

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Project	**Leases**		
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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"), as well as the Boards' discussion at their January 2014 joint meeting.

2. This paper is structured as follows:

   (a) Overview

   (b) Background to the lessee accounting model

   (c) Proposed lessee accounting approaches

   (d) Staff analysis of the proposed approaches

   (e) Approach variations

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

3. This paper is similar in many respects to Agenda Paper 3D/FASB Memo 265 discussed by the Boards at their January 2014 joint Board meeting. The main changes compared to that January Board paper relate to the following:

   (a) Approach 1A, described below, has been added to the paper.

   (b) The paper includes a new section— "Approach variations", which includes additional considerations for the Boards on the basis that, for most lessees, the principal difference in income statement outcomes between Approaches 1, 2 and 3 relates to whether a lessee would recognize and present:

      (i) The total lease expense as an operating expense; or

      (ii) Interest on the lease liability (as a financing expense) separately from amortization on the ROU asset (as an operating expense).

4. This paper does not include a staff recommendation because the staff are divided in their views regarding the lessee accounting model. For this reason, the staff think that there is little benefit for the Boards in setting out those differing views.

Overview

5. The staff are proposing four 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 1A* – Proposes a dual approach that would *permit* (but not require) lessees to account for most property leases as Type B leases (that is, recognizing a single lease expense rather than amortization and interest

separately). This approach proposes two possible ways to determine which leases of property would be eligible for Type B accounting.

(c) *Approach 2* – Proposes 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.

(d) *Approach 3* – Proposes a dual approach, with lease classification determined in accordance with the principle in existing lease requirements (that is, determining whether a lease is effectively an installment purchase by the lessee). Under this approach, 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.

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

Existing U.S. GAAP (IFRS)	**Approach 1**	**Approach 1A**		**Approach 2**		**Approach 3**
Capital (Finance)	Type A	Type A		Type A		Type A
Operating	Type A	*Non-Property* Type A	*Property* Type A *OR* Type B	*Non-Property* Type A	*Property* Type B	Type B

7. The March 2014 Agenda Paper 3E/FASB Memo 272, 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

8. Agenda Paper 3D/FASB Memo 265 discussed by the Boards at their January 2014 joint Board meeting included background to the lessee accounting model, including:

   (a) A discussion of the 2009 *Leases* Discussion Paper and the 2010 *Leases* Exposure Draft, including high level feedback on the lessee accounting model proposed.

   (b) A discussion of the 2013 ED and the feedback on the lessee accounting proposals included in that ED.

9. We have not repeated that information in this paper—for further information regarding the background to the project or the feedback received on the 2013 ED, please refer to Agenda Paper 3D/FASB Memo 265 from the January 2014 joint Board meeting.

Proposed lessee accounting approaches

10. All four of the proposed lessee accounting approaches set out in this paper would require the following for all leases (other than short-term leases):

    (a) At lease commencement, the recognition of a lease liability (initially measured at the present value of lease payments) and a ROU asset (generally measured at an amount equal to the lease liability), presented on a gross basis in the balance sheet.

    (b) Subsequent measurement of the lease liability at amortized cost using the effective interest method.

Approach 1 – Single Type A lessee accounting model

Overview of Approach 1

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

    (a) A lease liability, initially and subsequently measured as described earlier in this paper.

    (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.

12. 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

13. 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). The 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.

14. Under Approach 1, a lessee would recognize the components of the lease (that is, the ROU asset and the lease liability) 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 ROU asset. There is no relationship

between the pattern of consumption of benefits from the ROU asset and the manner of financing.

15. 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, no performance is required of the lessor in the context of the right-of-use. The lessor is only required not to do anything that would violate the lessee's right to use the underlying asset.

16. Although there are different types of leases (just as there are different types of purchase agreements and license arrangements), Approach 1 takes the view that all leases give rise to a nonfinancial ROU asset at lease commencement, and a lessee should account for these ROU assets in a manner consistent with other nonfinancial assets.

17. By comparison, *each* of the other three lessee approaches proposed in this agenda paper conclude that many leases are substantially different from the purchase of a nonfinancial asset (whether a tangible good or a license to intellectual property). Accordingly, different accounting from that of an asset purchase, financed over time, is reasonable (Approach 1A), or appropriate (Approach 2 and Approach 3) in order to reflect the different economics underlying those leases.

Approach 1A– Approach 1 with an option for property leases

Overview of Approach 1A

18. Approach 1A is based on Approach 1—a single Type A model—that would permit (but not require) a lessee to apply Type B accounting to property leases in specified circumstances.

19. Approach 1A could work in either of the following two ways:

    (a) Alternative 1 – A lessee would be permitted to apply Type B accounting to all leases of property for which the lessee does not obtain control of the property as a result of the lease.

    (b) Alternative 2 – A lessee would be permitted to apply Type B accounting to leases of property for which the lessee is expected to consume an insignificant portion of the property.

20. Alternative 2 would narrow the circumstances in which a lessee would be permitted to apply Type B accounting. This would have the benefit of reducing the comparability issues that might arise from proposing the wider option in Alternative 1.

21. Alternative 2 would use the consumption principle in the 2013 ED to determine when applying Type B accounting would provide useful information. Alternative 2 could, however, result in one entity applying both Type A accounting and Type B accounting to its existing operating leases of property. It could also result in, for example, one clothing retailer being permitted to apply Type B accounting to its property leases and another not when the second retailer has a strategy of entering into longer-term retail leases. Supporters of Alternative 2 would conclude that this outcome is appropriate because Type B accounting would *only* provide more useful information than Type A accounting when the property is not expected to be consumed by the lessee. Nonetheless, some preparers with significant property leases and users of those preparers' financial statements may not view such a restriction as helpful. Alternative 2 is also likely to be more complex than Alternative 1.

22. If the Boards choose Approach 1A, on balance, the staff would recommend Alternative 1 for simplicity reasons. Although there could be benefits in narrowing the application of the option for comparability reasons, some staff are not convinced that Alternative 2 would, in practice, improve comparability.

23. Throughout the remainder of this agenda paper, references to Approach 1A assume the election of Alternative 1 with respect to the development of the approach.

Rationale for Approach 1A

24. The rationale for Approach 1A 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).

25. Nonetheless, Approach 1A would 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 option to apply Type B accounting would be provided on the basis that it would permit a lessee to better reflect the economics of most property leases. Accordingly, it could provide more useful information about those leases to users than applying Type A accounting.

26. By permitting, but not requiring, the application of Type B accounting for most property leases, Approach 1A:

    (a) Addresses some of the cost and complexity concerns raised by constituents about applying a dual model. It does so by permitting a lessee to apply a single Type A model, which many users indicated would provide useful information; and

    (b) At the same time, permits Type B accounting for entities, such as retailers and hoteliers, for which the industry-specific analysts that follow those sectors indicated support for the recognition of a single lease expense for most property leases, as would be the outcome for Type B leases.

Approach 2 – Simplified version of 2013 ED lease classification test

Overview of Approach 2

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

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

    (a) A lessee would account for leases of property 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), a lessee 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 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.

Rationale for Approach 2

29. The rationale for Approach 2 is similar to the rationale supporting the dual model proposed in the 2013 ED, which concludes that the economics of most property leases are different from the economics of most leases of assets other than property. Accordingly, Approach 2 suggests that a lessee would provide better information about its leases if the lessee would apply a dual model that distinguishes between most property leases and all other leases. 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.

30. When a 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. Rather, it 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.

31. In contrast, when a 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:

    (a) Obtain a return on its total investment in the underlying asset; and

    (b) 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.

32. 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 agenda 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 agenda 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 between Approach 2 as compared to the 2013 ED. 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

33. 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 result 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."

34. 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 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.

35. When a lessee obtains control of the underlying asset, the lessee would account for the lease in the same manner as it would the purchase of the underlying asset (that is, in accordance with Type A accounting). A lessee would account for all other leases as Type B leases.

36. 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 would 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 criterion (criterion c) would not be met.

37. Under Approach 3, a lessee would assess land and other elements separately for purposes of lease classification when necessary, unless the land element is clearly immaterial.

Rationale for Approach 3

38. Approach 3 starts from the premise that a lease in which the lessee obtains control of the underlying asset (Type A lease) is effectively a purchase of the underlying asset by the lessee. Therefore, the lessee should account for it in the same manner as a purchase of the underlying asset (by applying Type A accounting).

39. Approach 3 then proposes a single accounting model for all leases that are not effectively purchases of the underlying asset (Type B leases). Approach 3,

therefore, proposes to account for those leases differently from the purchase of a nonfinancial asset and also differently from those leases (Type A leases) that are *effectively* purchases.

40. Approach 3 takes the view that Type B leases (that is, those that are not effectively purchases of the underlying asset) 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, a lessee's accounting for a lease does not have to conform to comparable accounting for a purchased asset or a services contract. Type B leases can also 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. However, the staff note that bankruptcy law varies by jurisdiction; therefore, this may or may not apply to some other jurisdictions.

    (a) A Type B 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 outright (either on credit from the supplier or through third-party financing). In general, obligations with respect to leases that would be classified as Type B under Approach 3 do not survive bankruptcy. In contrast, obligations with respect to purchased assets, licenses, and those leases that would be classified as Type A under Approach 3 do survive in bankruptcy.

    (b) A Type B lease is also not equivalent to a service contract because of the lessor's performance with respect to the right of use at lease

commencement. 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 Boards, in their forthcoming revenue recognition standard, have concluded that similar "passive" obligations in sales contracts do not transfer a promised good or service to the customer (for example, requirements to maintain exclusivity with respect to a license of intellectual property, to maintain or defend patent rights, or stand ready to accept product returns). Therefore, such obligations in sales or license contracts do not create additional performance obligations, nor affect when a good or license is considered to have been transferred to the customer. The staff think that, similarly, a lessor's "passive" obligations do not equate the lease to a service contract that requires continued "active" performance by the vendor.

41. Approach 3 proposes that the best reflection of the economics of a Type B lease to the lessee is recognition of a lessee's total lease expense based on 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 more faithfully represents the underlying economics of Type B leases than accounting for them in the same manner as purchases of the underlying asset. This is because those leases generally provide equal benefit to the lessee in each period during the lease term.

42. Although the lease itself is the unit of account under Approach 3, a lessee would be required to recognize and present separately the ROU asset and the lease liability (that is, the financial statement elements) that result from the lease (as is the case in any of the four approaches proposed in this agenda paper). This is 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 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).

43. The rationale for Approach 3 can also be considered from a pragmatic perspective. A single Type A lessee accounting model was previously exposed twice (in the 2009 DP and the 2010 ED). There was significant resistance to this path forward and no clear *consensus* from users that this model would always result in providing the most useful information to meet their needs. Similarly, although most constituents did not want the Boards to issue a final standard on the basis of the dual lessee model proposed in the 2013 ED, a majority of the Boards' constituents that commented on the 2013 ED expressed a preference for a dual lessee model. Only a minority of respondents disagreed with the view that there should be a dual lessee model.

44. Approach 3 further acknowledges that the principal perceived deficiency with respect to existing lessee accounting is in relation to the lessee's balance sheet. Although users often make adjustments to a lessee's income statement (and less frequently, the statement of cash flows), nearly all users consulted make adjustments to a lessee's balance sheet to capitalize operating leases. This corresponds with the fact that, throughout the project, there has been no consensus among constituents as a whole, including among users, as to the most appropriate lessee accounting model. There has been significantly more support overall, including from users, for recognizing lease assets and lease liabilities on a lessee's balance sheet.

45. Accordingly, Approach 3 can be viewed as targeting and addressing the principal deficiency in lessee accounting. It would explicitly require the gross presentation of a lessee's lease assets and lease liabilities. At the same time, it would not fundamentally change those aspects of lessee accounting (that is, the effects of lease accounting on the income statement and statement of cash flows) for which there is neither agreement that existing accounting is deficient nor a consensus on how to correct any perceived deficiency.

46. Type B accounting is described in the following four paragraphs. This description applies equally to Type B leases under Approaches 1A and 2, as well as Approach 3.

47. 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 four 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).

48. 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.

49. 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. This is 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.

50. A lessee would present Type B ROU assets and lease liabilities on a gross basis (that is, separate from each other) under any of the three dual model approaches presented in this agenda paper. The presentation of ROU assets and lease liabilities are discussed in further detail in Agenda Paper 3B/FASB Memo 269.

Staff analysis of the proposed approaches

51. The staff evaluated each of the four approaches outlined above under three main headings— 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

52. The staff think that Approach 1 is the most supportable approach on the grounds of having a sound basis in the conceptual framework. 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).

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

    (a) Some place greater emphasis on having a model that aligns the accounting for the assets and liabilities arising from a lease with the accounting for other similar assets and liabilities, rather than other factors such as the underlying economics of the lease. 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, including many users, 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.

54. 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 for which an entity purchases a nonfinancial asset and pays for that asset over time.

55. Approaches 2 and 3 are premised on the view that not all leases are economically equivalent to the purchase of a nonfinancial asset that is typically paid for over time. Consequently, they should not be accounted for as such. Supporters of Approach 2 or Approach 3 conclude that accounting for all leases as if they *were* equivalent to the purchase of a nonfinancial asset 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 subsequent accounting for the financial statement elements that result from the lease.

56. Approach 2 and Approach 3 are different 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 those which do not. Broadly:

    (a) 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.

57. Approach 1A starts from the premise that Approach 1 (Type A accounting for all 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 1A would not prevent a lessee from applying Type A accounting to all leases. In addition, Approach 1A would limit the optional application of Type B accounting to only those leases for which, from an economic perspective, it might be more useful to present a single lease expense (rather than amortization and interest).

58. The staff think each of the approaches can be supported and that 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 and Approach 3 come from the view that not all leases are the same and therefore propose a dual model with different income statement results. To differentiate between those two models, Approach 2 focuses on consumption of the underlying asset in determining what a lessee is economically paying for in a lease and 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.

59. Nonetheless, we acknowledge that:

    (a) The conceptual basis for Approach 1A is questionable because it is an optional approach that permits lessees to apply different accounting to most property leases, which would impair comparability. Those leases represent a substantial proportion of all leases (by value).

    (b) Type B accounting would be applied to most leases under Approach 3 and most leases (by value) under Approach 2 (as well as Approach 1A if that were the lessee's election). Many constituents have expressed the view that Type B accounting could call into question whether a lessee has obtained an asset at lease commencement 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. However, the staff think that a lessee has obtained a ROU asset and incurred a lease

liability at lease commencement under any of the approaches proposed in this paper.

(c) From a conceptual standpoint, Approach 2 might be considered to confuse the unit of account by focusing on the underlying asset rather than the ROU asset. Under Approach 2, a lessee would apply 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

60. 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. Because Approach 1A incorporates aspects of Approach 1 and Approach 2, the feedback from users on Approach 1 and Approach 2 are relevant when assessing Approach 1A. We discuss the costs for users associated with Approach 1A at the end of this section.

Background

61. 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.

62. The relative benefit of the four 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.

63. 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.

64. 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.

65. 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).

66. 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 four 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

67. For those users who do not adjust the financial information reported by lessees, the proposed changes to a lessee's balance sheet under all four 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

68. Credit analysts are of the view that operating leases create assets and debt-like liabilities. All four 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.

69. A few credit analysts consulted, including some retail and hotel credit analysts, supported the income statement outcomes under Approach 2, and those that would also result under Approach 3 for property leases. The retail and hotel credit analysts indicated that:

    (a) They view leases as creating debt-like liabilities and, thus, would treat lease 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 four approaches would satisfy their information needs.

70. A few credit analysts, including some 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

71. 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.

72. 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 four 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.

73. 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.

74. 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. 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 four approaches would satisfy their information needs.

    (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 Approach 2 or Approach 3 would best satisfy their needs. Those analysts are likely to adjust the income statement information that they would receive under Approach 1 and Approach 1A (if the entities that they follow choose to apply a single Type A model).

75. 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. Approach 3 would provide the most useful information for these analysts.

76. 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). Approach 2 would provide the most useful information for these analysts.

Summary of benefits to users of the approaches

77. Taking into account all of the feedback received from users, Approach 1 would likely 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), particularly when assessing the operating performance of an entity. This is especially 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.

78. We 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."

79. For many of the same reasons as noted above for Approach 1, we think that Approach 2 would provide more useful information for users than Approach 3. The main difference between Approach 2 and Approach 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.

80. In preparing outreach materials to discuss with users, we 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)

81. 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.

82. 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.

83. However, the staff note that user views were not unanimous and some do not think that leases create debt-like obligations. Many users think there is merit to a dual-model approach and would prefer Approach 2 or Approach 3.

The costs for users of an optional approach (that is, Approach 1A)

84. Users generally tend to dislike options in accounting standards. This is because providing a choice of accounting treatment creates potential comparability issues, uncertainty and, often, additional cost and complexity for users. When analyzing an entity, it adds an extra step. First, the user must assess which optional treatment has been selected and then perhaps assess whether a different choice would result in significantly different amounts. Users also generally dislike options because they potentially permit an entity to choose the option that makes the entity look better and not necessarily the option that provides the most useful information to users. For these reasons, Approach 1A would add costs and complexity for users and may reduce the benefit of the information provided to users.

85. The above notwithstanding, the outcomes of applying Type A or Type B accounting may not be significantly different for some entities, particularly those with shorter-

term leases. The lease liability is measured in the same way for both Type A and Type B leases and there would often be little difference in a lessee's net income from applying Type A or Type B accounting. It is also unclear how many entities would choose to apply Type B accounting under Approach 1A. Approach 1A would be more complex than applying Approach 1 because a lessee would be required to classify its property leases if applying Type B accounting under Approach 1A—applying Type A accounting to all leases removes the need for classification. In addition, a lessee's earnings measure before interest would be lower under Type B accounting than under Type A accounting. Some entities are likely to view this as a reason *not* to apply Type B accounting and, instead, apply Type A accounting.

Costs and complexity

86. 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). Concerns raised about other aspects of the proposals in the 2013 ED will be addressed within other Board papers.

Areas of costs and complexity relating to the lessee accounting model

87. The main areas of costs and complexity relating to the lessee accounting model, which are discussed in the following paragraphs, are as follows:

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

88. 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.

89. Because Approach 1A permits a lessee to apply either Approach 1 or Approach 2 to its leases, the comments included in this section relating to Approach 1 and Approach 2 are also relevant for Approach 1A.

Lease classification

90. 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 or fair value of the underlying asset.

91. 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.

92. Other 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. They also note that they perform the same analysis for lease classification today as is proposed in Approach 3.

Staff analysis

93. A lessee would account for all leases in the same manner under Approach 1. Approach 1 is, therefore, the least costly of the possible approaches, both initially and on an ongoing basis, with regards to the costs of assessing lease classification. This is because a lessee would *not* be required to classify any of its leases. This would reduce the complexity, and associated costs, of the requirements—lessees would not be required to apply any judgment associated with terms such as "major part" and "substantially all", 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.

94. Approach 2 and Approach 3 are dual models and, therefore, require a lessee to classify at least some of its leases. Although there is clearly a cost associated with classifying leases, we 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 non-property assets.

95. 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 Approach 2 and Approach 3. Therefore, there is likely to be little difference with respect to complexity for leases of property between those two approaches.

96. However, *some* of that simplification 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.

97. We 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.

98. In addition, we are not convinced that the lease classification test under Approach 2 or Approach 3 would involve significant costs for lessees. Based on feedback received from field visits, 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").

IT systems and accounting processes

99. 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, preparers were generally unable to provide any detailed information about those implementation costs largely because most software providers have yet to develop new IT systems that could be used to apply any new lessee model. Nonetheless, we have spoken to a number of software providers and consultants to better assess the relative costs of systems changes required for each of the approaches.

100. 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, 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.

101. The staff think that a single model for all leases (that is, Approach 1) would require the least system requirements because it would negate the 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: Type A and Type B lease liabilities are measured in the same way both initially and subsequently; 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.

Type A versus Type B accounting

102. Many constituents have evaluated the potential costs of applying the new standard in the context of their existing processes for accounting for operating leases and providing the required disclosures (total lease expense and a maturity analysis of remaining lease payments). Some constituents have expressed the view that Type B accounting would be less costly to apply in that context than Type A accounting. This assertion appears to be premised, primarily, on the view that a lessee:

(a) Would largely be able to use its existing lease information on remaining noncancellable lease payments, augmented to include discount rate information, to establish the lease liability at each reporting date; and

(b) Already calculates a straight-line total lease expense under existing operating lease requirements.

103. Based on that as a starting point, a lessee may be able to measure the Type B ROU asset by reference to the lease liability. For example, as outlined above, when lease payments are even throughout the lease term (and there are no initial direct costs or lease incentives), the Type B ROU asset would equal the Type B lease liability at each reporting date.

104. However, when lease payments are not even or other items affect the measurement of the ROU asset (for example, impairment, initial direct costs, or lease incentives), the ROU asset would not equal the lease liability. At each reporting date, in determining the carrying amount of the Type B ROU asset, a lessee would need to adjust the carrying amount of the lease liability for the effect of these items or uneven payments. The staff note, however, that a lessee could monitor and track these items separately from the ROU asset itself within its accounting systems and simply present those items together with the ROU asset. Accordingly, the presentation of these items together with the ROU asset would not necessarily affect the accounting required for these items.

105. Lessees that would intend to apply Type B accounting in this manner would need to add an additional step to their process if the Boards retain the requirement in the 2013 ED to disclose separately the unwinding of the discount on the lease liability. This is because the process outlined above would not calculate that amount.

106. To apply Type A accounting in this context, a lessee could use the same process outlined above for Type B accounting to measure the lease liability if they wished to principally rely on existing lease information. This is because the lease liability is measured in the same way under any of the proposed lessee accounting approaches.

107. Then, *rather than* calculate the straight-line lease expense using the existing lease information, the lessee could use that same information to calculate the interest (or accretion) expense for the period.

108. Lastly, rather than measuring the ROU asset at each reporting date by reference to the lease liability, at lease commencement a lessee would enter the initial ROU asset carrying amount into its fixed asset system, together with the same inputs it uses for purchased fixed assets (for example, lease term and lease commencement date). Those inputs would be expected to be readily available to the lessee because the lessee would have used both of these pieces of information to establish the discount rate and measure the lease liability at lease commencement. Most fixed asset systems would then:

    (a) Automatically calculate the periodic ROU asset amortization; and

    (b) Automatically calculate the ROU asset carrying amount at each reporting date.

109. The staff think that, on balance, there would be no appreciable difference in complexity between the Type B accounting described in this section and that described for Type A accounting.

Other accounting process costs

110. A dual lessee model can result in incremental costs resulting from the need to provide evidence and explanations about the accounting conclusions reached, particularly when a lessee has complex or non-standard leases. 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.

Transition and costs associated with change

111. 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 during

transition 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, which would not be the case under Approach 1 or Approach 2. Therefore, under Approach 3, 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 a lessee would typically measure the ROU asset 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 comparative periods should exist from the information a lessee would have had:

   (i) To compile to meet existing lease disclosure requirements (the table of lease commitments); and

   (ii) 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 a lessee would generally not have to revisit their existing deferred income tax accounting.

(d) If an entity is implementing the new leases standard at the same time as implementing the new revenue recognition standard (and possibly financial instruments and insurance), a simpler transition for leases would reduce the burden on scarce resources and the need to incur additional costs (such as for external consultants).

112. 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.

113. Nonetheless, many of the transition costs associated with Approach 1 and Approach 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.

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

114. 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.

115. 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 aligned with existing lease accounting would likely alleviate that issue.

Other considerations

The effect of Type A leases on a lessee's income statement

116. 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 is consumed by the lessee evenly over the lease term.

117. 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 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.

118. 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 preparer 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.

119. In order to test this hypothesis more fully, the staff created two relatively large portfolios of leases, with varied lease payments, lease terms, lease commencement dates, and discount rates. The staff assumed that each lease, during a fifteen year period, had a predecessor lease and a successor lease with lease payments adjusted for inflation so as to create a "steady-state" environment. The result of this test was that the total lease expense recognized in each period was materially the same between the two total lease expense profiles (Type A or Type B).

120. The staff further tested scenarios in which a lessee would experience significant growth and significant decline. In these scenarios, the total lease expense varied more significantly during the years in which a large number of leases commenced or most leases had expired. However, the staff think that in times of significant growth or decline:

    (a) Lease expense would vary widely by *period* (for example, from Year 1 to Year 2), regardless of the lease expense profile (Type A or Type B); and

    (b) There would generally be other significant variations in income and expense, other than that resulting from leases during such periods (for example, increased headcount or R&D expenses during times of growth and impairment or restructuring charges during periods of decline).

121. 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 other market-based rental factors). The total lease expense would also not be equal between periods if leases include variable lease payments.

122. A lease software provider further tested the front-loading effect by setting up a portfolio of 50 property leases with differing lease terms and conditions, beginning and ending in different periods. The results of that test also confirmed that there is likely to be very little front-loading effect of applying Type A accounting—the effect on net income was estimated as approximately 1% of the periodic total contract cost.

123. A number of more recent academics studies have also investigated the effects on a lessee's net income of capitalising existing operating leases and accounting for those leases similarly to existing capital/finance leases (that is, similarly to Type A leases). They also indicate minor effects on a lessee's profitability ratios. Some earlier academic studies that used higher discount rates within their assumptions indicate a slightly bigger effect on a lessee's profitability ratios.

124. Based on this information, the staff think that the difference in income statement outcomes between the proposed lessee accounting approaches is one principally of *presentation*, rather than lease expense profile. In other words, the principal difference in outcomes is whether a lessee would recognize and present:

    (a) The total lease expense as an operating expense (Type B accounting); or

    (b) Interest on the lease liability as a financing expense and amortization of the ROU asset as an operating expense (Type A accounting).

125. The staff note, however, that this portfolio effect discussion does not change the fact that, for an individual lease, there is a front-loaded expense profile under Type A accounting, which some view as not appropriately reflecting the economics of *that* lease to the lessee.

The effect of Type A leases on a lessee's equity

126. Type A accounting would 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. In the test performed by the lease software provider described above, the effect on equity of applying Type A accounting was estimated as approximately 15% of the lease liability.

127. 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.

Approach variations

128. This section suggests that there is a variation to both Approach 1 and Approach 3 that the Boards may wish to consider as they assess the merits of each of the proposed lessee accounting approaches. Each of these possible variations is derived from the view that, from the staff's perspective, the principal difference in income statement outcomes between the approaches is one of *presentation* for most lessees. This is because the staff think that for most lessees the effect of any "front-loading" of total lease expense under Approach 1 (or possible "back-loading" of ROU asset amortization in the variation on Approach 3 discussed below) is largely negated. In fact, the more significant the entity's leasing activity, the more likely that the portfolio effect negates any front-loading (or back-loading) expense effect.

129. The staff have considered these variations largely because the staff understand that:

(a) IFRS generally requires the recognition of the unwinding of the discount on a liability as a financing expense (for expense, pension obligations and decommissioning liabilities, as well as other financial liabilities); while

(b) U.S. GAAP requires the recognition of the unwinding of the discount on particular liabilities that are not considered to be debt-like as an operating expense (for example, restructuring or contract termination liabilities and asset retirement obligations).

Approach Variation #1 – Approach 1 with single lease expense presentation

130. Similarly to Approach 1 set out earlier in this paper, a lessee's total lease expense for an individual lease would typically decrease over the lease term because:

(a) The effect of the unwinding of the discount on the lease liability decreases as the lessee makes payments; and

(b) The lessee would typically amortize the ROU asset on a straight-line basis.

131. However, in this variation of Approach 1, rather than presenting interest expense on the lease liability separate from amortization of the ROU asset, a lessee would present (a) the unwinding of the discount on the lease liability, and (b) the ROU asset amortization, together in the same income statement line-item within operating expenses. Accordingly, a lessee would present a single lease expense in its income statement.

132. This manner of income statement presentation may be more appropriate in jurisdictions (for example, the U.S.) within which the lease obligation can be characterized as operating in nature (that is, it is not considered debt in circumstances such as bankruptcy). This is because the effect of unwinding the discount on the lease liability may be best characterized as accretion expense when the liability is operating in nature. The U.S. GAAP Master Glossary defines accretion expense as follows:

> **Accretion Expense** - "An amount recognized as an expense classified as an operating item in the statement of income resulting from the increase in the carrying amount of the liability."

133. Under this variation, the staff think that it may be inappropriate to present a single lease expense for leases that are in-substance purchases. Accordingly, without adding any significant complexity, this variation could preclude presentation of a single lease expense for leases for which the lessee obtains title to the underlying asset as a result of the lease or for which the lease includes a purchase option that the lessee has a significant economic incentive to exercise.

134. As a result of the portfolio effect discussed above, the staff think that this variation on Approach 1 would likely result in income statement outcomes substantially equivalent to those that would result from Approach 3 for most lessees that have any significant volume of leasing activity. If a lessee has only minor leasing activity, the effect of any potential front-loading should not be significant to its financial statements. Compared to Approach 3, the staff note that this variation on Approach 1 would achieve a similar outcome in a lessee's

income statement but with a stronger conceptual basis (under either U.S. GAAP or IFRS) and without the complexity of a lease classification test.

Approach Variation #2 – Approach 3 with separate presentation of the components of the single lease expense

135. In this variation on Approach 3 (as set out earlier in this paper), a lessee would consider the single lease expense for Type B leases to be comprised of two expense components: (a) the unwinding of the discount on the lease liability, and (b) the amortization of the ROU asset. Unlike Approach 3 as proposed earlier in this paper, these two components would be presented separately in the lessee's income statement. The unwinding of the discount would be presented as a financing expense (that is, interest expense).

136. Although the interest and amortization would be presented separately, a lessee would recognize a total lease expense reflective of the pattern in which the benefit from the lease is consumed (generally, on a straight-line basis). This would be consistent with Approach 3.

137. As a result of the portfolio effect discussed above, the staff think that this variation on Approach 3 would likely result in income statement outcomes substantially equivalent to those that would result from Approach 1 for most lessees that have any significant volume of leasing activity. The staff note that this variation would retain separate presentation of interest expense on the lease liability and amortization of the ROU asset. At the same time, it would be responsive to those constituents that have expressed the view in all three exposure documents (that is, the 2009 DP, the 2010 ED, and the 2013 ED) that the straight-line recognition of total lease expense best reflects the lessee's economics in the lease.

Question: Lessee Accounting Model
Which approach do the Boards prefer, and why?

APPENDIX A: Lessee lease classification guidance (2013 ED and existing IFRS/U.S. GAAP)

Classification of leases (2013 ED)

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.

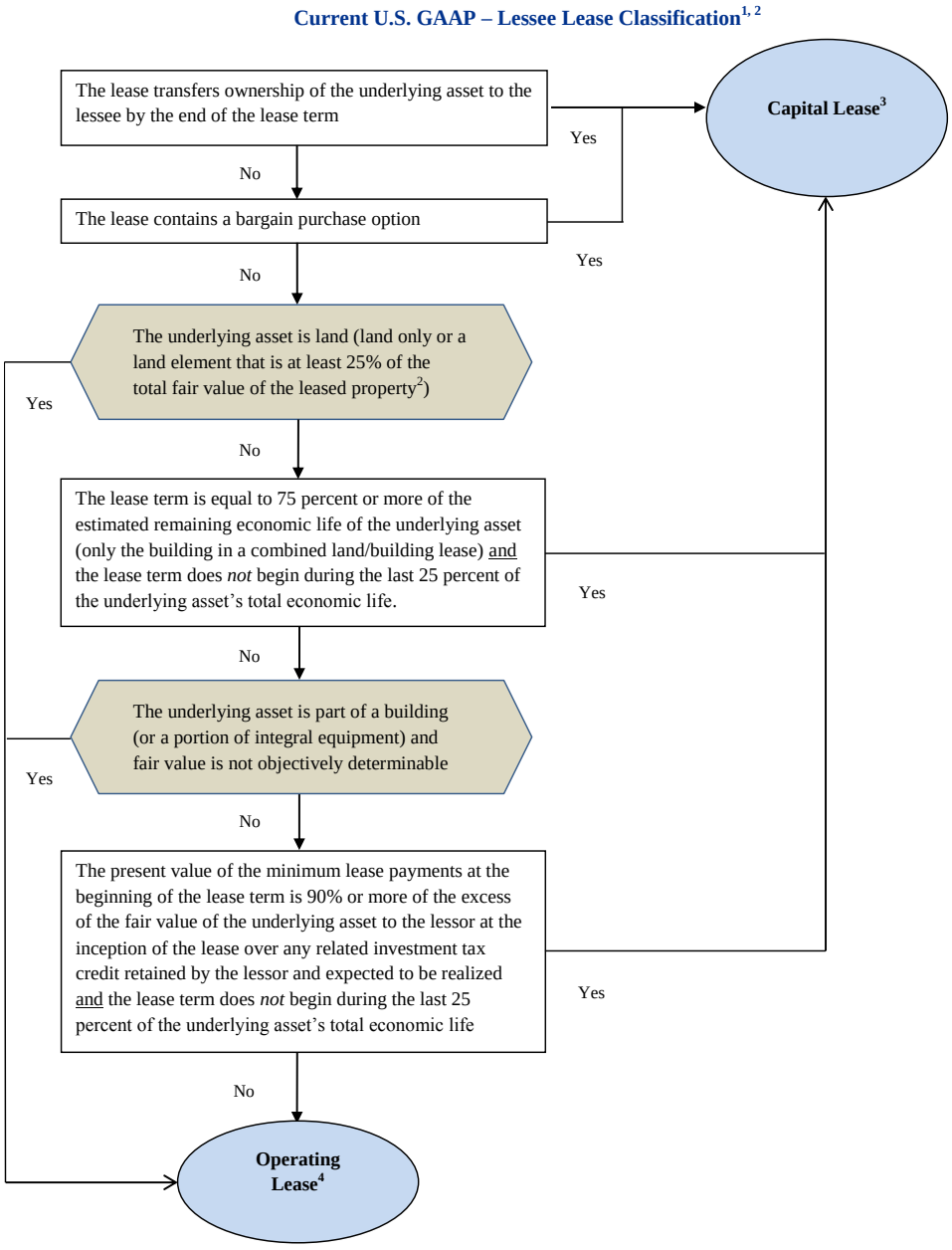
19. In accordance with IAS 40, it is possible for a lessee to classify a property interest held under an operating lease as an investment property. If it does, the property interest is accounted for as if it was a finance lease and, in addition, the fair value model is used for the asset recognised. 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.