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Illuminating the Path of Lease Resistance

Boards Review Feedback on the Revised Leases Exposure Draft

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In May 2013, the FASB and IASB issued a revised exposure draft[1] (ED) of their proposed lease accounting model. The proposal would significantly change the current accounting for leases — especially for lessees, which would be required to account for all leases on the balance sheet.[2]

Given the significance of the proposed changes, it should come as no surprise that constituents have had a lot to say about the ED. As of the date of this publication, the boards have received over 630 comment letters on the ED and hosted five separate roundtable sessions (in London, Brazil, Norwalk, Los Angeles, and Singapore) to discuss it.

This *Heads Up* summarizes the key themes of the comments received on the ED.[3]

Overall Feedback

Objectives

In general, most constituents support the boards' stated objectives for the lease project.[4] Many agree that the current lease model is complex, may not provide enough decision-useful information, and can result in different accounting for similar economic transactions. Many also believe that a lease contract gives rise to rights and obligations that should be recognized as an asset and obligation in the financial statements.

Most constituents indicated that the revised ED fails to meet the lease project's objectives.

However, most constituents indicated that the revised ED fails to meet the lease project's objectives. Specifically, a large number of respondents noted that the proposal would not reduce complexity, with some even claiming that it would make the accounting for leases more complex. These respondents asserted that the proposed dual-classification model and reassessment requirements would not improve current GAAP.

Some constituents indicated that the boards should consider an approach that retains the current lease accounting guidance but introduces additional disclosure requirements. Others questioned whether the project should focus on lessee accounting issues only and whether symmetry between lessee and lessor accounting is necessary.

Nearly all preparer respondents asserted that the costs of adopting the new guidance would be significant, especially those associated with implementing (or modifying) accounting systems to comply with it. Other costs mentioned include those related to hiring and training of new employees, renegotiating debt covenants, and educating investors.

[1] FASB Proposed Accounting Standards Update, *Leases*.
[2] For further information on the revised ED, see Deloitte's May 17, 2013, *Heads Up*.
[3] For more information, see the boards' summary of feedback of comments received on the ED.
[4] See paragraph BC3 of the ED for further discussion of the boards' objectives for the lease project.

Definition of a Lease

Most respondents agree with the proposed definition of a lease,[5] which is broadly consistent with the definition under existing GAAP. Under the proposal, an entity would determine whether a contract contains a lease by assessing whether (1) fulfillment of the contract depends on the use of an identified asset and (2) the contract conveys the right to control the use of such asset. Many respondents expressed concerns related to performing this assessment and suggested that the boards draft implementation guidance, particularly on:

- *Assessing substitution rights* — Respondents expressed concern about the requirement to determine whether a substitution right for an identified asset is considered substantive, and many requested additional guidance on how to assess whether there are barriers to substitution.
- *Evaluating "the right to control the use" of the identified asset* — Respondents requested additional guidance on evaluating whether a lessee controls the use of the identified asset. They noted numerous situations in which such guidance would be warranted, including those in which two or more parties each have the ability to make unilateral decisions that significantly affect the economic benefits to be obtained from an identified asset, those in which a lessee is not in physical possession of the asset, and those in which a customer was involved in the design of the asset. Some respondents indicated that the guidance should align with that on control in the proposed revenue recognition standard and existing consolidation standards.
- *Determining assets that are "incidental to the delivery of services"* — The ED states that an arrangement is not a lease but rather the delivery of a service if (1) the "customer can obtain the benefits from use of the asset only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or other suppliers" and (2) the "asset is incidental to the delivery of services." Some respondents believe that the boards should add more examples illustrating this concept, and others had questions about the conclusions in the ED's examples. In addition, some respondents suggested that the boards clarify how an asset's value affects the evaluation of whether the asset is "incidental" to the delivery of a service.
- *Identifying and separating lease and nonlease components* — Respondents indicated that they may have difficulty distinguishing between lease components and service components in a single arrangement. In addition, many expressed concerns about how to allocate consideration between the various components, particularly when a lessee cannot determine the stand-alone selling price of each component. Some indicated that when separation is prohibited, recording the nonlease component as part of the lease liability would not be appropriate.

Most respondents agree with the proposed definition of a lease.

Short-Term Leases

The short-term lease exemption in the ED allows both lessees and lessors to elect, as an accounting policy choice by asset class, whether to apply the ED to lease contracts that have a maximum possible lease term of 12 months. Entities applying such exemption will treat eligible contracts in a similar manner as operating leases under the existing guidance in ASC 840.[6]

Many constituents support the short-term lease exemption as a way to reduce the burden on preparers. However, several suggested broadening the exemption, generally by expanding it to leases that are shorter than 24 or 36 months or are for noncore assets. In addition, some respondents questioned the requirement to consider the maximum possible lease term in the assessment of a lease's eligibility for the exemption. Such respondents were concerned that a lease that is ineligible for the exemption because of

[5] See paragraphs 842-10-15-2 and 15-3 of the ED for the proposed definition of a lease.

[6] FASB Accounting Standards Codification Topic 840, *Leases*.

the existence of a renewal option may be measured on the basis of a lease term that is less than 12 months since the lessee does not have a significant economic incentive to renew the lease.

Lease Term

Constituents had mixed views on the proposed definition of lease term and the related reassessment requirements. While many support the proposed definition — which would include the noncancelable period of the lease as well as renewal periods for which the lessee has a significant economic incentive to exercise the renewal option (or not exercise a termination option) — some urged the boards to retain the "reasonably certain" notion in current GAAP.

A number of constituents argued that if the proposal was not intended to change the evaluation of lease term, as suggested in the ED's basis for conclusions, then the boards should retain the current concepts. Some constituents also argued that renewal periods should be excluded from the lease term until the renewal option is exercised and the lessee has an obligation to make lease payments. Further, certain lessor constituents noted that it would be too difficult (if not impossible) to determine whether a lessee has sufficient economic incentive to exercise a renewal option (or not exercise a termination option) and expressed concerns that requiring such an assessment would reduce comparability of lessor entities' financial statements.

Most constituents also disagreed with the proposal's requirement to reassess lease term on an ongoing basis, and some suggested that reassessment be performed only upon the occurrence of a significant triggering event. These constituents cited the costs as well as the complexity of performing individual reassessments of potentially thousands of leases.

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Variable Lease Payments

Under the proposal, measurement of the right-of-use (ROU) asset and lease liability would include variable payments that are (1) based on an index or rate and (2) in-substance fixed lease payments (e.g., disguised fixed lease payments). For the most part, respondents agree with these provisions and believe that variable payments based on usage and performance of the underlying asset should be excluded from the measurement of the ROU asset and liability. Some respondents requested additional clarity about what would constitute an in-substance fixed payment and recommended that the boards add guidance on, and examples of, such payments.

Most respondents, however, are opposed to the requirement to remeasure the ROU asset and lease liability in response to changes in the index or the rate used to measure the ROU asset and lease liability. These constituents cited the undue burden, costs, and complexity associated with the requirement and suggested that changes in an index or rate be (1) recognized in earnings with no adjustment to the ROU asset and lease liability or (2) reassessed at reasonable intervals (e.g., annually) or when the change is significant.

Lease Classification

Under the proposal, the lease classification would affect the lessee's subsequent accounting for its ROU assets (i.e., financing approach versus the straight-line approach) and whether a lessor accounts for the transaction as an operating lease or by using the receivable-and-residual approach. The lease classification depends on the nature of the leased asset (i.e., either property or something other than property) as well as the terms and conditions of the lease.

Constituents' views on the proposal's classification guidance are mixed. Some oppose any dual-model approach for lessees. Accordingly, lessees would classify all leases similarly, though respondents disagree about whether a single model should be based on a straight-line expense model, financing model, or some other hybrid model. Those supporting a financing model expressed concerns about the conceptual merits of the proposed Type B leases model, which would result in an increasing amount of amortization over the term of the lease. They also indicated that this amortization approach could increase the potential risk of impairment of the ROU asset.

Certain respondents preferred a dual-model approach for lessees but had different views about applying such approach. For example, some agreed with the ED's proposal to distinguish between "property" and "not property" while others would expand the definition of property to include other assets with economic characteristics that are similar to property (e.g., railcars, storage containers). Many also suggested that the boards retain the classification guidance in ASC 840 and IAS 17.[7]

Many respondents also noted that in the evaluation of the classification of a lease, the analysis of the lease's terms and conditions for assets that are considered property would focus on whether the lease term is for a major part of the asset's remaining life whereas the analysis for assets that are considered other than property would focus on whether the lease term is for an insignificant part of the asset's total life. Such respondents indicated that the boards should avoid inconsistency by selecting one metric (i.e., either a major part or an insignificant part) and specifying whether the evaluation would be based on the remaining economic life or the total economic life of the asset. Other respondents suggested that regardless of the metric selected, the boards should add guidance on the definition of "major part" and an "insignificant part." Some suggested that the classification be based solely on the nature of the asset and not take into account the lease's terms and conditions.

Lessor Considerations

Respondents generally noted that they were unable to understand how the proposal and its related complexities would improve current lessor accounting. They recommended that the boards retain the existing guidance since there has been little criticism of the model or resulting information by financial statement users.

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Related Parties

The majority of constituents agreed with the proposals to eliminate the current GAAP requirements specific to accounting for related-party leases and that no new disclosures would be required for such leases. These constituents agreed with the view that related-party leases should be accounted for in accordance with their contractual terms, although some believe that additional disclosures would be warranted. A number of constituents also expressed concerns that not retaining the current "substance over form" guidance on related-party leases would allow entities to structure such leases with terms that do not reflect the true economics of the leasing arrangement.

Transition

Although some constituents believe that full retrospective adoption is appropriate, many are concerned that this method would be too costly and onerous to apply. They recommended a modified retrospective approach (similar to the method outlined in the proposal) or a fully prospective transition approach. Other respondents indicated that the ED's transition provisions should align more closely with those in the proposed revenue recognition guidance.

Other constituent recommendations include grandfathering the existing leveraged leases requirements and the current requirements in ASC 840-10-15 (formerly EITF Issue No. 01-8[8]) for existing leases. Many preparer respondents also commented that they would need at least three years from the final standard's issuance date to adopt the new guidance, and some noted that they would prefer an even longer transition period. A recurring theme in the feedback, however, was that implementing the proposed requirements would be time-consuming, arduous, and expensive.

Next Steps

At a joint meeting in late November 2013, the boards' staffs presented (1) a summary of feedback received on the proposal and (2) a plan for redeliberating the significant issues associated with it. Redeliberations are expected continue into the first half of 2014 (if not longer). The boards have not yet established an expected effective date for the final standard.

[7] IAS 17, *Leases.*

[8] EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."

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