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Accounting Journal Entry

Leases — FASB Continues Redeliberations

October 8, 2015 — Yesterday, at a FASB-only meeting, the Board discussed the feedback received on its confidential external review draft (i.e., “fatal flaw” draft) of its final guidance on accounting for leases. Specifically, the staff discussed feedback related to (1) the lessee’s subsequent accounting for an operating lease (formerly referred to as a “Type B” lease) after an impairment is recognized, (2) the recognition of initial direct costs in a sales-type lease, (3) the lessor’s presentation of its net investment in a lease, (4) the accounting for lease modifications that extend the term of a lease, and (5) when a lessee would be required to reassess lease classification. In addition, the FASB discussed certain alternatives for nonpublic business entities that were proposed by the Private Company Council.

Subsequent Accounting for an Operating Lease After the Recognition of an Impairment

The FASB staff highlighted that feedback received on the fatal flaw draft indicated that the guidance illustrating the lessee’s accounting for an operating lease after it impaired the right-of-use (ROU) asset was not operational. The staff agreed with this feedback and stated that the final guidance will include an approach in which the lessee amortizes the remaining ROU asset evenly over the remaining lease term. Therefore, in periods after the impairment, the recognized lease expense would comprise the ROU amortization and lease accretion for the period (i.e., the total lease expense would no longer be recorded on a straight-line lease basis).

Recognition of Initial Direct Costs in a Sales-Type Lease

Under the proposed guidance, a lessor would be required to expense the initial direct costs associated with a sales-type lease. Feedback on the proposed guidance suggested that the Board reconsider that requirement. The Board tentatively decided that initial direct costs would be deferred and recognized over the lease term if there is no selling profit or loss resulting from the lease. This approach would be consistent with how initial direct costs are recognized under current U.S. GAAP.

Lessor’s Presentation of Its Net Investment in a Lease

On the basis of the tentative decisions reached to date, a lessor would be required to present, in its statement of financial position, the net investment in its sales-type or direct financing leases. In addition, a lessor would be required to present, either in the statement of financial position or the notes to the financial statements, the components that make up the net investment of the sales-type and direct financing leases (e.g., the carrying amount of the receivables, asset unguaranteed residual values, and deferred selling profit). Feedback received on this requirement suggested that the option of presenting the components in the statement of financial position or disclosing them in the notes would result in unnecessary complexity. The Board tentatively decided that an entity would be required to disclose the components of its net investment in a lease in the notes to the financial statements.

Accounting for Lease Modifications That Extend the Term of a Lease

The proposed guidance would require an entity to account for a lease modification that only extends the term of a lease as an additional (and separately recorded) ROU asset. In this case, the original ROU asset would be amortized and the lease liability would be paid down until the end of the original lease term. Once the renewal period begins, a separate ROU asset and lease liability would be recognized. Fatal flaw reviewers disagreed with this approach, suggesting that the lease term is an attribute of the right to use the underlying asset and that a modification of the lease term represents a continuation (or contraction) of the use of the same underlying asset.

The Board agreed with this feedback and tentatively decided that the final guidance would clarify that the lease term is an attribute of a lessee's right to use the underlying asset and that modifications resulting in changes to the lease term would not result in an additional right of use. Therefore, when a lessee exercises a renewal option, it would reassess its current ROU asset and lease liability rather than recording a separate ROU asset and lease liability as of the beginning of the renewal period. The Board tentatively decided to make these clarifications only to the lessee modification guidance and not to the lessor modification guidance.

Lessee Classification Reassessment

Under the currently proposed guidance, a lessee would only be required to reassess the classification of a lease if the lease is modified and is not accounted for as a separate lease. However, feedback indicated that the guidance does not address whether a lessee is required to reassess lease classification when there is a change in either the lease term or the lessee's expectation about whether it will exercise an option to purchase the underlying asset. On the basis of this feedback, the Board tentatively decided that in addition to reassessing classification in response to a modification that does not result in a new lease, a lessee would also be required to reassess classification upon the change in lease term or when there is a change in its assessment regarding whether it is reasonably certain that it will exercise an option to purchase the underlying asset.

Alternatives for Nonpublic Business Entities

The Board tentatively decided against two proposed alternatives for nonpublic business entities. As a result, the only alternative accounting that will be available to nonpublic business entities is the risk-free discount rate alternative that the FASB previously decided on.

Next Steps

The FASB and IASB staffs will continue to assess and present to the boards any additional sweep issues that may result from further analysis of the feedback received on the fatal flaw draft or issues identified during the drafting of the final standard. In addition, the boards are expected to separately meet and tentatively decide on the effective date of each of their respective standards in November. The boards are expected to issue their final standards in late 2015 or early 2016.