Background Information and Basis for Conclusions

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Introduction

BC1. This basis for conclusions summarizes the Board's considerations in reaching the conclusions in Topic 842, Leases. It includes reasons for accepting particular views and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. A new standard should provide information that is useful in making business and economic decisions, and the benefits should justify the costs. Providing useful information means, among other things, producing economically "neutral" information (that is, information that faithfully represents the economics of a transaction, regardless of perceived positive or negative effects of reporting that information) that permits users to make their own decisions on the basis of the financial information.

BC3. Paragraph OB2 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 1,* The Objective of General Purpose Financial Reporting*, and Chapter 3,* Qualitative Characteristics of Useful Financial Information, states the following:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. [Footnote reference omitted.]

BC4. Given the objective of general purpose financial reporting, the Board also considered the objective of the leases project, which is to increase the decision usefulness and comparability among organizations by recognizing lease assets and lease liabilities on the statement of financial position and disclosing key leasing information. For example, users of financial statements are interested in obtaining information about a lessee's leasing activities, in general, to assess the cash flows, returns, and capital structure of the lessee and to assess the lessee's ability to meet financial commitments. Most users already make adjustments that are often based on incomplete information to a lessee's reported statement of financial position to capitalize operating leases when operating leases are significant to the lessee.

BC5. As part of the due process that led to Topic 842, the Board conducted extensive outreach activities with users, preparers, and auditors of financial statements to obtain information about specific deficiencies in the accounting requirements for leases in previous GAAP (Topic 840, Leases). Input was received both before the project was added to the Board's technical agenda and throughout the duration of the project.

BC6. The FASB's *Rules of Procedure* states the following:

> The mission of the FASB is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.

BC7. In fulfilling that mission, the Board follows certain precepts, including the precept to promulgate standards only when the expected benefits of the resulting information justify the expected costs. The Board strives to determine that a standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information.

BC8. On the basis of extensive due process and significant input received from financial statement users, the Board concluded that Topic 842 provides users with more relevant information on and a more faithful representation of leasing arrangements for both lessees and lessors than previous GAAP. The Board developed Topic 842 principally to improve users' understanding about lessees' obligations under lease contracts. Topic 842 provides transparent and economically neutral information about the assets and liabilities that arise from leases, which is in contrast to the incomplete information provided about leases in previous GAAP that did not recognize the assets and liabilities that arise from most leases. Topic 842 also provides improved financial information about a lessor's leasing activities. As such, Topic 842 results in more useful information being provided to users of financial statements. The requirements in Topic 842 will:

a. Result in a more faithful representation of the rights and obligations arising from leases by requiring lessees to recognize the lease assets and lease liabilities that arise from leases in the statement of financial position and to disclose qualitative and quantitative information about lease transactions, such as information about variable lease payments and options to renew and terminate leases
b. Improve understanding and comparability of lessees' financial commitments regardless of the manner they choose to finance the assets used in their businesses
c. Clarify the definition of a lease to address practice issues that were raised about the previous definition of a lease and to align the concept of control, as it is used in the definition of a lease, more closely with the control principle in both Topic 606, Revenue from Contracts with Customers, and Topic 810, Consolidation
d. More closely align the lessor accounting and sale and leaseback transactions guidance to the comparable guidance in Topic 606 and Topic 610, Other Income
e. Provide users with additional information about lessors' leasing activities and lessors' exposure to credit and asset risk as a result of leasing

f. Result in fewer opportunities for entities to structure leasing transactions to achieve a particular accounting outcome on the statement of financial position.

BC9. The Board's outreach activities also included discussions about the potential costs and feasibility of implementing its proposals for improving the accounting for leases. That outreach discussed, among other things, the costs and relevance of the various lease accounting models that the Board has considered over the course of the project. Both preparers and auditors agreed that the approach to lessee accounting that the Board decided to include in Topic 842 was among the lowest cost options considered.

BC10. The Board understands that certain reporting entities will incur additional costs as a result of Topic 842. For example, entities will, in general, incur initial costs to educate employees about how to apply the new requirements, as well as how to explain the effects of the changes in accounting for leases on the entity's financial statements to users of financial statements. In addition, many entities will need to undertake activities to ensure they have appropriately identified all of their leases and implement more robust processes and controls to ensure that they capture all material leasing activity going forward. However, the Board noted that once these implementation activities are completed, the ongoing costs for most entities of providing the information in Topic 842 are unlikely to be significantly higher than the costs of complying with the accounting model in previous GAAP. In previous GAAP, entities were similarly required to identify leases, evaluate each lease to determine the applicable accounting model to apply (capital or operating), and to subsequently account for each lease, including meeting the ongoing disclosure requirements about cash flows from leases. Topic 842 will not substantially change this level of effort, and the Board concluded that, based on substantial outreach with preparers of financial statements, many entities will be able to apply the requirements in Topic 842 using similar systems and processes to what they used in previous GAAP to meet those reporting and disclosure requirements.

BC11. The Board considered an entity's initial costs to comply with the requirements in Topic 842, and this affected its conclusions both on the lessee and lessor accounting requirements and on transition to the new requirements. Regarding the lessee and lessor accounting requirements, as outlined in paragraph BC10, the Board concluded that a substantial portion of all entities will be able to apply the new requirements using systems and processes similar to those used in previous GAAP. The Board decided that a modified retrospective approach for transition, as opposed to a full retrospective approach, provides an appropriate balance between minimizing costs of transition and providing users of financial statements with comparable financial information. The practical expedients related to transition, if elected, should further significantly reduce the costs associated with transitioning to the new requirements.

BC12. The Board received considerable feedback on the 2010 Exposure Draft, *Leases (Topic 840)*, and the 2013 Exposure Draft, *Leases (Topic 842),* and the Board made decisions during redeliberations that were responsive to the feedback. Throughout the course of developing the proposed requirements, the Board sought to minimize the cost of improving the lease accounting requirements in GAAP. This is discussed in further detail in the background section below.

BC13. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new requirements are borne primarily by the preparers' current investors. The Board's assessment of the costs and benefits likely to result from issuing new requirements is unavoidably more qualitative than quantitative because there is not an identified method to objectively quantify the costs to implement new guidance or to quantify the value of expected, improved information in financial statements.

BC14. The Board further considered the concern that the additional lease liabilities recognized as a result of adopting Topic 842 will cause some entities to violate debt covenants or may affect some entities' access to credit because of the potential effect on the entity's GAAP-reported assets and liabilities. Regarding access to credit, outreach has demonstrated that the vast majority of users, including private company users, presently adjust an entity's financial statements for operating lease obligations that are not recognized in the statement of financial position under previous GAAP and, in doing so, often estimate amounts significantly in excess of what will be recognized under Topic 842. The Board also considered potential issues related to debt covenants and noted that the following factors significantly mitigate those potential issues:

a. A significant portion of loan agreements contain "frozen GAAP" or "semifrozen GAAP" clauses such that a change in a lessee's financial ratios resulting solely from a GAAP accounting change either:
    1. Will not constitute a default
    2. Will require both parties to negotiate in good faith when a technical default (breach of loan covenant) occurs as a result of new GAAP.
b. Banks with whom outreach has been conducted state that they are unlikely to dissolve a good customer relationship by "calling a loan" because of a technical default arising solely from a GAAP accounting change, even if the loan agreement did not have a frozen or semifrozen GAAP provision.
c. Topic 842 characterizes operating lease liabilities as operating liabilities, rather than debt. Consequently, those amounts may not affect certain financial ratios that often are used in debt covenants.
d. Topic 842 provides for an extended effective date that should permit many entities' existing loan agreements to expire before reporting under Topic 842. For those loan agreements that will not expire, do not have frozen or semifrozen GAAP provisions, and have covenants that are

affected by additional operating liabilities, the extended effective date provides significant time for entities to modify those agreements.

BC15. Overall, the Board concluded that the expected benefits of Topic 842 justify the perceived costs.

Overview

Why the Need to Change Existing Accounting?

BC16. The previous accounting model for leases in GAAP and International Financial Reporting Standards (IFRS) did not require lessees to recognize the assets and liabilities arising from operating leases in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements* (and the IFRS's *Conceptual Framework for Financial Reporting*), but it did require lessees to recognize assets and liabilities arising from capital leases. The FASB, together with the IASB, initiated a joint project to improve the financial reporting of leasing activities in GAAP and IFRS in light of criticism that the previous accounting model for leases failed to meet the needs of users of financial statements. In particular:

a. Many, including the U.S. Securities and Exchange Commission (SEC) in its 2005 *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, which was mandated by and issued to the United States Congress, and a number of academic studies published over the past 15 years, have recommended that changes be made to the existing lease accounting requirements to ensure greater transparency in financial reporting and to better address the needs of users of financial statements. Most users adjusted a lessee's financial statements to capitalize operating leases. Some tried to estimate the present value of future lease payments. However, because of the limited information available, many used techniques such as multiplying the lessee's annual lease expense by a factor, often in the range of six to eight, to approximate the fair value of the lessee's obligations and to assess, for example, total leverage and the capital employed in operations. Other users were unable to make adjustments—they were reliant on data sources such as data aggregators when screening potential investments or making investment decisions. Those different approaches created information asymmetry in the market because the adjustments made varied significantly depending on the assumptions made by different users.
b. The existence of two very different accounting models in which the assets and liabilities associated with most leases were not recognized, but were recognized for a minority of leases, resulted in transactions that were economically similar being accounted for very differently in the statement of financial position. That reduced comparability for users and provided

opportunities to structure transactions to achieve a particular accounting outcome.

c. Some users of financial statements also criticized previous GAAP applicable to lessors because that guidance did not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from the lessor's retained interest in the underlying asset), particularly for those leases of assets that were previously classified as operating leases.

BC17. The Board decided to address those criticisms by modifying the lessee accounting model in GAAP to require a lessee to recognize assets and liabilities for the rights and obligations created by leases. Topic 842 requires a lessee to recognize the lease assets and lease liabilities for all leases with a lease term of more than 12 months. This approach will result in a more faithful representation of a lessee's assets and liabilities and, together with the enhanced disclosures required by Topic 842, greater transparency about a lessee's financial leverage and its leasing activities. Topic 842 also requires a lessor to provide enhanced disclosures that will improve reported information about a lessor's exposure to credit risk (of the lessee and any third party providing a residual value guarantee) and asset risk (that is, the risk associated with ownership of the underlying asset in the lease).

Background

BC18. In March 2009, the Boards published a joint Discussion Paper, *Leases: Preliminary Views*. The Discussion Paper set out the Boards' preliminary views on lessee accounting, proposing a right-of-use accounting model. Feedback on the Discussion Paper was generally supportive of the right-of-use model for lessees in which a lessee would recognize a right-of-use asset and a lease liability at the commencement date of the lease. The Discussion Paper did not discuss lessor accounting in any detail.

BC19. In August 2010, the Boards published a joint Exposure Draft, *Leases* (2010 Exposure Draft). The Boards developed the guidance in the joint 2010 Exposure Draft after considering the 302 comment letters received on the Discussion Paper, as well as input obtained from their International Working Group on Lease Accounting and from others that were interested in the financial reporting of leases. That guidance further developed the right-of-use accounting model proposed for lessees in the Discussion Paper. That guidance also set out changes to lessor accounting by proposing a changed dual lessor accounting model in which a lessor would recognize a lease receivable for all leases but, depending on the lessor's exposure to the risks and benefits of the underlying asset, would either derecognize a portion of the underlying asset or continue to recognize the underlying asset and recognize a performance obligation liability for others. The Boards decided to include lessor accounting in the proposals in response to respondents' comments on the Discussion Paper. Those respondents

recommended that the Boards develop accounting models for lessees and lessors on the basis of a consistent rationale. The Boards also saw merit in developing lessor accounting proposals at the same time as developing proposals on the recognition of revenue.

BC20. The Boards received 786 comment letters in response to the 2010 Exposure Draft from entities and organizations from a range of industries, including both public business entities and private companies.

BC21. The Boards also consulted extensively on the proposals in the 2010 Exposure Draft. Roundtable discussions were held in Hong Kong, the United Kingdom, and the United States. Workshops were organized in Australia, Brazil, Canada, Japan, South Korea, the United Kingdom, and the United States. Members of the Boards also participated in conferences, working group meetings, discussion forums, and one-on-one discussions that were held across all major geographical regions. In 2011 and 2012, while redeliberating the proposals in the 2010 Exposure Draft, the Boards conducted targeted outreach on specific issues with more than 100 organizations. The purpose of the targeted outreach was to obtain additional feedback to assist the Boards in developing particular aspects of the revised proposals. The targeted outreach meetings involved working group members, representatives from accounting firms, local standard setters, users of financial statements, and preparers, particularly those from industries most affected by the lease accounting proposals.

BC22. The main feedback received on the proposals included in the 2010 Exposure Draft was as follows:

a. There was general support for the recognition of assets and liabilities arising from a lease by lessees, which was consistent with comments received on the Discussion Paper.
b. Some respondents supported the effects of the proposed right-of-use model on a lessee's profit or loss in which a lessee would recognize separately amortization of the right-of-use asset and interest on the lease liability. They noted that leases are a source of financing for a lessee and should be accounted for accordingly. However, others disagreed stating that the approach would not properly reflect the economics of all lease transactions. In particular, some respondents referred to shorter term property leases as examples of leases that, in their view, were not financing transactions from either the lessee's or the lessor's perspective.
c. Many respondents disagreed with the lessor accounting proposals:
    1. Some were concerned that the dual accounting model proposed for lessors was not consistent with the single accounting model proposed for lessees.
    2. Many did not support the performance obligation approach. According to that approach, a lessor would recognize a lease receivable and a liability at the commencement date and also would continue to recognize the underlying asset. Those respondents

indicated that, in their view, the approach would artificially inflate a lessor's assets and liabilities.

3. Some supported applying the derecognition approach to all leases. According to that approach, a lessor would derecognize the underlying asset and recognize a lease receivable and a retained interest in the underlying asset (referred to as a residual asset) at the commencement date. However, many disagreed with the proposal to prevent a lessor from accounting for the effects of the time value of money on the residual asset.
4. Others said that there are not significant issues with the lessor accounting requirements in IAS 17, *Leases,* and Topic 840, that they work well in practice, and supported retaining those requirements.

d. Almost all respondents were concerned about the costs and complexity of the proposals, in particular the proposals on measurement of the lessee's lease liability and the lessor's lease receivable. The 2010 Exposure Draft had proposed that an entity would make an estimate of all variable lease payments to be made not only during the noncancellable period of a lease but also during any optional extension periods that the entity considered more likely than not to occur. Some questioned whether lease payments to be made during optional extension periods would meet the definition of an asset (for the lessor) or a liability (for the lessee). Others indicated that it would be extremely difficult in many cases to make a reliable estimate of variable lease payments if the amounts to be paid were dependent on future sales or use of the underlying asset. Because of the amount of judgment involved, many indicated that the cost of including variable lease payments and payments to be made during extension periods in the measurement of lease assets and lease liabilities would not justify the benefit for users of financial statements.
e. Many respondents also were concerned about the breadth of the scope of the proposals, indicating that the proposed definition of a lease had the potential to capture some arrangements that they considered to be service contracts rather than leases.

BC23. The Boards considered all of the feedback received during the redeliberations of the proposals in the 2010 Exposure Draft and observed that it would not be possible to reflect the views of all stakeholders because stakeholders did not have a uniform view of the economics of leases. Having received significant feedback on the single model proposed in the 2010 Exposure Draft, the Boards decided to expose for comment an alternative model that was responsive to those stakeholders who said that the economics vary among different types of leases. Consequently, in May 2013 the Boards published a second joint Exposure Draft, *Leases* (2013 Exposure Draft). The 2013 Exposure Draft proposed two approaches to the recognition and measurement of expenses arising from a lease. That model distinguished between different types of leases on the basis of the level of the lessee's consumption of the economic benefits embedded in the underlying

asset. That model was based on the view held by some stakeholders that the recognition of a single lease expense in a lessee's statement of profit or loss and other comprehensive income (income statement) would provide better information about those leases for which the lessee pays only for the use of the underlying asset and is expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset itself. A lessee would account for those leases for which it consumes more than an insignificant amount of the benefits embedded in the underlying asset in a similar manner to the approach proposed in the 2010 Exposure Draft. The 2013 Exposure Draft also proposed an alternative model for lessor accounting under which a lessor would account for leases in which the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset by recognizing its residual interest in the underlying asset separately from its right to receive lease payments (that is, its lease receivable). A lessor would account for all other leases in a similar manner to operating lease accounting in Topic 842.

BC24. The Boards received 657 comment letters in response to the 2013 Exposure Draft from entities and organizations from a range of industries. In addition, the Boards consulted extensively on the proposals in the 2013 Exposure Draft, including:

a. Consultations with more than 270 users of financial statements based in the United States, the United Kingdom, Sweden, Switzerland, Belgium, the Netherlands, France, Australia, New Zealand, Hong Kong, Japan, and Canada.
b. Fieldwork meetings with individual preparers from various industries including consumer goods, retail, aviation, oil and gas, telecommunications, and automotive. These meetings were held in Germany, France, Spain, the United States, the United Kingdom, Japan, and Brazil and included detailed discussions about the costs of implementation for those companies.
c. Roundtables held in London, Norwalk, Los Angeles, Singapore, and Sao Paulo, Brazil. These were attended by approximately 100 stakeholder representatives.
d. Meetings with all of the FASB's advisory groups—the Financial Accounting Standard Advisory Council (FASAC), the Investor Advisory Committee (IAC), the Not-for-Profit Advisory Committee (NAC), and the Small Business Advisory Committee (SBAC).
e. Meetings with the Private Company Council (PCC).
f. Outreach meetings with various other individual preparers and groups of preparers, standard setters, and regulators. These meetings included presentations during accounting conferences, keynote presentations at industry forums, and meetings with individual organizations or groups.
g. Project webcasts that attracted over 2,000 participants.

BC25. The main feedback received on the proposals included in the 2013 Exposure Draft was as follows:

a. Similar to feedback received on the 2010 Exposure Draft, many stakeholders supported the recognition of a right-of-use asset and a lease liability by a lessee for all leases of more than 12 months. These stakeholders included most users of financial statements consulted, who stated that the proposed recognition of assets and liabilities by a lessee would provide them with better information for their analyses.
b. Many stakeholders disagreed with the proposed lessee accounting model. Some of those stakeholders (1) said that the lessee accounting model in Topic 840 did not need to be changed or (2) supported improving the lessee accounting model in Topic 840 by only improving the disclosure requirements instead of changing the recognition and measurement requirements. Other stakeholders disagreed with one or more specific aspects of the proposed lessee accounting model in the 2013 Exposure Draft, such as the proposed classification test or the proposal to periodically reassess lease assets and lease liabilities.
c. Many stakeholders said that the measurement proposals in the 2013 Exposure Draft represented a significant improvement over the proposals in the 2010 Exposure Draft, especially relating to simplifications of variable lease payments and payments under renewal options and purchase options. Nonetheless, the majority of stakeholders still had concerns about the costs and complexity of the proposals in the 2013 Exposure Draft. Specific areas of the proposals that stakeholders highlighted as being particularly costly or complex included the dual lessee and lessor accounting models (both the lease classification proposals as well as the accounting requirements), the reassessment proposals, the disclosure proposals, and the scope of the transactions subject to the proposals.
d. The majority of stakeholders disagreed with the proposed lessor accounting model because, in their view, it was not an improvement to the financial reporting model for those transactions. Most of those stakeholders said that the lessor accounting model in previous GAAP should not be changed substantially.

BC26. During redeliberations, the Boards considered all of the feedback received throughout the project and in response to the different models proposed in the 2010 and 2013 Exposure Drafts. As they did in both Exposure Drafts, the Boards decided that a lessee should be required to recognize right-of-use assets and lease liabilities for all leases (with some exceptions—for the FASB, short-term leases, and for the IASB, short-term leases and leases of “low-value assets”). However, the Boards reached different decisions on the expense recognition model. The FASB decided to adopt a lessee accounting model that distinguishes between two types of leases, classifying leases as operating leases or finance leases in a similar manner to the requirements for distinguishing between operating leases and capital leases in previous GAAP. Conversely, the IASB decided to adopt a single lessee accounting model in which a lessee accounts for all leases as finance leases. In light of all of the feedback received, the FASB

concluded that its lessee accounting approach provides useful information to the broadest range of users of financial statements and reflects the economics of each type of lease. At the same time, the FASB noted that the lessee accounting approach in Topic 842 addresses many of the concerns raised by stakeholders about cost and complexity of the previous proposals in the 2010 and 2013 Exposure Drafts. In making these decisions, the Boards observed that for a lessee with a portfolio of leases starting and ending at different times that is not significantly increasing or decreasing its leasing activity, any difference in total reported profit or loss between a lessee in GAAP and a lessee in IFRS is not expected to be significant.

BC27. Topic 842 and IFRS 16 are converged in many respects. However, there are a number of other differences—beside the differences in the core lessee accounting model—between Topic 842 and IFRS 16. Many but not all of those differences arose because of the different decisions reached on the lessee accounting model; however, others arose because of other core decisions of the two Boards such as whether and to what extent the lessor accounting guidance should substantially align with the revenue recognition guidance in Topic 606 and IFRS 15, *Revenue from Contracts with Customers*. Consequently, other than as discussed in the "Comparison with IFRS 16, *Leases*" section in paragraphs BC418–BC431, this basis for conclusions summarizes only the reasons for decisions made by the FASB and reflected in Topic 842 or the conforming amendments to the *FASB Accounting Standards Codification*®.

BC28. Topic 842 addresses many of the concerns raised by stakeholders about the costs and complexity of the proposals in the 2010 and 2013 Exposure Drafts. Largely in response to those concerns, Topic 842:

a. Includes a lessee accounting model that recognizes two types of leases and distinguishes between those two types (finance leases and operating leases) using a classification approach substantially similar to the classification approach in the previous leases guidance for distinguishing between operating leases and capital leases. This decision, along with other simplifications described below, will permit many lessees to use their existing systems and processes for applying previous GAAP to apply the requirements in Topic 842.
b. Substantially retains the lessor accounting model in previous GAAP.
c. Permits a lessee to not recognize assets and liabilities for short-term leases and aligns the determination of whether a lease is a short-term lease with the definition of *lease term*.
d. Permits a lessee to apply the leases guidance at a portfolio level for leases with similar characteristics.
e. Simplifies the measurement of the lease liability relating to variable and optional lease payments and the reassessment requirements as compared with the guidance in the Exposure Drafts.

f. Simplifies lessee expense recognition and the process for subsequently measuring the right-of-use asset in an operating lease as compared with the guidance in the Exposure Drafts.
g. Permits lessees to separate lease from nonlease components in all cases and estimate the standalone prices of lease and nonlease components. This represents a simplification of the previous guidance on the separation of lease and nonlease components of a contract in the Exposure Drafts.
h. Clarifies application of the sale guidance in Topic 606 to sale and leaseback transactions.
i. Simplifies the lessee and lessor disclosure requirements, principally by eliminating previously proposed reconciliation disclosures.
j. Simplifies the transition requirements for lessees, lessors, leveraged leases, and sale-leaseback transactions, while clarifying the transition for build-to-suit leases.
k. Clarifies the definition of a lease.

Application to Private Companies

BC29. During the leases project, the FASB carefully considered the potentially different needs of private companies in deciding to modify some of the requirements. In making those decisions, the Board considered the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies*; the Conceptual Framework; input from preparers, auditors, and users of private company financial statements (that is, lenders to private companies); the potentially different needs of users of private company financial statements compared with users of public business entity financial statements; and the feedback and recommendations of the PCC (as well as its predecessor, the Private Company Financial Reporting Committee [PCFRC], which was the Board's private company advisory body during most of the period of the project—that is, from 2007 through 2012), the NAC, and the SBAC. The Board observed the recommendations of the PCC, the PCFRC, and others that the accounting should be consistent for public business entities and private companies with respect to leases.

BC30. The Board also considered the generally more limited resources of private companies in considering the costs and benefits of the requirements in Topic 842. The Board observed that the lease accounting requirements in previous GAAP were identical for public business entities and private companies; therefore, the Board's views of the initial and ongoing costs to apply the new requirements (see paragraphs BC9–BC11) apply equally to public business entities and private companies. That is, for most entities, including most private companies, the ongoing costs of applying the requirements in Topic 842 should not be significantly greater than the costs of applying previous GAAP, and a significant portion of private companies will be able to apply the requirements in Topic 842 using similar

systems and processes to what they used in previous GAAP to meet those reporting and disclosure requirements.

BC31. Paragraphs BC402–BC414 discuss the Board's considerations about whether to modify some of the requirements in Topic 842 for private companies in the following areas:

a. Recognition
b. Measurement
c. Disclosures
d. Presentation
e. Transition.

The Lessee and Lessor Accounting Models and Classification of Leases

Lessee Accounting

BC32. Contracts create rights and obligations for the parties to the contract. The lessee accounting model in Topic 842 considers the rights and obligations created by a lease, which is defined as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the property, plant, or equipment (the underlying asset) during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the point in time that it makes the underlying asset available for use by the lessee. Consequently, the Board refers to the model as a right-of-use model.

BC33. A lessee has an obligation to make payments to the lessor as a direct consequence of the lessor making the underlying asset available for use by the lessee (that is, granting the lessee the right to use the underlying asset). The lessee also has an obligation to return the underlying asset to the lessor at the end of the lease term. Similarly, the lessor has a right to receive payments from the lessee for granting the right to use the underlying asset. The lessor also retains rights associated with the underlying asset. Having identified the rights and obligations that arise from a lease for the lessee and lessor, the Board then considered which of those rights and obligations should be recognized as assets and liabilities by the lessee and lessor.

Obligations Arising from a Lease That Create Liabilities for the Lessee

Obligation to make lease payments (lease liability)

BC34. Paragraph 35 of Concepts Statement 6 states that "liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." The Board concluded that the lessee's obligation to make lease payments meets the definition of a liability in Concepts Statement 6 because:

a. Under the lease contract, the lessee has a present obligation to make lease payments once the underlying asset has been delivered (or made available) to the lessee. In accordance with Concepts Statement 6, that obligation arises from a past event—the lessor's performance in delivering (or making available) the underlying asset for use by the lessee. The lessee has no contractual right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term. In addition, unless the lessee breaches the contract, the lessor has no contractual right to take possession of, or prevent the lessee from using, the underlying asset until the end of the lease term.
b. The obligation results in a future outflow of economic benefits from the lessee—typically contractual cash payments—in accordance with the terms and conditions of the contract.

Obligation to return the underlying asset to the lessor

BC35. The lessee controls the use of the underlying asset during the lease term and has an obligation to return the underlying asset to the lessor at the end of the lease term. That is a present obligation that arises from a past event (the underlying asset being made available for use by the lessee in accordance with the lease contract).

BC36. It might appear that there is an outflow of economic benefits at the end of the lease term because the lessee must surrender the underlying asset, which often will still have some economic potential. However, the Board concluded that there is no outflow of economic benefits from the lessee when it returns the leased item, other than incidental costs, because the lessee does not control the economic benefits associated with the asset that it returns to the lessor. Even if the lessee has physical possession of the underlying asset, it has no right to obtain the remaining economic benefits associated with the underlying asset once the lease term expires (ignoring any options to extend the lease or purchase the underlying asset). In that case, the position of the lessee at the end of the lease term is like that of an asset custodian. The lessee is holding an asset on behalf of

a third party, the lessor, but has no right to the economic benefits embodied in that asset at the end of the lease term.

BC37. Consequently, the Board concluded that the lessee's obligation to return the underlying asset does not meet the definition of a liability in Concepts Statement 6.

Rights Arising from a Lease That Create Assets for the Lessee

Right to use the underlying asset

BC38. Paragraph 25 of Concepts Statement 6 states that "assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." The main characteristics of the definition of an asset are that the entity controls an economic resource or benefit, the resource or benefit arises from a past event, and future economic benefits are expected to flow to the entity. The Board concluded that a lessee's right to use the underlying asset meets the definition of an asset because:

a. The lessee's right of use permits the lessee to obtain substantially all the benefits from use of the asset during the lease term and to control others' access to the identified underlying asset through its right to control the use of the underlying asset throughout the lease term. Once the underlying asset is delivered (that is, the right of use is conveyed) to the lessee, neither the lessor nor any other party is able to have access to the underlying asset without the consent of the lessee (or breach of contract). Despite being the legal owner of the underlying asset, the lessor is unable to retrieve or otherwise use the underlying asset during the lease term without breaching the contract with the lessee.
b. The lessee's control of an asset resulting from its right of use is demonstrated by its ability to determine how and when it uses the underlying asset and, thus, how it obtains future economic benefits from that right of use. For example, assume a lessee leases a truck for 4 years, for up to a maximum of 160,000 miles over the lease term. Embedded in the right to use the truck is a particular volume of economic benefits or service potential that is used up over the period of time that the truck is driven by the lessee. Upon delivery of the truck to the lessee, the lessee can decide how (often within parameters defined in the contract) it wishes to consume the economic benefits embedded in its right of use. It could decide to drive the truck constantly during the first two years of the lease, using up all of the economic benefits in those first two years. Alternatively, it could use the truck only during particular months in each year or decide to use it evenly over the four-year lease term.
c. In most leases, a lessee's right to use an asset includes some restrictions on its use. For example, in the truck example in (b) above, the lessee cannot drive the truck for more than 160,000 miles over the 4-year lease

term. A similar example may preclude the lessee from transporting an asset outside of, or to, a particular territory. Some suggested that those restrictions result in the lessee not having control of the right to use the underlying asset. However, the Board concluded that, although those restrictions may affect the value of and payments for the right-of-use asset, they do not affect the existence of the right-of-use asset. That is consistent with the recognition of other assets. It is not unusual for particular restrictions to be placed on the use of owned assets as well as leased assets. For example, assets that are used as security for particular borrowings may have restrictions placed on their use by the lender, or a government may place restrictions on the use or transfer of assets in a particular region for environmental or security reasons. Licenses of intellectual property also frequently have restrictions attached. Those restrictions do not necessarily result in the conclusion that the entity does not control an asset. The restrictions may limit choice in terms of decision making and affect the economic benefits that will flow to the entity from the asset, and that will be reflected in the price that the entity is willing to pay for those economic benefits.

d. The lessee's control of the right of use arises from a past event—the lessor's performance of making the underlying asset available for use by the lessee at the commencement date. Some suggested that the lessee's right to use the underlying asset is conditional on the lessee making payments during the lease term. In other words, if the lessee does not make payments, it may forfeit its right to use the asset (which is similar to the situation that would arise if an entity failed to make payments on an installment purchase). However, unless the lessee breaches the contract, the lessee has an unconditional right to use the underlying asset.

BC39. Some Board members further observed that other rights of use that result from a supplier making an underlying asset available for use by a customer, for example, regarding intangible assets (that is, licenses of intellectual property), are recognized as assets in accordance with GAAP.

Why Leases Are Different from Service Contracts for the Lessee

BC40. Leases are different from service contracts and, therefore, generally give rise to different rights and obligations. That is because in a lease the lessee continues to benefit throughout the lease term from the lessor's performance, at lease commencement, of making the underlying asset available for use by the lessee. The lessee benefits in substantially the same manner that a licensee continues to benefit from a license to intellectual property, and from the licensor's performance that occurs at the start of the license period by making the underlying intellectual property available for the licensee's use, throughout the license period.

BC41. When the lessor delivers (or makes available) the underlying asset for use by the lessee at the commencement date, the lessor has fulfilled its obligation

to transfer the right to use that underlying asset to the lessee even if it has other obligations that require continuing performance under the contract (for example, an obligation to provide services). The lessee now controls the right-of-use asset and has an obligation to pay for that right-of-use asset, which has arisen from the past event of the lessor's performance at lease commencement. The lease liability reflects that the lessee will pay for the right-of-use asset obtained at lease commencement in the future, typically over the lease term. After the lessor makes the underlying asset available for use by the lessee, the lessee cannot avoid making the required lease payments because it cannot return the underlying asset to the lessor before the end of the lease without breaching the contract (or incurring termination penalties). Similarly, unless the lessee breaches the contract, the lessor cannot retrieve the underlying asset from the lessee (that is, revoke the lessee's right to use the underlying asset transferred to the customer at lease commencement or infringe on the lessee's "quiet enjoyment" of the use of the underlying asset) before the end of the lease without breaching the contract.

BC42. In contrast, in a typical service contract, the customer obtains economic benefits from the service only as the supplier performs the service. The supplier's performance to date does not continue to benefit the customer throughout the remaining service period. However, where it does, for example, by creating an asset for the customer, the customer typically recognizes that asset and any obligation to pay for the services provided. In a typical service contract, the vendor has a remaining obligation to perform until it has provided all of the service to its customer. Consequently, the customer typically has an obligation to pay only for the services provided to date.

BC43. Some Board members see less of a distinction between a lease contract and a service contract. Those Board members agree that leases create assets and liabilities for the lessee, but they observe that operating leases, which typically convey rights to the lessee different from those conveyed by ownership of a similar asset, are similar in at least some respects to many service contracts. Those Board members concluded that there are contracts that do not meet the definition of a lease, yet convey economically similar rights and obligations to the customer. For example, in Example 2 of Section 842-10-55 (paragraphs 842-10-55-52 through 55-54), the airport operator (Supplier) has conveyed a right to use its space at the inception of the arrangement, and the Customer has an obligation to pay that is conditional only on the continued access to space owned by the Supplier. This, in substance, is very similar to the economics of a lease and is similar, in those Board members' views, to the rights and obligations under many service contracts. Thus, it is not as definitive to those Board members that leases give rise to rights and obligations substantially different from those that arise in service contracts. Rather, those Board members support the reporting and presentation of right-of-use assets and lease liabilities separately in the statement of financial position based on the enhanced information content about leases that such reporting will provide to users of financial statements. Those Board members noted that the requirements in Topic 842 meet user demands for greater transparency about the rights and

obligations of lessees, rather than rely on a distinction between leases and service contracts. Consequently, for some of those Board members, the decision not to require the recognition of assets and liabilities arising from services in a contract that contains a lease was because they did not want to introduce changes to the accounting for services on a piecemeal basis in the leasing guidance (that is, only for services entered into in conjunction with a lease). In their view, changes to recognize assets and liabilities arising from arrangements for services would need to be addressed more comprehensively.

The Lessee Accounting Model in Topic 842

BC44. Having concluded that the lessee's obligation to make lease payments meets the definition of a liability and the lessee's right to use the underlying asset meets the definition of an asset, the Board considered whether requiring a lessee to recognize that asset and that liability for all leases would improve financial reporting to such an extent that the benefits from the improvements would justify the costs associated with such a change.

BC45. On the basis of comments from respondents to the Discussion Paper as well as to the 2010 and 2013 Exposure Drafts and from participants at consultation meetings (including meetings with more than 270 users of financial statements—including lenders for private companies), the Board concluded that there would be significant benefits from requiring a lessee to recognize a right-of-use asset and a lease liability for all leases (except short-term leases), particularly for users of financial statements and others that have raised concerns about the extent of off-balance-sheet financing for operating leases. The Board considered the costs associated with that proposed change throughout its redeliberations and simplified the proposals included in the 2010 and 2013 Exposure Drafts to address concerns about costs (see paragraphs BC189–BC197, BC205–BC212, and BC375–BC381 on the lease term, variable lease payments, and short-term leases, respectively).

Determining Whether and How to Classify Leases

BC46. Having concluded that lessees should recognize a right-of-use asset and a lease liability for all leases other than short-term leases, the Board considered whether all leases should be accounted for in the same manner (that is, whether the lessee accounting model should be a model with a single approach or a model with multiple approaches).

Lessee accounting model with a single approach

BC47. One of the original objectives for the leases project was to develop a lessee accounting model that would apply a single accounting approach for all leases. The Discussion Paper and the 2010 Exposure Draft proposed a lessee accounting model that would have accounted for all leases in the same manner as

finance leases are accounted for in the amendments in this Update. To clarify, for all leases in a lessee accounting model of this nature, the lessee would have:

a. Amortized the right-of-use asset in a similar manner to other nonfinancial assets, on a systematic basis reflecting the pattern in which the lessee is expected to consume the right-of-use asset's future economic benefits. That typically would have resulted in the lessee recognizing amortization of the right-of-use asset on a straight-line basis over the lease term.
b. Measured the lease liability in a manner similar to other financial liabilities such that interest would have been recognized each period to produce a constant periodic rate of interest on the remaining balance of the liability. This typically would have resulted in the lessee recognizing decreasing interest costs over the lease term as the lessee makes lease payments reducing the liability balance.

BC48. The Board received differing views on the effects of this proposed single-approach model on a lessee's profit or loss. Some stakeholders agreed with the proposals in the 2010 Exposure Draft. For example:

a. Some stakeholders noted that every lessee obtains an asset (the right to use the underlying asset) at the commencement date and has an obligation to pay for that right. Accordingly, a lessee should account for the transaction no differently from acquiring any other nonfinancial asset and separately financing that purchase, which would result in recognizing interest on the liability and amortization of the asset.
b. Other stakeholders said that a single-approach lessee accounting model may not best reflect the economics of all lease transactions. Nonetheless, they supported the single-approach lessee accounting model proposed in the 2010 Exposure Draft because, in their view, it would be less complex and less costly to apply than a model with multiple approaches. They noted the benefits of removing the need for a lease classification test and having only one method of accounting for all leases from an administrative perspective. They also questioned whether multiple expense recognition patterns would increase the usefulness of information provided to users of financial statements.
c. The majority of financial statement users engaged throughout the project, including most credit analysts, supported a single-approach lessee accounting model in which lessees account for the acquisition of right-of-use assets in a manner consistent with the manner in which other entities account for the acquisition of similar, physical assets. Those users generally stated that the single-approach model proposed in the 2010 Exposure Draft would most closely resemble the adjustments they make to lessees' financial statements in previous GAAP, which are to adjust a lessee's operating lease accounting to approximate capital lease accounting (that is, they split a lessee's operating lease expense into hypothetical amortization and interest expense components).

d. A majority of practitioners generally expressed a conceptual preference for a single-approach lessee accounting model.

BC49. However, many of the Board's stakeholders, including most preparers, disagreed with having a single-approach lessee accounting model. For example:

a. Some stakeholders noted that in a typical lease the lessee receives equal benefits from use of the underlying asset and pays equal amounts in each period. The result of separately recognizing interest on the lease liability and amortization of the right-of-use asset, which would typically result in higher total expense in the earlier years of the lease and lower total expense in the later years of the lease, would not, in their view, reflect the economics of receiving equal benefits for equal payments over the life of the lease. They suggested a lessee accounting model that would allocate the total cost of the lease to each period to reflect the pattern in which the lessee consumes benefits from use of the underlying asset for those leases accounted for as operating leases in previous GAAP, while acknowledging that some leases, effectively those accounted for as capital leases in previous GAAP, are similar in nature to the purchase of a nonfinancial asset.
b. Other stakeholders said that because leases vary widely, ranging from those covering almost all of the life of the underlying asset to those covering a very short portion of the life of the underlying asset, a single-approach lessee accounting model would not accurately reflect the economics of all lease transactions. They suggested that the Board propose different accounting approaches for different populations of leases.
c. Many other stakeholders commented that accounting for all leases as finance leases would be a costly way to achieve what many view as the primary improvement resulting from the amendments in this Update (that is, the recognition of lease assets and lease liabilities for all leases other than short-term leases). Even though many lessees accounted for capital leases in previous GAAP, lessees typically had a much smaller volume of capital leases than operating leases, such that many preparers commented that significant new systems capabilities and process changes would be necessary to implement the single-approach lessee accounting model and that those would be costly to implement. In addition, accounting for all leases as finance leases would break the alignment between GAAP and U.S. tax and regulatory reporting, resulting in additional costs to preparers to maintain separate accounts for those reporting purposes.
d. A significant minority of financial statement users supported one or more alternatives that accounted for more than one type of lease, such as the model proposed in the 2013 Exposure Draft (see paragraph BC53) or an approach that would retain the income statement and cash flow results in previous GAAP (as is the result from the provisions in Topic 842).

BC50. Topic 842 does not include a single-approach lessee accounting model such as that proposed in the Discussion Paper and in the 2010 Exposure Draft, in some measure, for all of the reasons outlined in paragraph BC49. The relative importance of each of those reasons differed for each Board member. However, the principal reasons that model was rejected include the following:

a. The lessee accounting model in Topic 842 reflects the view of those Board members that believe there are substantive economic differences between different types of leases that should be reflected in the financial statements as described in paragraphs BC56 and BC57. Those Board members concluded that the lessee accounting model in Topic 842 provides a faithful representation of those economic differences in a lessee's financial statements, even if the subsequent measurement for operating lease right-of-use assets is different from that for other nonfinancial assets.
b. Those Board members who view the primary improvement resulting from the amendments in this Update to be the recognition of lease assets and lease liabilities for all leases (other than short-term leases) concluded that accounting for all leases in the manner of finance leases to enact this improvement will be more costly than the lessee accounting model included in Topic 842 for the reasons explained in paragraph BC49(c). Preparers in the United States stated that they generally were not concerned about having to assess lease classification in a manner substantially consistent with previous GAAP and did not consider the elimination of a lease classification assessment to be a significant source of cost savings. Therefore, the lessee accounting model (including the classification approach) in Topic 842 represents the most cost-effective way to achieve this primary improvement.

BC51. Some Board members, however, continue to support a single-approach lessee accounting model because, in their view, the generally straight-line single lease cost for operating leases required by Topic 842 does not faithfully represent the underlying economics of those leases because it is inconsistent with accounting for the time value of money and amortization of the right-of-use asset that would reasonably reflect diminution of value of that right-of-use asset. Despite preferring a single-approach lessee accounting model, those Board members support the issuance of this Update because they consider the requirements in Topic 842, in particular, the recognition of lease assets and lease liabilities for operating leases and the enhanced disclosures for lessees and lessors, to be a significant improvement in financial reporting as compared with previous GAAP.

Consumption-based lessee accounting model

BC52. The 2013 Exposure Draft proposed that there should be two different types of leases (Type A and Type B) and that different lessee accounting approaches should be applied to each type of lease. The Board proposed that the factor that would be used to distinguish between the two types of leases would be

the level of the lessee's consumption of the economic benefits embedded in the underlying asset.

BC53. Feedback on those proposals was mixed. Overall, most U.S. preparers (and preparer groups) that commented on the 2013 Exposure Draft preferred a model with multiple approaches under which some leases would be accounted for in the same manner as other financed purchases of nonfinancial assets and other leases would be accounted for in a manner more similar to operating lease accounting in previous GAAP (but with recognition of right-of-use assets and lease liabilities). This was preferred over the single lessee accounting model proposed in the Discussion Paper and in the 2010 Exposure Draft. However, most of those respondents did not support the "consumption" principle proposed in the 2013 Exposure Draft for determining which model applied to which leases. Those U.S. preparers were of the view that there should be no change from previous GAAP to the statement of comprehensive income or the statement of cash flows, which would have been the result of the lessee accounting model proposed in the 2013 Exposure Draft. Most of those practitioners that supported a dual-approach lessee accounting model were, like most preparers, not supportive of the consumption-based classification approach proposed in the 2013 Exposure Draft. In contrast, some users, particularly those using the financial statements of lessees with significant real estate leases, were supportive of the dual-approach model based on consumption proposed in the 2013 Exposure Draft, stating that it was consistent with how they analyze the leasing activity of the companies they follow.

BC54. The Board rejected the consumption-based classification approach in the 2013 Exposure Draft in favor of the classification approach in Topic 842 principally for one or more of the following reasons, which are generally consistent with the feedback received from many of the Board's stakeholders in response to the 2013 Exposure Draft:

a. Some Board members concluded that the classification approach in the 2013 Exposure Draft would have resulted in inappropriately classified Type A and Type B leases. Those Board members generally agreed that some leases should be accounted for in a manner consistent with purchases of nonfinancial assets (Type A leases), while other leases should result in the lessee recognizing a generally straight-line single lease cost throughout the lease term (Type B leases), but those Board members concluded that a lessee should reflect a single lease cost for most (or all) leases classified as operating leases in previous GAAP. The consumption-based classification approach would have accounted for many of those leases as Type A leases.
b. The Board generally agreed that the lease classification approach in the 2013 Exposure Draft would have been more costly and complex to apply than one mostly aligned with the classification approach in previous GAAP. The Board concluded that retaining the lease classification regime in previous GAAP, in all material respects, will substantially reduce the costs of implementing and applying Topic 842 as compared with any

other classification approach that was considered. This is because the classification approach in previous GAAP is:

1. Well established in practice such that lessees are comfortable in applying the guidance. Any new lease classification approach, such as that in the 2013 Exposure Draft, would require entities to undertake training on the new classification requirements as well as to design, develop, and implement new processes and internal controls.
2. Substantially aligned with U.S. tax and regulatory accounting and reporting requirements. Retaining the alignment between book, tax, and regulatory accounting and reporting prevents lessees from having to maintain multiple sets of records to meet different reporting requirements.

BC55. Those Board members who view the primary improvement in Topic 842 to be the recognition of lease assets and lease liabilities concluded that, in the face of diverse views about the effects of the right-of-use model on a lessee's profit or loss (including no clear consensus from users), as well as diverse views on how to effect the "line" within a lessee accounting model that accounts for more than one type of lease, substantially retaining the lease classification approach in previous GAAP is a more practical solution than attempting to introduce an entirely new classification regime.

Classification approach in Topic 842

BC56. The lessee accounting model in Topic 842 does not account for all leases in the same way on the basis that there are economic differences among leases. After considering feedback on the Discussion Paper and on both Exposure Drafts, however, the Board decided to abandon the consumption principle that was proposed in the 2013 Exposure Draft for distinguishing between leases. Instead, the lessee accounting model in Topic 842 classifies leases as finance or operating leases on the basis of whether the lease is economically similar to the purchase of a nonfinancial asset because the lessee, in effect, obtains control of the underlying asset (that is, the ability to direct the use of and obtain substantially all the remaining benefits from the underlying asset), in contrast to merely obtaining control over the *use* of the underlying asset for a period of time. This classification principle is broadly consistent with the longstanding classification principle in previous GAAP and is applied in substantially the same way as the lease classification guidance in previous GAAP.

BC57. A lease is not the same as a purchase of the underlying asset, even when the lease is a finance lease. The rights that a lessee obtains under any lease (whether that lease is classified as a finance lease or an operating lease) are different from the rights that are obtained from the outright purchase of an asset (for example, a lessee cannot sell the underlying asset). However, the Board decided that a finance lease is economically similar to an acquisition of the underlying asset because the terms of a finance lease generally (a) permit an entity

to direct the use of the underlying asset in a manner that allows it to obtain substantially all of the remaining benefits from the asset and (b) impose obligations on the lessee that are similar to those an entity incurs if it finances the purchase of an asset. The Board observed that, even within the category of finance leases, some leases are more similar than others to an acquisition of the underlying asset. Operating leases on the other hand grant different rights to and impose different obligations on the lessee than finance leases and other "rights of use," such as licenses of intellectual property. Rather than granting rights similar to those conveyed by ownership, the lessee in an operating lease has no rights or exposure to a generally more significant residual asset (that is, the lessee does not obtain substantially all of the remaining benefits from the underlying asset—frequently, the lessee obtains only a minor portion of the remaining benefits and will not be exposed to or benefit from any changes in the value of the underlying asset during the lease term). In the case of lessee bankruptcy (at least under U.S. law), the lessee's obligations in an operating lease are treated differently than the way its obligations in a finance lease are treated (or a license of intellectual property)—that is, operating lease obligations generally do not survive bankruptcy because they are not considered to be debt. In contrast, financial obligations arising from purchased assets, licenses, and finance leases generally survive in bankruptcy. Consequently, Topic 842 differentiates the financial statement reporting of finance leases from that of operating leases. Paragraphs BC59–BC65 explain the recognition of lease cost for finance and operating leases in Topic 842, while paragraphs BC66–BC69 explain the effect of the lessee accounting model (including its different approaches to finance and operating leases) on the statement of financial position in Topic 842. Paragraphs BC70–BC74 explain the lease classification criteria in Topic 842.

The business purpose of the lessee

BC58. Before issuing the 2013 Exposure Draft, the Board also considered a model that would have distinguished a lessee's accounting for a lease on the basis of the lessee's business purpose for entering into the lease. That is, a lessee that enters into a lease solely to gain access to the underlying asset for a period of time would account for the lease as an operating lease. In contrast, a lessee that is entering into the lease as a way to finance the purchase of the underlying asset would account for the lease as a finance lease. However, the Board rejected that approach for comparability reasons. Because leases would have been classified on the basis of each lessee's assessment of its business purpose, the judgment applied by management might have varied by lessee. That would have made it more difficult for users of financial statements to understand when and how management had applied its judgment when classifying leases, both within the same entity and between entities.

Recognizing Lease Cost

BC59. Topic 842 refers to recognizing and disclosing lease cost rather than lease expense because any lease cost that is capitalized as part of the cost to acquire or construct an asset will not be recognized as lease expense in the statement of comprehensive income (for example, costs capitalized as part of manufacturing inventory or placing an item of property, plant, and equipment into service).

BC60. A lessee's recognition of lease cost for a finance lease in accordance with Topic 842 is consistent with a lessee's recognition and presentation of lease cost for a capital lease in previous GAAP. A lessee in a finance lease will recognize and present amortization of the right-of-use asset consistently with the depreciation or amortization of other nonfinancial assets and will recognize and present interest on the lease liability consistently with interest on other debt-like financial liabilities measured on a discounted basis. This is consistent with the Board's decision that finance leases are economically similar to the financed acquisition of other nonfinancial assets. While stakeholders expressed different views throughout the leases project about which leases should be accounted for in this manner, they generally agreed that separate recognition of interest on the lease liability and amortization of the right-of-use asset are appropriate for those leases that will be classified as finance leases in Topic 842.

BC61. In contrast to the recognition of lease cost for finance leases, Topic 842 recognizes a single lease cost for operating leases on the basis of the pattern in which the benefits conveyed by the lease are consumed, which is generally (but not always) on an equal basis over the lease term. This difference in lease cost recognition for finance and operating leases is based on the view of some Board members that a single operating lease cost more appropriately reflects the economics of operating leases than the separate recognition of interest and amortization that Topic 842 requires for finance leases. This conclusion is consistent with those Board members' view that operating leases grant different rights to and impose different obligations on the lessee such that they are not economically equivalent to other acquisitions of nonfinancial assets because operating leases merely grant the lessee the right to direct the use of the lessor's asset during the lease term and do not expose the lessee to (or permit the lessee to benefit from) changes in the value of the underlying asset.

BC62. Other Board members disagree that the generally straight-line single lease cost that will be recognized for operating leases faithfully represents the underlying economics of those leases because it is inconsistent with accounting for the time value of money and the amortization that should result for a right-of-use asset that the lessee consumes on a generally straight-line basis over the lease term, regardless of how it pays for that asset, and recognizes separately from the lease liability. Those Board members would have preferred a lessee accounting model that recognizes lease cost for all leases in the manner prescribed for finance leases, but they support the issuance of this Update

nonetheless because they consider the requirements in Topic 842, in particular, the recognition of lease assets and lease liabilities for operating leases and the enhanced disclosures for lessees and lessors, to be a significant improvement from previous GAAP.

BC63. The lessee accounting model in the Discussion Paper and the 2010 Exposure Draft would have recognized lease cost in the manner described in paragraph BC60 for all leases. The lessee accounting model in the 2013 Exposure Draft proposed that for some leases (Type B leases), a lessee would recognize a single lease cost, which would *combine* (a) the periodic amortization of the right-of-use asset and (b) the periodic unwinding of the discount on the lease liability to produce a single, straight-line lease cost. The lessee would recognize the periodic unwinding of the discount on the financial lease liability in accordance with the interest method (consistent with the accounting for other financial liabilities), while recognizing amortization of the right-of-use asset as a "balancing figure" that, together with the periodic unwinding of the discount on the lease liability, would achieve a straight-line total lease cost throughout the lease term (absent an impairment of the right-of-use asset). This approach attempted to reconcile the Board's separate decisions that (1) all leases result in the creation of a nonfinancial right-of-use asset and a financial lease liability for the lessee and (2) a single lease cost recognized on a generally straight-line basis over the lease term best reflects the economics of some leases.

BC64. While a majority of respondents to the 2013 Exposure Draft agreed that a single lease cost should be recognized for some leases, many respondents said that the prescribed mechanics for the Type B single lease cost (combining separately determined amortization of the right-of-use asset and unwinding of the discount on the lease liability to achieve the single lease cost amount each period) was complex and unnecessary to achieve the Board's objective. Some stakeholders suggested that this prescribed method for producing the single lease cost, particularly when coupled with a requirement to disclose the periodic unwinding of the discount separately from the single total lease cost amount (as was proposed in the 2013 Exposure Draft), would be costly for preparers because it would require new systems capabilities and processes to calculate and report the separate unwinding of the discount on the lease liability and the unique amortization of the right-of-use asset. In response to those concerns, the Board decided not to refer to the determination of the single lease cost for operating leases in Topic 842 as the combination of two separate elements (that is, the periodic unwinding of the discount on the lease liability plus the amortization of the right-of-use asset). That characterization was inconsistent with the view that the single lease cost represents the lessee's singular consumption of the economic benefits embedded in an operating lease. In addition, the Board concluded that eliminating the prescribed mechanics in the 2013 Exposure Draft for the single lease cost for operating leases will permit entities to determine the single lease cost using the same operating lease cost process applied under previous GAAP (that is, when combined with the Board's decisions on subsequent measurement

of operating lease right-of-use assets and lease liabilities), which will significantly reduce the costs to implement and apply the new leases guidance as compared with the proposals in the 2013 Exposure Draft.

BC65. In reaching its decisions (a) on how to recognize lease cost for operating leases and (b) not to require separate disclosure of either the periodic unwinding of the discount on operating lease liabilities or amortization of operating lease right-of-use assets, the Board acknowledged that many users would not receive information that they deem important to their analysis (for example, separate interest information). Therefore, the Board decided to include alternative quantitative disclosures (for example, weighted-average discount rate information) that will allow those users to receive much, but not all, of the same information without requiring lessees to implement significant new systems or processes to produce those disclosures or to produce the periodic single operating lease cost. Lessee disclosures are discussed in more detail in paragraphs BC272–BC291.

Subsequent Measurement of the Right-of-Use Asset

BC66. In the Board's view, the right-of-use asset in a finance lease is economically similar to other nonfinancial assets, conveying to the lessee rights similar to many other nonfinancial assets (for example, many licenses to intangible assets). As a consequence, in Topic 842, the right-of-use asset arising from a finance lease is measured in the same manner as any other acquired nonfinancial asset. That is, the right-of-use asset is (a) measured at cost, net of accumulated amortization, and (b) amortized on a straight-line basis from the commencement date to the end of the lease term unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of that right-of-use asset.

BC67. In contrast, Topic 842 accounts for the right-of-use asset in an operating lease differently from other nonfinancial assets on the basis that it conveys rights to the lessee that are different from other nonfinancial assets. On the basis of those different rights conveyed by an operating lease, some Board members concluded that a reasonable representation of the economics of operating leases is to recognize a single lease cost that reflects the pattern in which the benefit from the right of use conveyed by the lease is consumed. Those Board members acknowledge that recognizing a single lease cost (that is, not separately recognizing amortization of the right-of-use asset in an operating lease) does not articulate how to subsequently measure the right-of-use asset in an operating lease and results in an atypical pattern of change in the carrying amount of that asset over the lease term. For those Board members, who view accurate measurement of the lease liability as paramount, the decision to measure the right-of-use asset by reference to the lease liability throughout the lease term, adjusted for the effects of accrual-based accounting, regardless of the atypical pattern of change in the carrying amount of the right-of-use asset, is principally one of cost benefit. In their view, measuring the right-of-use asset by reference to the lease

liability represents the most cost-effective way to enact what they view as the primary improvement resulting from Topic 842 (that is, the recognition of the lease assets and lease liabilities that arise from operating leases) while still reflecting what they view as the economic substance of those leases in the income statement and the statement of cash flows and reasonably representing the future economic benefits to the lessee in the lease.

BC68. Some Board members further explain that, in their view, the apparent atypical subsequent measurement of the operating lease right-of-use asset occurs solely because of the Board's decision to present that right-of-use asset and the related lease liability on a discounted basis in the financial statements. Absent the Board's decision to discount the lease liability and, correspondingly, the right-of-use asset, the subsequent measurement of the right-of-use asset would be consistent with that of other nonfinancial assets (that is, recognizing amortization expense on a generally straight-line basis consistent with the generally equal benefits the lessee receives from its access to the underlying asset over the lease term). For those Board members, the decision to more faithfully represent the lease liability and the right-of-use asset on the statement of financial position by presenting them on a discounted basis should not override what they view as the fundamental premise of the lessee accounting model in Topic 842. That premise is that operating leases are economically different from finance leases and that recognition of a generally straight-line single lease cost for operating leases appropriately reflects the fact that, in an operating lease, the lessee solely obtains a generally equal right to use the underlying asset throughout the lease term and is not exposed to, nor does it benefit from, changes in the value of the underlying asset in the way an owner of a similar asset is exposed to (or benefits from) such changes. Because the owner of a nonfinancial asset is exposed to (or benefits from) changes in value of the underlying asset, the benefits to be derived from the asset are not directly correlated with the generally equal payments to repay the financing of the asset, which supports the changes in the carrying amount of the asset not being linked to the carrying amount of the financial liability and separate recognition of depreciation (or amortization) of the owned nonfinancial asset and interest on the financial liability. Those Board members view the measurement of the right-of-use asset in an operating lease as linked, economically, to the measurement of the lease liability because the carrying value of the right-of-use asset, which reflects the remaining economic benefits of equal access to the underlying asset during the remainder of the lease term, is directly correlated to the generally equal lease payments the lessee makes for those benefits. Because, in their view, the measurement of the right-of-use asset and the measurement of the lease liability should remain linked throughout the lease term, the measurement of the right-of-use asset should be affected by the time value of money in the same way as the lease liability such that its carrying amount changes in tandem with the changes to the lease liability over the lease term. However, this linked movement should be adjusted for the effects of increasing or decreasing lease payments (that is, the effects of accrual-based accounting) or impairment of the right-of-use asset (see paragraphs BC255–BC259 for additional discussion on

impairment of operating lease right-of-use assets). Those Board members believe that the "annuity-type" pattern of change in the carrying amount of the operating lease right-of-use asset between periods is a consequence of an accounting model under which both (a) the carrying amount of the right-of-use asset and the carrying amount of the lease liability are linked throughout the useful life of the right-of-use asset (that is, the lease term), absent impairment, and (b) the most faithful representation of the right-of-use asset and the lease liability in the statement of financial position requires discounting of those items. Those Board members would not support an annuity-type pattern of amortization outside those circumstances.

BC69. Initial and subsequent measurement of right-of-use assets and lease liabilities is further discussed in paragraphs BC187–BC259.

Lease Classification Test

BC70. The lessee accounting model in Topic 842 classifies leases as finance leases or operating leases on the basis of whether the lease is similar economically to the purchase of a nonfinancial asset because the lessee, in effect, obtains control of the underlying asset (in contrast to merely obtaining control over the *use* of the underlying asset) by being able to direct its use and obtain substantially all of its remaining benefits as a result of the lease.

BC71. The Board decided that a lease should be classified as a finance lease when any one of the following five criteria is met. The Board observed that some of the criteria below (for example, the transfer of ownership criterion) may provide a more concrete indication of when the lessee, in effect, obtains the ability to direct the use of, and obtain substantially all the remaining benefits from, the underlying asset as a result of the lease than other criteria (for example, the remaining economic life criterion). However, the Board concluded that the criteria, as outlined and for the reasons below, provide a reasonable, even if not absolute, basis for distinguishing leases that are economically similar to the purchase of a nonfinancial asset (finance leases) from those that are not, acknowledging that economic similarity may be greater or less for some finance leases than others and that use of these classification criteria will achieve the goal of those Board members who wanted the classification test in Topic 842 to yield similar results to the classification test in previous GAAP.

a. *The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.* A lessee directs the use of an underlying asset during the lease term. A provision that transfers ownership of the underlying asset to the lessee by the end of the lease term means that the lessee has the right to both (1) direct the use of the underlying asset (both during the lease term and subsequently) and (2) obtain substantially all of the remaining benefits of the underlying asset.
b. *The lease grants the lessee an option to purchase the underlying asset that it is reasonably certain to exercise. Reasonably certain* is a high

threshold, evaluated on the basis of relevant economic factors (see paragraphs BC193–BC197). Such a provision is not substantively different from a provision that automatically transfers ownership of the underlying asset to the lessee.

c. *The lease term is for a major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.* The Board considered whether this criterion should refer to the lease term being for "substantially all" of the remaining economic life of the underlying asset to align with the notion that for an entity to control an asset, it must have the ability to obtain substantially all the remaining benefits from the asset. The Board rejected the use of "substantially all" as the threshold for this criterion because although the lease term may represent only a major part of the remaining economic life of the underlying asset, equipment assets, in particular, depreciate in a front-loaded manner. This means that a lease term that is, for example, 75 percent of an asset's remaining economic life will frequently give the lessee the ability to obtain a disproportionate percentage of the remaining benefits from that asset. This is because new (or newer) equipment, reflecting later technology and in better condition, can be assumed to be more efficient and, hence, yield proportionately more use benefit than older equipment that has been subject to obsolescence and/or the wearing-out process. The Board also decided that an entity should assess whether the lease term is for a major part of the *remaining* economic life of the underlying asset at the commencement date rather than its *total* economic life, because that aligns with the notion that an entity controls an asset when, in part, it has the ability to obtain substantially all of the *remaining* benefits from that asset. Some Board members observed that this criterion may provide the most circumstantial evidence as to whether the lessee obtains the ability to direct the use of, and obtain substantially all the remaining benefits from, the underlying asset of the criteria provided. However, the Board concluded that inclusion of this criterion is important to ensuring that a lease that is expected to consume substantially all of the remaining benefits of an underlying asset is not classified inappropriately solely because all or a significant portion of the lease payments are variable lease payments. The exception to considering this criterion when the lease commences at or near the end of the economic life of the underlying asset is contrary to the lease classification principle because a lessee can direct the use of and obtain substantially all the remaining benefits from a significantly used asset just the same as it can a new or slightly used asset. However, the Board determined that an exception is appropriate because it would be inconsistent to require that a lease covering the last few years of an underlying asset's economic life be recorded as a finance lease by a lessee (or sales-type lease by a lessor) when a similar lease of that asset earlier in its economic life would have been classified as an operating

lease. The Board concluded that this would not appropriately reflect the economics of those leases.

d. *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 underlying asset.* If the lessee, through its contractually obligated payments, guarantees recovery of substantially all the fair value of (that is, in essence, the lessor's investment in) the underlying asset, the lessee controls substantially all the remaining benefits of the underlying asset. Some stakeholders questioned whether this criterion should take into account those payments that would be made only to satisfy a residual value guarantee. However, when the lessee has guaranteed all or a portion of the lessor's estimated residual value, the lessee controls that portion of the underlying asset that it has guaranteed. Under the terms of the contract, the lessee could either return the asset to the lessor with the required residual value or use and consume the economic benefits in the asset, making a financial payment to the lessor to satisfy the residual value guarantee. Because the lessee controls that decision, it controls the benefits of the asset embodied in that guaranteed residual value. The Board considered whether this criterion should be based on the present value of the expected residual asset because that might be more indicative of whether the lessor had transferred substantially all the remaining benefits and, therefore, control of the underlying asset to the lessee. However, the Board decided that this might be much more subjective and complex for lessees to apply than this criterion because lessees often have much less information or technical knowledge about the underlying asset from which to make this determination. The Board decided that this criterion, which existed in previous GAAP and, therefore, is familiar to lessees (and lessors), is an effective proxy for a residual-value-focused criterion because it effectively measures the opposite.
e. *The underlying asset is of a specialized nature such that it is expected to have no alternative use to the lessor at the end of the lease term.* In general, it is expected that lessors would lease specialized assets that have no alternative use to them at the end of the lease term only under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee (thus, one of the other criteria for a finance lease also likely will be met). However, even if that is not the case, when an underlying asset has no alternative use to the lessor at the end of the lease term, the lessee consumes all (or substantially all) of the remaining benefits from the underlying asset. Absent significant rework or a change in circumstances during the lease term (for example, the emergence of another potential customer or new use for the underlying asset in its present, specialized form), there are no remaining benefits inherent in the specialized underlying asset that revert to the lessor at the end of the lease term.

BC72. Despite evaluating whether the lease is economically similar to the purchase of a nonfinancial asset from the perspective of control rather than from the perspective of risks and benefits of ownership (as was the basis in previous GAAP), the classification approach in Topic 842 is substantially similar to that in previous GAAP for determining whether a lease is a capital lease or an operating lease and will be applied similarly in most circumstances. The Board concluded that, in the absence of a compelling rationale for any other classification approach, of which many were considered during the course of the leases project, retaining an approach that is substantially similar to that in previous GAAP will reduce the costs and complexity of applying a new leases standard. Paragraphs BC54 and BC55 explain the Board's conclusion in this regard. Board members further observed that, in general, and at least partially because of U.S. tax, regulatory, and legal requirements, an entity's rights and obligations differ for leases that were classified as capital leases in previous GAAP from those that were classified as operating leases. Therefore, reflecting that "line" as the point at which the accounting for a lease should reflect differing economics in Topic 842 is reasonable.

BC73. The lease classification criteria in Topic 842 do not depend on bright-line thresholds as they did in previous GAAP. The Board observed that the bright-line classification thresholds were one of the areas most frequently criticized in previous GAAP. Those criticizing the bright-line thresholds often noted that transactions that were only immaterially different were accounted for very differently. Consequently, the Board decided that it should not mandate bright-line thresholds for the lease classification test in Topic 842. Nevertheless, the Board understands that entities need to ensure the leases guidance is operational in a scalable manner, which often requires the establishment of internal accounting policies and controls. As a result, the Board included implementation guidance in Topic 842 that states that one reasonable application of the lease classification guidance in that Topic is to conclude, consistent with previous GAAP, that 75 percent or greater is a "major part" of the remaining economic life of an underlying asset, a lease term that commences within the last 25 percent of the economic life of the underlying asset is commencing "at or near" the end of the economic life of the underlying asset, and that 90 percent or greater is "substantially all" the fair value of the underlying asset (and that anything less than those amounts is not a major part, at or near the end of the economic life of the underlying asset, or substantially all, respectively). While the Board acknowledges that this largely retains some, but not all, of the "bright lines" in the lease classification test in previous GAAP, it does not mandate those bright lines. The Board also observed that, to some extent, criticism of the previous bright-line thresholds will likely be mitigated solely by the fact that all leases (other than short-term leases for which a lessee elects the recognition and measurement exemption) are required to be recognized on the balance sheet under Topic 842.

BC74. Lastly, the Board decided that lessees should determine lease classification for each separate lease component. That is, an entity assesses lease

classification for the component, not for each lease within the component (for example, Example 13 in Section 842-10-55 [paragraphs 842-10-55-146 through 55-149] states that the entity assesses lease classification for the turbine plant and not for the turbine, the building, and the land individually). The Board decided that determining lease classification for each lease within the separate lease component would be inconsistent with determining that the separate lease component is the proper unit of account at which to apply the leases guidance to then assess lease classification at a different level. Because the Board understands that a single lease component may include multiple underlying assets, the Board has specified that when classifying a single lease component that includes the lease of multiple underlying assets, an entity considers:

a. The remaining economic life of the predominant asset in the lease component for purposes of applying the classification criterion in paragraph 842-10-25-2(c). The Board noted that assessing the predominant asset in a lease component that includes multiple underlying assets will be straightforward in most cases. That is, the assessment is a qualitative one that requires entities to conclude on what is the most important element of the lease, which should be relatively clear in most cases. The Board also noted that if an entity is unable to identify the predominant asset, it may indicate that there is more than one separate lease component in the contract.
b. The fair value of the separate lease component for purposes of applying the classification criterion in paragraph 842-10-25-2(d). The Board noted that the fair value of the separate lease component may be different from the sum of the fair values of the underlying assets.

The Lessor Accounting Model

Rights and Obligations Arising from a Lease for the Lessor

Lease receivable

BC75. When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee controls the right of use and has a liability to make lease payments (lease liability). Accordingly, the lessor has a lease receivable. The lessor controls that right to payment—for example, it can decide to sell or securitize that right. The right arises from a past event (the lessor's performance at the commencement date of making the underlying asset available for use by the lessee—that is, transferring the right-of-use asset to the lessee) and is expected to result in future economic benefits (typically cash from the lessee) flowing to the lessor.

BC76. Consequently, the Board concluded that the lessor's lease receivable meets the definition of an asset in Concepts Statement 6. Paragraphs BC88–BC90

explain the Board's rationale for lessors not recognizing the lease receivable that results from an operating lease.

Rights retained in the underlying asset

BC77. Although the lessor transfers the right to use the underlying asset to the lessee at the commencement date, the lessor has the right to the underlying asset at the end of the lease term (and retains some rights to the underlying asset during the lease term, for example, the lessor retains title to the asset). Consequently, the lessor retains some of the potential economic benefits embedded in the underlying asset.

BC78. The lessor controls the rights it retains in the underlying asset. A lessor can often, for example, sell the underlying asset (with the lease attached) or agree at any time during the initial lease term to sell or re-lease the underlying asset at the end of the lease term. The lessor's rights to the underlying asset arise from a past event—the purchase of the underlying asset or signing of the head lease, if the lessor is a sublessor. Future economic benefits from the lessor's retained rights in the underlying asset are expected to flow to the lessor, assuming that the lease is for anything other than the full economic life of the asset. The lessor would expect to obtain economic benefits either from the sale, re-lease, or use of the underlying asset at the end of the lease term.

BC79. Consequently, the Boards concluded that the lessor's rights retained in the underlying asset meet the definition of an asset in Concepts Statement 6. However, consistent with the Board's decision that a lessor should not recognize separately the lease receivable that results from an operating lease (see paragraphs BC90–BC92), the Board concluded that lessors should not recognize separately their rights retained in underlying assets subject to operating leases. Instead, the lessor should continue to recognize the entire underlying asset.

The Lessor Accounting Model

BC80. Having concluded that the lessor's lease receivable and rights retained in the underlying asset both meet the definition of an asset, the Board considered whether requiring a lessor to both recognize those assets for all leases and derecognize the underlying asset would improve financial reporting to such an extent that the benefits from the improvements would justify the costs associated with such a change.

Whether to replace (or change) the lessor accounting model in previous GAAP

BC81. Both the 2010 and 2013 Exposure Drafts proposed substantial changes to the lessor accounting model from that in previous GAAP. The Board considered the lessor accounting proposals in and feedback on each of those Exposure Drafts

in deciding whether to replace (or substantially change) the lessor accounting model in previous GAAP as part of the amendments in this Update.

BC82. In the 2010 Exposure Draft, the Board proposed that a lessor would recognize a lease receivable for all leases. That is consistent with a lessee recognizing a lease liability for all leases.

BC83. If the lessor retained exposure to significant risks or benefits associated with the underlying asset, the Board proposed that the lessor would continue to recognize the underlying asset as its asset, as well as recognize a lease receivable. The lessor also would recognize a liability. This approach was described as the performance obligation approach in the 2010 Exposure Draft. Under this approach, the lease was considered to create an asset, the lease receivable, and a liability (that is, an obligation to permit the lessee to use the underlying asset over the lease term). The asset and the liability created by the lease would be separate from the underlying asset itself. The lessor would retain control of the underlying asset and would continue to recognize it. The lessor would recognize periodic lease income on the performance obligation liability (on the basis of the pattern in which the lessee consumed benefits under the lease, often straight line), periodic interest income on the lease receivable (using the effective interest method), and depreciation on the underlying asset.

BC84. If the lessor did not retain exposure to significant risks or benefits associated with the underlying asset, the Board proposed that the lessor would derecognize the portion of the underlying asset relating to the right-of-use asset transferred to the lessee and recognize a lease receivable. The rights retained in the underlying asset would be reclassified as a residual asset. That approach was described as the derecognition approach in the 2010 Exposure Draft. The lessor would recognize the difference between the initial lease receivable and the cost of the portion of the underlying asset that was derecognized as a gain or loss at lease commencement. After lease commencement, the lessor would recognize interest income each period on the lease receivable.

BC85. There was very little support for the performance obligation approach from respondents to the 2010 Exposure Draft or from participants at outreach meetings. Many viewed the approach as inappropriately inflating a lessor’s assets and liabilities. Many questioned how one set of cash flows—the cash flows to be received from the lessee—could relate to both the lease receivable and the underlying asset. Many also questioned how the obligation to permit the lessee to use the asset would meet the definition of a liability. Having delivered the underlying asset to the lessee, the lessor typically would have nothing further to do in relation to the right-of-use asset other than to comply with the terms and conditions of the contract. While for most leases, the lessor must not interfere with the lessee’s “quiet enjoyment” of the underlying asset unless the lessee breaches the contract, most respondents did not view complying with the terms and conditions of a contract as an obligation that should give rise to a liability, particularly because there would appear to be no expected outflow of future

economic benefits from the lessor, which is an essential component of the definition of a liability.

BC86. Some stakeholders supported applying the derecognition approach to all leases; they generally agreed that the lessor does not have a liability solely because it must comply with the terms and conditions of the contract and noted that the derecognition approach was the most consistent with the view that the lessor fulfills its obligation to transfer a right-of-use asset at lease commencement. Other stakeholders stated that the existing lessor accounting requirements were not "broken" and questioned whether the benefit of changing lessor accounting would justify the costs associated with that change. Others were concerned about the lack of consistency between the lessee accounting proposals (a single lessee accounting model) and the lessor accounting proposals (a dual lessor accounting model). Many stakeholders suggested that the Board make the lessor proposals consistent with the revenue recognition proposals, the lessee accounting proposals, or, ideally, both.

BC87. On the basis of the feedback on the 2010 Exposure Draft, the Board decided to propose an alternative lessor accounting model in the 2013 Exposure Draft. In accordance with the proposals in the 2013 Exposure Draft, a lessor would determine the appropriate lessor accounting approach using the same classification requirements as those proposed for lessee accounting (that is, based on the same "consumption" principle) in that Exposure Draft. If a lessee was expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset (a Type A lease), the lessor would account for the transfer of the right-of-use asset to the lessee as the sale of that portion of the underlying asset that the lessee is expected to consume. Accordingly, the lessor would derecognize the underlying asset and recognize a lease receivable and a residual asset, which would be measured on a cost basis. The lessor also would recognize any profit relating to the lease at the commencement date (that is, the portion of the difference between fair value of the underlying asset and its carrying amount attributable to the right-of-use asset granted to the lessee). If the lessee was not expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset (a Type B lease), the lessor would account for the lease in a manner substantially similar to operating lease accounting in previous GAAP and in Topic 842. Accordingly, the lessor would not recognize a lease receivable and a residual asset and would not derecognize the underlying asset. The lessor would recognize rental income over the lease term, typically on a straight-line basis. The Board decided that any other approach to Type B leases (such as the performance obligation approach in the 2010 Exposure Draft or netting the lease receivable and the performance obligation liability) would not be justified.

BC88. Despite concluding that under the right-of-use model the lessor's performance at lease commencement (that is, making the underlying asset available for the lessee's use) creates an unconditional right to receive lease payments (that is, a lease receivable), the Board decided not to propose the

recognition of a lease receivable for all leases, thereby rejecting a single lessor accounting model along the lines of the derecognition approach in the 2010 Exposure Draft. Although some stakeholders had suggested applying the derecognition approach to all leases, the Board rejected that approach, mainly for most property leases (that is, leases of land or buildings), for a number of reasons:

a. When a lessee is not expected to consume a significant portion of the underlying asset (for example, in many property leases), an approach that requires a lessor to continue to recognize the underlying asset and separately recognize rental income would generally provide more useful information to users.
b. A single model based on the recognition of a lease receivable and derecognition of the underlying asset would not appropriately reflect the business model of many lessors, principally those that lease longer lived assets (such as property).
c. It would be extremely complicated to apply the approach to leases of portions of a larger asset (that is, when a lessor leases portions of a single asset to multiple parties concurrently, such as one floor of a building).

BC89. While some stakeholders continued to support making changes to lessor accounting, after evaluating the Board's proposals in the 2010 and 2013 Exposure Drafts, a majority of the Board's stakeholders, including both preparers and users, said that lessor accounting should not be fundamentally changed from that in previous GAAP. Many stakeholders communicated that the changes proposed to lessor accounting in either of the Exposure Drafts would be costly to implement, including the need for many lessors to implement new accounting systems and processes. Meanwhile, outreach with financial statement users confirmed that, in contrast with lessees' financial statements, users do not typically adjust lessors' financial statements, which indicates that the lessor accounting model in previous GAAP substantially fulfills users' needs. Many users, and others, said that the proposed model would reduce, rather than improve, the quality of financial reporting.

BC90. On the basis of this and other feedback received on the lessor accounting proposals in the 2010 and 2013 Exposure Drafts, the Board decided that the lessor accounting model in previous GAAP did not need comprehensive improvements and, therefore, changing that model in a significant way would not produce benefits (and would perhaps reduce the usefulness of lessors' financial reporting) significant enough to justify the costs of doing so. In reaching that conclusion, the Board considered whether the lessee and lessor accounting models should result in symmetrical accounting. In Topic 842, the accounting by lessees and lessors is broadly symmetrical in the statements of comprehensive income and cash flows (and also with respect to lease classification), but not so in the statement of financial position. The Board acknowledged that there are good conceptual arguments to support requiring the recognition of a lease receivable for all leases for which the lessee will record a lease liability. This also would necessitate separate asset recognition of the rights retained in the underlying asset by the

lessor (that is, a residual asset). Nonetheless, having considered all of the feedback received throughout the project, including that from financial statement users, the Board concluded that achieving symmetry between the statements of financial position of lessees and lessors was not a paramount objective of Topic 842. Instead, the Board decided lessors should continue to recognize all of the economic benefits inherent to the underlying asset in a single unit of account (that is, as a net investment in the lease for sales-type and direct financing leases or by continuing to recognize the underlying asset for operating leases). The Board's decision not to significantly change the lessor accounting model from previous GAAP in Topic 842 is consistent with the original objectives for the leases project, which initially set out only to improve lessee accounting.

BC91. While the Board decided not to significantly change the lessor accounting model in previous GAAP, the Board concluded that the previous lessor accounting model should not be retained in its entirety in Topic 842. For one, the Board decided that the scope, the definition of a lease, and some other aspects of the new leases guidance should be aligned between lessees and lessors, in particular because of subleasing, but also because the Board acknowledges that some of these areas should remain consistent between lessees and lessors and that doing so would not involve substantial costs for lessors, but that having different guidance applicable to lessees and lessors might involve significant costs for entities engaged in subleasing.

BC92. In addition, the Board decided that some updates were needed to the lessor accounting model as a result of the Board's issuance of the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes all other previous GAAP on revenue recognition. The Board decided that some updates to the lessor accounting guidance consistent with provisions in Topic 606 were warranted. First, that is because leasing is, fundamentally, a revenue-generating activity for lessors. Therefore, the Board decided there should be cohesion between the revenue recognition (and related cost) guidance applicable to sellers of tangible goods and the guidance applicable to lessors of those same assets, just as there was in previous GAAP. Second, aligning some aspects of the revenue recognition and the lessor accounting guidance should eliminate opportunities for arbitrage that might otherwise exist (for example, an opportunity to arbitrage the difference between a lessor model in previous GAAP based on the transfer of risks and rewards from a seller's perspective and a new revenue model based on the transfer of control from the customer's perspective or an opportunity to recognize revenue and profit from the sale of an asset to a low-credit-quality customer by structuring the sale as a sales-type lease). And third, Topic 606 supersedes previous GAAP on revenue recognition that formed the basis for some aspects of the previous lessor accounting model (for example, previous guidance on accounting for sales of real estate heavily influenced the guidance in previous GAAP about when a lease of real estate could be classified as a sales-type lease).

The lessor accounting model in Topic 842

BC93. The lessor accounting model in Topic 842, consistent with previous GAAP, distinguishes between sales-type, direct financing, and operating leases. Lease classification for lessors is based on the same lease classification approach as that for lessees. A lease that meets any one of the criteria in paragraph 842-10-25-2 is a sales-type lease because the lessor, in effect, transfers control of the underlying asset to the lessee. Even though, other than in cases in which either of the first two lease classification criteria in paragraph 842-10-25-2 is met, the lessor has the right to reacquire the underlying asset at the end of the lease term, when any of the final three criteria in paragraph 842-10-25-2 are met, the lessee has the ability to direct the use of and obtain *substantially* all the remaining benefits from the underlying asset. Even though a sales-type lease is not necessarily identical to a sale, the transactions are economically similar (for example, because sales-type lessors often use leasing as an alternative means to sell their assets and have no intention of reusing or re-leasing assets leased under a sales-type lease). Therefore, recognizing selling profit at lease commencement is consistent with the principle of a sale in Topics 606 and 610.

BC94. In addition to recognizing selling profit on a sales-type lease, a lessor's accounting for a sales-type lease in accordance with Topic 842 includes derecognizing the underlying asset (which is consistent with the view that the lessor has effectively transferred control of that asset to the lessee) and recognizing a net investment in the lease. The lessor's net investment comprises its lease receivable (that is, the lessor's right to receive lease payments plus any residual value of the underlying asset that is guaranteed by the lessee or any other third party unrelated to the lessor) and the unguaranteed residual value of the underlying asset. These two components of the lessor's net investment must be disclosed separately. The unguaranteed residual value of the underlying asset is that portion of the estimated residual value not guaranteed by the lessee or any other third party unrelated to the lessor.

BC95. The Board decided that when the lessee does not, in effect, obtain the ability to direct the use of, and obtain substantially all the remaining benefits from, the underlying asset as a result of the lease, it would be inconsistent with the principle of a sale in Topics 606 and 610 for the lessor to recognize selling profit or to recognize product or sales revenue on the lease. Therefore, a lease that does not meet any of the criteria in paragraph 842-10-25-2 is either a direct financing lease or an operating lease. A lease is an operating lease unless both of the following criteria are met:

a. The present value of the sum of all of the following amounts to substantially all of the fair value of the underlying asset:
    1. The lease payments
    2. Any residual value of the underlying asset guaranteed by the lessee
    3. Any residual value of the underlying asset guaranteed by a third party unrelated to the lessor (other than the lessee)

b. It is probable that the lessor will collect the lease payments (see paragraphs BC100–BC109 for a discussion of the Board's consideration of collectibility and the lessor accounting model).

BC96. When a lease is not a sales-type lease but meets the criteria to be classified as a direct financing lease, the lease transaction effectively converts the lessor's risk arising from ownership of the underlying asset (that is, asset risk) into credit risk. Consequently, the most faithful representation of a lessor's involvement in a lease that transfers substantially all the risks and rewards incidental to ownership of the underlying asset to one or more third parties is to recognize the lessor's financial net investment in the lease and financial (interest) income on that net investment.

BC97. If a direct financing lease gives rise to selling profit (which the Board understands to be infrequent), a lessor does not recognize the selling profit at lease commencement, reducing the lessor's net investment in the lease. A lessor then recognizes the profit over the lease term in such a manner so as to produce, when combined with the interest income on the remainder of the net investment (that is, the lease receivable and the unguaranteed residual asset), a constant periodic rate of return on the lease. A direct financing lessor recognizes selling profit in this manner over the lease term because that accounting reflects that the lessor generally prices the lease to achieve a reasonable return on its investment in the underlying asset and would not position itself to incur a loss on disposition of the residual asset after the end of the lease. If a direct financing lessor were to defer the selling profit in its entirety until the asset is sold at the end of the lease term, the lessor might frequently recognize a loss on the sale of the residual asset. The Board decided that would not be a faithful representation of the economics for those leases.

BC98. The Board decided that a lessor should recognize any selling loss on a direct financing lease. This is because if the lessor considers other applicable GAAP (such as the impairment guidance in Topic 330, Inventory, or in Topic 360, Property, Plant, and Equipment), that consideration will generally result in the recognition of any loss on the underlying asset on or before lease commencement. For example, the pricing in the lease will likely serve as evidence that the cash flows to be derived from the underlying asset will be less than its carrying amount, resulting in the recognition of an impairment.

BC99. Unlike previous GAAP, the lessor accounting model in Topic 842 does not include any differences in accounting for leases of real estate and leases of other assets other than the requirement to account for the right to use land as a separate lease component unless the accounting effect of doing so will be immaterial (see paragraphs BC145–BC147 for the discussion of separating lease components). Previous GAAP included different lessor requirements for leases of real estate (for example, a lease of real estate could only be a sales-type lease if it transferred title to the real estate to the lessee by the end of the lease term) because the revenue requirements in previous GAAP for the sale of real estate

differed from the revenue requirements in previous GAAP applicable to the sale of other assets. The creation of Topic 606 eliminated those different revenue accounting requirements; therefore, there is no longer a reason for the accounting for leases of real estate to differ from the accounting for leases of other assets.

Collectibility and unreimburseable costs

BC100. The 2013 Exposure Draft did not include any explicit guidance that would require a lessor to assess the collectibility of the lease payments (or other payments not included in the definition of lease payments, such as variable lease payments) to recognize lease revenue. The 2013 Exposure Draft did, however, stipulate that a lessor would recognize impairment losses on lease receivables using the impairment guidance applicable for other financial instruments in Topic 310, Receivables.

BC101. Collectibility of the lease payments was not factored into the lessor accounting model in the 2013 Exposure Draft because:

a. The tentative decisions in the 2013 Exposure Draft were completely converged with the IASB's tentative decisions, and previous IFRSs (that is, IAS 17) did not include any consideration of collectibility in lessor accounting like previous GAAP did.
b. The Boards' November 2011 joint revised Exposure Draft, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers* (2011 Exposure Draft), did not include a collectibility threshold. The effects of a customer's credit risk did not affect the timing or the measurement of revenue. Instead, those effects were recognized as bad-debt expense presented in a line-item "adjacent to revenue" (in effect, as "contra-revenue"). It was not until shortly before issuance of the amendments in Update 2014-09 (which codified Topic 606) that the Boards introduced a collectibility threshold.

BC102. As discussed throughout this basis for conclusions, after the issuance of the 2013 Exposure Draft, the Board:

a. Decided to mostly retain the lessor accounting model in previous GAAP, except to the extent necessary to update the lessor accounting guidance for:
    1. Changes to the lessee accounting guidance (that is, to realign those aspects of the leases guidance that the Board decided should be consistent between lessees and lessors)
    2. Changes to the revenue recognition guidance in GAAP resulting from the codification of Topic 606 (that is, to realign certain aspects of the lessor accounting guidance with the revenue recognition guidance where such alignment existed in previous GAAP on leases and revenue).

b. Incorporated a collectibility threshold into the revenue recognition guidance in Topic 606.

BC103. Therefore, the Board decided that collectibility should be considered by lessors in accounting for their leases. The Board decided that collectibility should affect a lessor's accounting differently depending on whether the lease would otherwise be classified as a sales-type lease, a direct-financing lease, or an operating lease.

BC104. The Board decided that a lessor should classify a lease as a sales-type lease only when the lease is similar to the purchase of a nonfinancial asset by the lessee because the lease, in effect, transfers control of the underlying asset to the lessee. This was, in large part, to ensure that sellers could not structure a sale as a sales-type lease to circumvent the guidance on satisfying performance obligations in Topic 606. Similarly, the Board decided that significant concerns about collectibility should affect the accounting for sales-type leases in the same way they affect the accounting for sales accounted for in accordance with Topic 606. Therefore, the collectibility guidance in Topic 842 applicable to sales-type leases results in generally consistent outcomes with the collectibility guidance in Topic 606, including the guidance about how to account for consideration received from a lessee when collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee provided by the lessee is not probable.

BC105. Direct financing leases and operating leases are not similar to sales of a nonfinancial asset. Consequently, the Board decided that the collectibility guidance that should apply to direct financing leases and operating leases does not need to align with the collectibility guidance in Topic 606, because leases are outside the scope of Topic 606 and those two types of leases are not similar to a sale. For direct financing and operating leases, the Board decided that the guidance in Topic 842 should be mostly consistent with the collectibility guidance applicable to leases in previous GAAP. Therefore, any lease that is not a sales-type lease is classified as an operating lease if collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee (whether provided by the lessee or another third party) is not probable at lease commencement. In addition, cumulative lease income (that is, cumulative lease revenue) is limited for those leases to the lesser of the income that would be recognized in accordance with the operating lease guidance in Subtopic 842-30 and lease payments received. In addition to this guidance generally being consistent with previous GAAP, the Board decided that precluding classification of a lease as a direct financing lease when collectibility of both the lease payments and any amount necessary to satisfy a residual value guarantee is not probable is consistent with the Board's rationale for when a lease should be classified as a direct financing lease (see paragraph BC96). The Board decided that when collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee is not probable, the lessor's conversion of its risk in the underlying asset to credit risk is nonsubstantive. Thus, the lessor should continue to recognize the underlying asset and account for the lease as an operating lease.

BC106. Consistent with the Board's overall decisions on lease classification, a lessor should not reassess lease classification if the assessment of collectibility of the lease payments changes after the commencement date for reasons other than a modification of the contract.

BC107. The Board decided that a lessor should not reassess collectibility for a sales-type lease or a direct financing lease if collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee is deemed probable at lease commencement. In reaching this decision, the Board considered that the lessor's net investment in the lease would be subject to the financial instruments impairment guidance in Topic 310 and, therefore, any deterioration in the credit quality of the lessee should be captured through an impairment of the net investment in the lease.

BC108. Because a lessor does not recognize a net investment in the lease for an operating lease, the Board decided that additional guidance was necessary (included in paragraph 842-30-25-13). Upon a change in the assessment of collectibility, a lessor should recognize any difference between the lease income that would have been recognized in accordance with the recognition guidance in Subtopic 842-30 and the lease payments, including variable lease payments, that have been received from the lessee as an adjustment of the period in which the collectibility assessment changes.

BC109. The lessor accounting model in Topic 842 does not include a requirement that no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease to account for a lease as a sales-type lease or a direct financing lease. Previous GAAP stated that important uncertainties might include commitments by the lessor to guarantee performance of the underlying asset in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the underlying asset. The Board did not carry forward this criterion because it is not relevant to determining whether the lessee, in effect, obtains control of the underlying asset (that is, whether the lessee has the ability to direct the use of and obtain substantially all the remaining benefits from the underlying asset) as a result of the lease. Rather, this criterion was included in previous GAAP because important uncertainties about unreimburseable costs yet to be incurred by the lessor under the lease indicated that the lessor had not transferred substantially all the risks and benefits of asset ownership. Topic 842 does, however, include guidance instructing lessors to consider the warranties implementation guidance in Topic 606 to determine whether a lessor commitment to guarantee performance of the underlying asset in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the underlying asset is an additional service to the lessee in addition to the lease (that is, a nonlease component).

Scope

BC110. The Board decided that, consistent with previous GAAP, only leases of property, plant, and equipment (that is, land and/or depreciable assets) are within the scope of Topic 842. Consequently, none of the items in the list that follows, which is not intended to be an all-inclusive list, are in the scope of Topic 842. In addition to the fact that none of these assets are depreciable assets, the Board observed the following with respect to each:

a. Leases of intangible assets. The Board acknowledged that there was no conceptual basis for excluding leases of intangible assets from the scope of Topic 842 and that many intangible assets are amortized (rather than depreciated); however, the Board concluded that a separate and comprehensive review of the accounting for intangible assets should be performed before requiring leases of intangible assets to be accounted for within the scope of the leasing guidance.
b. Leases to explore for or use natural resources, such as minerals, oil, and natural gas. That is because accounting practices for assets relating to exploration and evaluation are diverse and differ from the accounting for other types of assets. Furthermore, the accounting for assets related to the exploration and use of natural resources is specified in Topics 930, Extractive Activities—Mining, and 932, Extractive Activities—Oil and Gas. Leases to explore for or use natural resources also were excluded from previous GAAP. However, the determination of whether certain ancillary items were leases was less important in previous GAAP than in Topic 842 because the operating leases and services were accounted for similarly. Some stakeholders asked whether this scope exception referred solely to the intangible right to explore for these natural resources. The Board observed that this scope exception refers to that as well as to the rights to use the land in which those natural resources are contained. However, leases of equipment used to explore for natural resources (for example, drilling equipment) are not part of this scope exception.
c. Leases of biological assets (including plants and living animals). The Board wanted to ensure that requirements relating to biological assets are found in a single Topic (Topic 905, Agriculture). Leases of timber are specifically excluded from Topic 842 to be consistent with the scope exclusion that existed in previous GAAP.
d. Leases of inventory. While the conceptual basis for excluding leases of inventory from the scope of Topic 842 is questionable, the Board observed that few arrangements conveying the right to use inventory would likely meet the definition of a lease. That is because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by another party) for sale in the ordinary course of business or for consumption in the process of production for sale in the ordinary course of business. Consequently, the cost of requiring entities to evaluate whether arrangements conveying the right to use inventory would meet

the definition of a lease, which would be a change from the scope of the previous leases guidance, would not be justified by the benefits of potentially recognizing those few arrangements that would likely meet the definition of a lease.

e. Leases of assets under construction (construction in process). As in (d) above, the Board observed that there is not necessarily a clear conceptual basis for excluding leases of construction in process from the scope of Topic 842. However, the Board observed that the guidance in Subtopic 842-40 requires a lessee to recognize the construction in process (that is, the underlying asset that is under construction) if it controls that asset during the construction period before the commencement date of the lease (see paragraphs BC398–BC401) and apply the sale and leaseback transaction guidance to the contract. Stakeholders provided feedback that there was likely to be significant overlap between an evaluation of whether the lessee controls the construction in process before the commencement date and an evaluation of whether the lessee controls *the use of* the construction in process before the commencement date. Therefore, the Board excluded leases of construction in process from the scope of Topic 842 primarily for pragmatic reasons including cost-benefit reasons. The cost and complexity of the evaluation that entities would be required to undertake would not yield sufficiently different results in financial reporting to justify the undertaking of those efforts.

Noncore Assets

BC111. Assets that are not essential to the operations of an entity are sometimes of less importance to users of financial statements because those assets often are less material to the entity. Accordingly, the benefits to users of recognizing and measuring the assets and liabilities arising from leases of noncore assets might not justify the costs to preparers of doing so. For example, information about assets and liabilities arising from the lease of a delivery van is important to assess the operations of a delivery company, but it may not be important in assessing the operations of a financial institution, which uses the van to deliver stationery to its retail banking locations. Consequently, the Board considered whether to exclude leases of noncore assets from Topic 842.

BC112. Ultimately, the Board decided not to exclude leases of noncore assets from the scope of Topic 842 (or provide an exemption to their recognition and measurement). In reaching this decision, the Board noted the following difficulties with excluding leases of noncore assets from the scope of the proposals:

a. Defining core and noncore would be extremely difficult. For example, would office buildings used by a financial institution be a core asset, and would the conclusion be different if the financial institution has retail banking operations? Would an entity consider some offices or cars to be core assets and others noncore assets? If core assets were defined as

those essential or crucial to the operations of an entity, it could be argued that every lease would be a lease of a core asset. Otherwise, why would an entity enter into the lease?

b. Different entities might interpret the meaning of noncore assets differently, thereby reducing comparability for users of financial statements.
c. GAAP does not distinguish between core and noncore purchased assets for the purposes of recognition. Because of that, it would be difficult to justify distinguishing a right-of-use asset relating to a core asset from one that relates to a noncore asset.

Long-Term Leases of Land

BC113. A long-term lease of land is sometimes regarded as being economically similar to the purchase or sale of the land, and, therefore, some suggested that such leases should be excluded from the scope of Topic 842. However, the Board decided to not specifically exclude long-term leases of land from the scope of Topic 842 because:

a. There is no conceptual basis for differentiating long-term leases of land from other leases. If the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term, the contract is a lease and should be accounted for as such.
b. Inevitably, any definition of a long-term lease of land would be arbitrary.
c. A very long term lease of land (for example, a 99-year lease or 999-year lease) could be classified as a finance (or sales-type) lease because the present value of the lease payments (plus the present value of any lessee residual value guarantee) could represent substantially all of the fair value of the land. In that case, the accounting applied by the lessee and lessor will be similar to accounting for a purchase or sale of the land.

Subleases

BC114. In the Board's view, leases of right-of-use assets (that is, subleases) should be accounted for in the same way as other leases. Accordingly, subleases are within the scope of Topic 842.

BC115. In addition, the Board decided that an entity should account for a head lease and a sublease as two separate contracts unless those contracts meet the contract combinations guidance. Even if entered into at close to the same date, each contract is generally negotiated separately, with the counterparty to the sublease being a different entity from the counterparty to the head lease. Because of this, the obligations that arise from the head lease for the lessee are generally not extinguished by the terms and conditions of the sublease. Therefore, it is appropriate to account for a head lease and sublease separately, and the head lease right-of-use asset is not considered to be held for sale.

BC116. The Board decided that when classifying a sublease, an entity (that is, the intermediate lessor) should evaluate the sublease with reference to the underlying asset rather than the right-of-use asset arising from the head lease. The lessee in a sublease may not know the terms and conditions of the head lease, and, accordingly, referring to the item of property, plant, and equipment that is subject to the lease should be easier to apply than referring to the right-of-use asset arising from the head lease. In addition, the Board noted that it may be difficult to understand and explain why a lessor would account for similar leases differently. That could occur if an entity were required to refer to the right-of-use asset when classifying a sublease. For example, if subleases were classified with reference to the right-of-use asset, a lessor that leases two similar assets on similar terms for five years could account for those leases differently if the lessor owned one of the two assets and leased the other.

Onerous Contracts

BC117. The Board decided that if a lease is onerous (for example, because the lease payments exceed the expected benefits to be derived from use of the asset for a lessee) between the date of inception and the commencement date, an entity should account for it in accordance with Topic 450, Contingencies. The Board decided not to include any particular exclusion for such onerous contracts in Topic 842 because it could potentially be misleading. The guidance includes a requirement to disclose information about leases before the commencement date if they create significant rights and obligations for the lessee. In addition, the Board noted that an entity should apply the requirements in other Topics in any event, without the need to state it specifically in Topic 842.

Embedded Derivatives

BC118. The Board considered whether an entity should be required to account for embedded derivatives within a lease separately, as it does in accordance with Topic 815, Derivatives and Hedging. The Board noted that some variable lease payments that depend on an index or a rate could meet the definition of an embedded derivative.

BC119. Topic 842 does not, in and of itself, require variable lease payments that depend on an index or a rate to be measured at fair value. If the Board did not retain the current requirements to account for embedded derivatives separately, unrelated derivative contracts could be bundled with leases to avoid measuring such embedded derivatives at fair value. Consequently, the Board decided to retain, unchanged, the existing GAAP requirement to assess leases for embedded derivatives and, if they exist, to require the embedded derivatives to be separated from the lease and accounted for in accordance with Topic 815.

Applying Topic 842 at a Portfolio Level

BC120. Topic 842 specifies the accounting required for an individual lease. Many entities have a large number of leases, and, as a result, some respondents noted practical challenges in applying the model on a lease-by-lease basis. These respondents questioned whether it would always be necessary to apply Topic 842 on a lease-by-lease basis. The Board observed that the way in which an entity applies the model to its leases is not a matter for which the Board should provide specific guidance. Nonetheless, in light of the feedback, the Board decided to explicitly state that lessees and lessors are permitted to apply the leases guidance at a portfolio level. The Board acknowledged that an entity would need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio. In the discussion, the Board indicated that it did not intend for an entity to quantitatively evaluate each outcome but, instead, that the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of leases.

BC121. The Board observed that the cost relief offered by applying the leases guidance at a portfolio level need not be limited to simply grouping contracts together. The cost relief also could be particularly high for certain aspects of the leases guidance for which entities need to make judgments and estimates, such as determining the discount rate or determining and reassessing the lease term. For example, rather than establishing a specific discount rate for a single leased asset, an entity might conclude that it can establish a single discount rate applied to all leases in a portfolio because using that discount rate would not result in a materially different answer than using a discount rate determined for each individual lease. The implementation guidance in Subtopic 842-20 includes an example of one way a lessee might apply a portfolio approach in determining the discount rate for its leases.

Utilizing Recognition (Capitalization) Thresholds

BC122. The Board observed that, in addition to accounting for some leases at a portfolio level, entities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance. An entity's practice in this regard may be consistent with many entities' accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment).

Identifying a Lease

Definition of a Lease

BC123. Topic 842 defines a lease on the basis of whether a customer controls the use of identified property, plant, or equipment (that is, an identified asset) for a period of time, which may be described in terms of the amount of use of the identified asset (for example, the number of production units that an item of equipment will be used to produce). If the customer controls the use of an identified asset for a period of time, then the contract contains a lease. That will be the case if the customer can make the important decisions about the use of the asset in a similar way to that in which it makes decisions about owned assets that it uses. In such cases, the customer (the lessee) has obtained the right to use an asset (the right-of-use asset) that it should recognize on its balance sheet (subject to the recognition and measurement exemption for short-term leases). In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service.

BC124. The 2010 Exposure Draft essentially retained the definition of a lease and the accompanying requirements in previous GAAP. Many respondents expressed concerns about the population of contracts that would be captured by the proposed requirements (and in particular that some contracts that they viewed as service contracts would be captured). Respondents also identified practice issues in previous GAAP, such as determining when the price that the customer will pay for the output from the asset is contractually fixed per unit of output or equal to the current market price per unit of output, and questioned why the control criteria used in previous GAAP to define a lease were different from the control proposals that were then being developed within the context of revenue recognition and the control principle in Topic 810 on consolidation.

BC125. Accordingly, in the 2013 Exposure Draft, the Board proposed changes to the guidance on the definition of a lease to address those concerns. The 2013 Exposure Draft proposed using a control principle as the means of distinguishing between a service and a lease and to align the principle with that used in other Topics. Respondents generally supported those changes. However, many respondents stressed the increased importance of the definition of a lease, noting that the assessment of whether a contract contains a lease would generally determine whether a customer would recognize lease assets and lease liabilities. Those respondents said that the Board had not provided adequate guidance to support consistent application of the proposed definition to more complicated scenarios.

BC126. Accordingly, Topic 842 generally retains the approach to the definition of a lease that was proposed in the 2013 Exposure Draft, but makes a number of changes to clarify the Board’s intentions and reduce the risk of inconsistent application.

BC127. The Board noted that, in most cases, the assessment of whether a contract contains a lease should be straightforward. A contract either will fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgment. However, the Board added guidance to make it easier for entities to make the lease assessment for more complicated scenarios.

Identified Asset

BC128. The first requirement for a contract to meet the definition of a lease in Topic 842 is that a customer should control the use of identified property, plant, and equipment (an identified asset). The requirement that there be an identified asset is substantially the same as the requirement in previous GAAP that a lease depends on the use of a specified asset. It is important to know what the asset is to assess whether the customer has the right to control the use of that asset and, for example, to determine which asset to derecognize for lessors with sales-type or direct financing leases. Nonetheless, when assessing whether there is an identified asset, an entity does not need to be able to identify the particular asset that will be used to fulfill the contract to conclude that there is an identified asset. Instead, the entity simply needs to know whether an asset is needed to fulfill the contract from commencement. If that is the case, an asset is implicitly specified. Topic 842 clarifies that if a supplier has a substantive right to substitute the asset throughout the period of use, there is not an identified asset and the contract does not contain a lease. That is because the supplier (and not the customer) controls the use of the asset if it can substitute that asset throughout the period of use, thereby deciding for what purpose the asset is used.

BC129. The Board has included guidance to help determine the circumstances in which substitution rights are substantive. This guidance focuses on whether the supplier has the practical ability to substitute the asset and would benefit economically from doing so. The Board's intention in including this guidance is to differentiate between the following:

a. Substitution rights that result in there being no identified asset because the supplier, rather than the customer, controls the use of an asset
b. Substitution rights that do not change the substance or character of the contract because it is either not practically or economically feasible for the supplier to exercise those rights or not likely the supplier will be able to exercise those rights.

BC130. If a substitution clause is not substantive because it does not change the substance of the contract, that substitution clause should not affect an entity's assessment of whether a contract contains a lease. The Board noted that, in many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset.

BC131. Substitution rights may not be substantive (that is, for purposes of determining whether there is an identified asset) for various reasons. Some substitution rights are not substantive because the contract restricts when a supplier can substitute the asset. For example, if a contract states that a supplier can substitute the asset only on or after a specified future date or after the occurrence of a specified event, that substitution right is not substantive because it does not give the supplier the practical ability to substitute the asset *throughout the period of use*. Other substitution rights are not substantive even if the supplier contractually has the right to substitute the asset at any time. For example, if a supplier has the right or obligation to substitute an asset for the purpose of repair or maintenance, or if a supplier would benefit from substitution only in circumstances that are not likely to arise, those substitution rights also are not substantive regardless of whether those circumstances are specified in the contract.

BC132. Stakeholders raised concerns that in some cases it would be difficult, if not impossible, for a customer to determine whether a supplier's substitution right is substantive. Difficulties may arise because the customer often does not have information about the costs of substitution that would be incurred by the supplier. On the basis of that feedback, the Board decided to add guidance stating that if a customer cannot readily determine whether a supplier has a substantive substitution right, the customer should presume that any substitution right is not substantive. It is intended that a customer should assess whether substitution rights are substantive if it is reasonably able to do so; if substitution rights are substantive, the Board noted that this should be relatively clear from the facts and circumstances. However, the requirement also is intended to clarify that a customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive.

BC133. Topic 842 also clarifies that an asset must be physically distinct to be an identified asset. The Board concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (for example, if it is a 20 percent capacity portion of a pipeline). The customer is unlikely to have the right to control the use of its portion because decisions about the use of the asset are typically made at the larger asset level. Widening the notion of an identified asset to possibly capture portions of a larger asset that are not physically distinct might have forced entities to consider whether they lease assets used to fulfill any contract for services, only to conclude that they do not. Consequently, the Board concluded that widening the definition to include capacity portions of a larger asset would increase complexity for little benefit.

Contract Conveys the Right to Control the Use of an Identified Asset

BC134. Topic 842 contains application guidance on what it means to have "the right to control the use of an identified asset." This guidance is consistent in many

respects with the concept of control in Topics 606 and 810. In previous leases guidance, a customer could have the right to control the use of an asset solely on the basis of obtaining substantially all of the output from that asset, assuming that the contract is priced in a particular way. This defined *control* on the basis of only a "benefits" element. Topics 606 and 810, however, define control to require both a "power" element and a "benefits" element. The Board decided that, to control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use (a "benefits" element), but also the ability to direct the use of that asset (a "power" element). That is, a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from use of the asset throughout the period of use. Without any such decision-making rights, the customer would have no more control over the use of the asset than any customer purchasing supplies or services. If that were the case, the customer would not control the use of the asset.

Right to obtain substantially all of the economic benefits from use of the identified asset

BC135. Topic 842 clarifies that only the economic benefits arising from use of an asset rather than the economic benefits arising from ownership of that asset should be considered when assessing whether a customer has the right to obtain the benefits from use of an asset. A lease does not convey ownership of an underlying asset; it conveys only the right to use that underlying asset (even in the case of a finance lease or a sales-type lease that transfers title to the lessee at the end of the lease, ownership is only conveyed at the end of the lease term). Accordingly, the Board concluded that, when considering whether a contract contains a lease, a customer should not consider economic benefits relating to ownership of an asset (for example, tax benefits as a result of owning an asset). However, a customer should consider benefits relating to the use of the asset (for example, renewable energy credits received from the use of an asset or by-products resulting from the use of an asset).

Right to direct the use of the identified asset

BC136. Topic 842 includes guidance on when a customer has the right to direct the use of an asset if it has the right to direct *how and for what purpose* the asset is used during the period of use. If the supplier has that right, the supplier directs the use of the asset and, thus, no lease exists.

BC137. In the Board's view, the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than other decisions to be made about use, including decisions about operating and maintaining the asset. That is because decisions about how and for what purpose an asset is used determine how and what economic benefits are derived from use. How and for what purpose an asset is used is a single concept; that is, "how" an

asset is used is not assessed separately from "for what purpose" an asset is used. Decisions about operating an asset are generally about implementing the decisions about how and for what purpose an asset is used and are dependent on (and subordinate to) those decisions. For example, a supplier's operational decisions would have no effect on the economic benefits derived from use of an asset if the customer decides that the asset should not be used. The Board observed that considering decisions about how and for what purpose an asset is used can be viewed as similar to considering the decisions made by a board of directors when assessing control of an entity. Decisions made by a board of directors about the operating and financing activities of an entity are generally the decisions that matter in that control assessment, rather than the actions of individuals in implementing those decisions.

BC138. Nonetheless, decisions about how and for what purpose an asset is used can be predetermined. In that case, those decisions cannot be made by either the customer or the supplier during the period of use. This could happen if, for example, in negotiating the contract, the customer and supplier agree on all the relevant decisions about how and for what purpose an asset is used and those decisions cannot be changed after the commencement date or are, in effect, predetermined by the design of the asset. The Board noted that it would expect decisions about how and for what purpose an asset is used to be predetermined in relatively few cases.

BC139. The approach to determining whether a customer has the right to direct the use of an identified asset changes if the decisions about how and for what purpose an asset is used are predetermined. Topic 842 clarifies that if decisions about how and for what purpose an asset is used are predetermined, a customer can still direct the use of an asset if it has the right to operate the asset, or if it designed the asset in a way that predetermines how and for what purpose the asset will be used. In either of these cases, the customer controls rights of use that extend beyond the rights of a customer in a typical supply or service contract (that is, the customer has rights that extend beyond solely ordering and receiving output from the asset). In those cases, the customer has the right to make (or has made in the case of design) decisions that affect the economic benefits to be derived from use of the asset throughout the period of use. Although the Board concluded that each of those cases represents a scenario in which the customer directs the use of an asset, it expects that, for most leases, the assessment of whether a customer directs the use of an asset will be based on identifying the party that decides how and for what purpose an asset is used.

BC140. Topic 842 clarifies that only decisions made *during* the period of use (and not before the period of use) should be considered in the control assessment, unless the customer designed the asset in a way that predetermines how and for what purpose the asset will be used. In the Board's view, if a customer specifies the output from an asset at or before the beginning of the period of use (for example, within the terms of the contract) and cannot change those specifications during the period of use, it generally does not control the use of an asset. In that

case, it would have no more decision-making rights than any customer in a typical supply or service contract.

BC141. In addition, Topic 842 provides guidance about protective rights—that is, terms and conditions included in the contract to protect the supplier's interest (or investment) in the underlying asset or other assets, to protect its personnel, or to ensure the supplier's compliance with applicable laws and regulations. In the Board's view, such protective rights define the scope of the rights obtained by a customer without preventing a customer from having the right to direct the use of that asset. Accordingly, protective rights may affect the price paid for the lease (for example, a lessee may pay less for the use of the asset if it is more restricted in its use of that asset). However, protective rights generally will not affect the existence of the customer's right to direct the use of the asset.

Other Approaches Considered for Definition of a Lease

BC142. In developing Topic 842, the Board considered other alternatives suggested by stakeholders on the definition of a lease. The main alternatives considered are as follows:

a. *Financing component.* The Board considered requiring a lease to be a financing arrangement for the right to use an asset. In other words, there would have to be a clearly identifiable financing component for a contract to contain a lease. However, the Board did not adopt this approach because:
    1. In the Board's view, it is appropriate to focus on whether the customer has obtained control of a right-of-use asset to determine whether a contract contains a lease. The right-of-use asset gives rise to a corresponding lease liability if payments are made over time, but exists even if there is no lease liability (for example, when lease payments are fully prepaid). If an entity obtains the right to use an asset for a period of time, the contract contains a lease, regardless of the timing of payments for that right of use. Whether the contract contains a financing element does not affect whether a lease creates an asset and a liability for the lessee. The focus on the asset obtained in a lease also distinguishes leases from other contracts, such as service or supply arrangements.
    2. Many of the suggested indicators of "financing arrangements" focus on the form of the payments and on those payments being similar to payments within a loan agreement. The Board was concerned that focusing on the form of an arrangement rather than its substance could result in the following:
        i. Many existing leases, including many existing finance leases and property leases, would no longer meet the definition of a lease, even when it is clear that the customer has obtained a right of use at contract commencement.

ii. It would be relatively easy to structure a contract to fail to meet the definition of a lease by, for example, changing the payment structure, while not changing the customer's right to use an asset.

b. *Topic 606.* The Board considered whether to link the guidance on the definition of a lease more closely to the requirements in Topic 606, in particular the requirements on whether a good or service is "distinct." Under this approach, the concept of "distinct" could have been used to distinguish between contracts that contain distinct lease and service components (that an entity should unbundle and account for separately) and those that do not contain distinct lease and service components (and therefore should be accounted for entirely as a contract for services). The Board did not adopt this approach because:

   1. The "distinct" guidance in Topic 606 was developed to address a different objective from that of identifying a lease. It was developed to identify the nature of an entity's promises in a contract with a customer to ensure the most appropriate allocation and recognition of revenue. In contrast, the lease definition guidance aims to identify whether a customer has obtained the right to use an asset and, therefore, should recognize the assets and liabilities associated with that transaction. Because it was developed for a different purpose, applying the "distinct" guidance in Topic 606 might have resulted in customers failing to recognize assets and liabilities that meet the conceptual definition. The Board concluded that control is a more appropriate basis on which to make this determination.
   2. The Board was concerned that a requirement to determine whether lease and service components were distinct would add unnecessary complexity to the guidance. That is because such an approach was expected to result in little difference in outcomes, and yet would have included an additional requirement that could have been complicated to interpret and apply within the context of leases.
   3. This approach would have required an additional step in identifying a lease as compared with the approach in Topic 842 *if* an entity were to conclude that it first has to identify a lease before determining whether it would be appropriate to separate that lease from other goods or services within the contract.

c. *Standalone utility.* The Board considered whether to specify that a customer controls the use of an underlying asset only if that asset has standalone utility to the customer; that is, only if the customer has the ability to derive the economic benefits from use of an asset, either on its own or together with other resources that could be sourced in a reasonable period of time. The Board decided not to add this requirement because:

   1. The control principle in Topic 842 is sufficient, without this additional requirement to appropriately determine whether a customer controls the use of an identified asset. Such an approach is not used

elsewhere in GAAP when assessing control of an asset, such as with the purchase of an item of property, plant, and equipment.

2. Entities might reach different conclusions for contracts that contain the same rights of use, depending on differences in customers' resources or suppliers' business models.
3. Assessing this requirement would have been subjective and required judgment beyond that required to apply the definition of a lease in Topic 842. It also may have had unintended consequences. In addition, the Board did not identify any existing scenarios for which the inclusion of such a requirement would have been expected to change the lease conclusion. Consequently, the Board concluded that the costs of including such a requirement would not be justified by any possible benefits.

d. *Substantial services*. The Board considered whether to require an entity to account for a contract with lease and service components entirely as a service if the service components are substantial and are the predominant portion of the overall contract. The Board decided not to include this requirement. Again, in the Board's view, if a contract conveys to the customer the right to use an asset, the contract contains a lease. The presence of services, no matter how substantial, does not change the rights of use that a lessee obtains. The Board was concerned that similar rights of use could be accounted for differently because services of a more significant value had been bundled together with some right-of-use assets and not with others.

Separating Components and Consideration in a Contract

Lease and Nonlease Components

BC143. Many contracts contain both lease and nonlease (generally, but not always, service) components, such as a contract for a lease of equipment that includes maintenance services. In addition, there are contracts that contain multiple lease components, such as a lease of a port that can incorporate the lease of land, buildings, and equipment.

BC144. Previous GAAP provided limited guidance on how to separate lease components and nonlease components of a contract, even though it required that separation. Because Topic 842 results in lease components of a contract being accounted for differently from nonlease components (for all leases except short-term leases for which a lessee elects the recognition and measurement exemption), the Board decided to provide expanded guidance on how entities should account for contracts that contain both lease components and nonlease components.

Separate Lease Components

BC145. Topic 842 includes guidance on determining whether rights to use two or more underlying assets in a single contract should be accounted for as a single lease component or multiple lease components. The guidance is applicable to lessees and lessors and is included principally because:

a. Different accounting answers can result from how the unit of account to which the leases guidance applies is determined. In particular, the unit of account that is identified can affect lease classification and the allocation of contract consideration to the components (lease and nonlease) in the contract. By way of example, regarding allocation, the Board noted that the standalone price (observable or estimated) for a bundled offering (for example, the lease of a data center) may be substantially different from the sum of the standalone prices for separate leases of the items within a bundled offering (for example, the lease of each asset in the data center). Given the substantially different accounting for lease and nonlease components in Topic 842, the allocation of contract consideration carries additional importance as compared with previous GAAP. Consequently, the Board concluded that including separate lease components guidance in Topic 842 will result in more accurate accounting that also is more consistent among entities.
b. Previous GAAP did not contain specific guidance on how to identify the appropriate unit of account for leases. However, the Board understands that practice developed such that entities often considered multiple pieces of equipment together for purposes of lease classification when, as a result of their functional interdependence, they were part of an overall process or facility. In the Board's view, the fact that practice developed interpretive guidance specifically in this respect demonstrates that including separate lease components guidance in Topic 842 will represent an improvement to GAAP.

BC146. The separate lease components guidance in paragraph 842-10-15-28 is similar to the guidance on identifying performance obligations in Topic 606, and, therefore, the Board expects that it will be applied in a similar manner. The Board notes that the identification of separate lease components in a lease contract is similar to the identification of separate performance obligations in a revenue contract—in both circumstances, an entity is trying to identify whether a customer (or a lessee) is contracting for a number of separate outputs (rights of use in the case of leases) or, instead, contracting for a single output that incorporates a number of different inputs. Accordingly, rather than developing entirely separate requirements addressing how to identify separate lease components, the Board decided that it is logical to provide requirements similar to those in Topic 606 on the identification of performance obligations to determine whether a lessee is contracting for the right to use multiple underlying assets (for example, five vehicles) or for the right to use a single solution that is comprised of multiple assets (for example, many data centers or manufacturing facilities).

BC147. Topic 842 also requires an entity to account for a right to use land as a separate lease component, even if the separating lease components criteria are not met, unless the accounting effect of doing so would be insignificant. The Board decided that land, by virtue of its indefinite economic life and nondepreciable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met. Previous GAAP included a series of rules for when land would be assessed separately from other elements, and those rules differed depending on whether the other element was a building (or integral equipment) or something else. The Board provided two examples of when the accounting effect of separation would be immaterial in paragraph 842-10-15-29; however, there may be additional circumstances in which the accounting effect of separately accounting for a right to use land would be immaterial.

Separating Lease from Nonlease Components

BC148. Topic 842 requires that lessors separate lease from nonlease components in a contract. However, lessees may elect, as an accounting policy election by class of underlying asset, not to separate nonlease components from the lease component(s) to which they relate. The Board decided that the leases guidance in Topic 842 should apply only to the lease components of a contract. In addition, for lessors, the Board considered that most nonlease goods or services that are included in a contract with a lease will be subject to the revenue recognition guidance in Topic 606. While some lessors, in response to previous proposals in this area, said that they would prefer not to separate lease and nonlease components in a contract (with some wanting to account for the entire contract as a lease and others wanting to account for the entire contract as a service contract), accounting for lease components in accordance with Topic 842 and the nonlease components in accordance with, typically, Topic 606 is consistent with the corresponding guidance on scope that is included in Topic 606. In addition, this decision is consistent with some of the Board's other decisions—the rationale for which was that a nonlease component should not, in general, be subject to different accounting requirements solely because it is included in a contract that contains a lease.

BC149. The Board also decided that lessees should account for lease and nonlease (typically, service) components separately (unless they elect the practical expedient). Board members observed that to do otherwise could result in different accounting for services solely depending on whether the service is included together with a lease. Consistent with the view in paragraph BC148 for lessors, the Board decided that the accounting for services should be the same, regardless of whether the contract that includes the services also includes a lease. In addition, for some Board members, this decision is based on their view that leases are different from service contracts (see paragraphs BC40–BC43). In their view, requiring lessees to capitalize service components in some cases would result in lessees overstating their assets and liabilities.

BC150. The practical expedient to account for a lease component and its related nonlease components as a single lease component was provided by the Board on the basis that the costs and administrative burden of allocating consideration to separate lease and nonlease components may not be justified by the benefit of more precisely reflecting the right-of-use asset and the lease liability. The availability of the practical expedient to a lessee is not affected by the relative size of the lease and the nonlease components. However, given that the result of electing this practical expedient is to record additional lease liabilities, the Board concluded that lessees will, in general, only elect this expedient in arrangements with less significant service components. Therefore, comparability should not be significantly affected as a result of providing this practical expedient. The practical expedient does not permit entities to circumvent the guidance on embedded derivatives.

BC151. The Board previously considered two other alternatives on separating lease components from nonlease components in a contract. The feedback received on those previous proposals significantly influenced the separation guidance included in Topic 842. The following details the proposals and the feedback received:

a. The guidance in the 2010 Exposure Draft put forth that an entity (lessee or lessor) should separately account for nonlease components of a contract if those components are distinct and the entity is able to separate those components. An entity would allocate consideration to lease and nonlease components in accordance with the amendments in the 2010 proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*. That proposed Update included guidance to help determine when the nonlease components of a contract would be distinct. Almost all respondents agreed that an entity should separate lease components of a contract from nonlease components, noting that the Board's proposals should be applied only to the lease components of a contract. However, many of those respondents found the proposals confusing, or they disagreed with some aspects of those proposals, in particular, the proposal to account for the entire contract as a lease if nonlease components were not distinct.
b. The 2013 Exposure Draft contained guidance for lessors consistent with that in Topic 842. However, lessees would not always have been permitted to separate nonlease components from lease components in the proposals. If the lessee did not have observable standalone prices for one or more nonlease components in a contract and also did not have observable standalone prices for one or more lease components, the nonlease components and lease components for which the lessee did not have observable standalone prices would be accounted for as a single lease component. Many respondents to the 2013 Exposure Draft (including lessees and lessors) expressed concern about the lessee proposals. A number of entities said that including nonlease components

within a single lease component would not be appropriate, regardless of whether the lessee had observable standalone prices for the components of the contract. Lessors additionally commented that the proposed guidance would result in them having to communicate proprietary information to customers about how they price contracts so that their lessees would be able to separate lease and nonlease components.

Allocating Consideration in the Contract

BC152. Topic 842 requires a lessor to allocate the consideration in the contract to the separate lease components and the nonlease components on the basis of the revenue recognition transaction price allocation guidance in paragraphs 606-10-32-28 through 32-41. In addition, largely in response to feedback from stakeholders on earlier proposals, and to ensure that the guidance is clear, Topic 842 further specifies that a lessor should:

a. Reallocate the consideration in the contract at the effective date of a contract modification that is not accounted for as a separate contract
b. Allocate changes in the consideration in the contract in accordance with the revenue recognition changes in the transaction price guidance (paragraphs 606-10-32-42 through 32-45)
c. Allocate consideration in the contract only to those items that transfer a good or service to the lessee and, therefore, are components (see paragraphs BC143 and BC144).

BC153. In reaching those decisions, the Board decided that lessors should allocate the consideration in the contract in accordance with the relevant revenue recognition guidance in Topic 606. In the Board's view, leasing transactions are fundamentally a revenue-generating activity (even if the principal revenue stream is interest income) in which the item that a lessor transfers to the customer is the right to use the underlying asset. Accordingly, it is appropriate for a lessor to allocate consideration to the lease and nonlease components as a seller allocates the transaction price (and changes in the transaction price) to performance obligations in a revenue contract and does not allocate consideration to activities or costs that do not transfer a good or service to the lessee. In reaching its decisions on lessor allocation, the Board noted that the basis for conclusions in Update 2014-09 states that an entity is not precluded from accounting for concurrently delivered goods or services that have the same pattern of transfer to the customer as if they were a single performance obligation, even if they are distinct from each other, because the outcome would be the same as accounting for the goods and services separately. Therefore, it similarly would be reasonable for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components). The

previous sentence notwithstanding, a lessor may need to separately consider presentation and disclosure in accordance with other Topics.

BC154. In addition, the Board considered that in any contract that contains both lease components and nonlease components, the entity transferring goods and/or services is likely to be both a lessor (relating to the lease components) and a seller (relating to the nonlease components). The Board's decision to allocate consideration to lease and nonlease components in accordance with the revenue recognition guidance in Topic 606 is intended to result in mostly consistent accounting for entities that are both a lessor and a seller of goods or services in the same contract.

BC155. The lessee allocation requirements in Topic 842 follow:

a. A lessee shall determine the standalone price of lease and nonlease components on the basis of observable standalone prices. The lessee shall estimate the standalone price of lease and nonlease components (maximizing the use of observable information) if observable standalone prices are not available. That may include use of a residual approach to estimate a standalone price if the standalone price of the component is highly variable or uncertain.
b. A lessee shall allocate consideration in the contract only to those items that transfer a good or service to the lessee and, therefore, are components (see paragraphs BC143 and BC144).
c. A lessee shall allocate changes in the contract consideration on the same basis as at contract inception.
d. A lessee shall reallocate the consideration in the contract either:
    1. On remeasurement of the lease liability (for example, a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the underlying asset)
    2. At the effective date of a contract modification that is not accounted for as a separate contract.

BC156. The allocation guidance for lessees in Topic 842 does not reference other Topics; the Board decided that it will be less complex and more intuitive for lessees to include the allocation guidance within the leases Topic. The Board also decided that having lessees apply the revenue recognition guidance in Topic 606 (as is the case for lessors) does not make conceptual sense because a lessee is the customer in a lease rather than the supplier. However, the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP, although some additional rigor has been added to the process for determining the standalone price of a lease or nonlease component. That is, the Board decided that in determining the standalone price of lease and nonlease components of the contract, a lessee is required to use observable standalone prices, if available, before using an estimated standalone price. Furthermore, a lessee should maximize the use of observable inputs and apply estimation

methods consistently in similar circumstances when estimating a standalone price. The Board decided that the ability to estimate standalone prices should include the ability to use a residual approach to estimate the standalone price, subject to the requirement to maximize the use of observable inputs in estimating the standalone price.

Activities (or Costs) That Do Not Transfer a Good or Service to the Lessee

BC157. The 2010 and 2013 Exposure Drafts did not provide guidance on what activities (or costs) constitute a *component* in a contract that is or contains a lease and, therefore, that should receive an allocation of the consideration in the contract. Therefore, after both Exposure Drafts were issued, some stakeholders commented that although it is clear that some activities, such as providing maintenance services, would be nonlease components, it was unclear whether other costs that are sometimes separately stated in a contract, such as taxes and insurance, would be considered components. Those stakeholders noted that executory costs were specifically excluded from the definition of *minimum lease payments* in previous GAAP. Those stakeholders further commented that, in some leases, it is common practice for one party to the contract to pay certain costs directly to a third party, although the counterparty to the contract is principally liable to make those payments (for example, a lessee may make property tax payments directly to the taxing authority although the lessor is principally liable for those payments).

BC158. In response to those concerns, the Board decided to provide guidance in Topic 842 on what constitutes a component in a contract and to clarify that only components get an allocation of the consideration in the contract. The Board decided that activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract. For example, an entity would not account for a portion of the consideration in the contract that is attributable to paying the lessor's property taxes (or its hazard insurance) as a component if the lessor is the primary obligor for those taxes (or insurance) and the amounts paid are not for a service (for example, maintenance or operations services) provided by the lessor to the lessee.

BC159. The guidance in Topic 842 in this respect is consistent with the revenue recognition guidance in Topic 606, which states that promised goods or services do not include set up or other activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to the customer. Those activities, therefore, do not get an allocation of the transaction price.

BC160. The Board further noted that, beyond items like property taxes and hazard insurance, a lessee's payments are almost always reimbursing costs of the lessor, all the way down to the profit margin. Therefore, the Board decided that guidance of this nature was necessary to ensure that entities only allocated the consideration

in the contract to those items or activities that actually provide a good or service to the lessee.

Consideration in the Contract

BC161. The guidance in the 2013 Exposure Draft stipulated how an entity should allocate the consideration in the contract but did not define consideration in the contract; therefore, some stakeholders questioned whether and, if so, when that included variable consideration. That is because, although the Board decided that an entity would not include variable lease payments other than those that depend on an index or a rate (or are in substance fixed payments) in lease payments, the revenue recognition guidance in Topic 606 requires an entity to estimate variable consideration in determining the transaction price.

BC162. In response to this feedback, the Board included the following guidance in Topic 842:

a. First, lessees should not include variable consideration in determining the consideration in the contract other than variable consideration that depends on an index or a rate. This aligns the accounting for variable payments for nonlease components with the Board's decision on the accounting for variable *lease* payments (see paragraphs BC205–BC212 for the Board's rationale on its variable lease payment decisions). The Board further considered that it would be costly and complex to require lessees to estimate variable payments for nonlease components included in a contract that contains a lease and that entities generally are not required to estimate variable payments for similar nonlease components that do not include a lease.
b. Second, lessors should determine whether the terms of a variable payment relate specifically to a lease component or a nonlease component, and:
    1. If the terms of the variable payment (other than those that depend on an index or a rate or are in substance fixed) relate specifically or partially to a lease component, then the entity should recognize those payments as income in profit or loss in the period in which the changes in facts and circumstances on which the variable payment is based occur, and, therefore, should not estimate those payments or include any amounts related to the variable payment in the consideration in the contract. When recognized, the income resulting from those variable payments should be allocated to the separate lease components and nonlease components of the contract on the same basis as the allocation of the consideration in the contract.
    2. If the terms of the variable payment relate specifically to a nonlease component (that is, the terms of the variable payment relate specifically to the entity's efforts to transfer the good or service or to a specific outcome from transferring the good or service), the entity should include in the consideration in the contract the amount of

those expected payments that would be included in the transaction price in accordance with the revenue recognition variable consideration guidance in paragraphs 606-10-32-5 through 32-13. A lessor should allocate the variable consideration in this case entirely to the nonlease component(s) to which it relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28. Otherwise, the variable consideration included in the consideration in the contract is allocated in the same manner as any other consideration in the contract (that is, to the separate lease components and nonlease components of the contract).

BC163. The Board decided that providing guidance on consideration in the contract was necessary to ensure consistent application of the allocation guidance in Topic 842, particularly for lessors because of the differences between how the Board decided a lessor should account for variable lease payments and how an entity accounts for variable consideration in Topic 606. The Board concluded that accounting for a variable payment that relates partially to a lease component (for example, a performance bonus that relates to the leased asset and the lessor's operation of that asset) in the same manner as a variable lease payment (that is, with respect to recognition and measurement) will be less costly and complex than accounting for that variable payment in accordance with the variable consideration guidance in Topic 606. In addition, the Board decided that a lessor should not account for a single variable payment in accordance with two accounting models (for example, partially as a variable lease payment and partially as variable consideration in the scope of Topic 606).

BC164. Allocating variable consideration that is included in the consideration in the contract entirely to the nonlease component(s) to which the variable consideration relates only when doing so would be consistent with the allocation objective in paragraph 606-10-32-28, which is consistent with the Board's objectives of:

a. Aligning the lessor allocation guidance to that applicable to sellers of goods or services in Topic 606
b. Accounting for nonlease components in a manner generally consistent with how they would be accounted for if not included in a contract that contains a lease.

Contract Combinations

BC165. The Board included guidance in Topic 842 for when an entity should combine two or more contracts and account for them as a single contract. Although it is usually appropriate to account for a contract individually, an entity should assess the combined effect of contracts that are interdependent. An entity may enter into multiple contracts in contemplation of another such that the contracts, in substance, form a single arrangement that achieves an overall commercial effect. The financial reporting effect of recognizing those contracts separately may be

different from the financial reporting effect of recognizing those contracts on a combined basis. In those situations, accounting for the contracts independently might not result in a faithful representation of the combined transaction. This accounting has been acknowledged throughout GAAP, and guidance similar to that in Topic 842 was included in Topic 606.

BC166. The Board decided that entering into contracts at or near the same time is a necessary condition for contracts to be combined. That decision is consistent with the objective of identifying the contract that is to be accounted for as the unit of account because that assessment also is performed at contract inception.

BC167. The Board decided that in addition to contracts being entered into at or near the same time, the contracts should satisfy one or more specified criteria for the contracts to be combined. The Board observed that when either criterion (a) or (b) in paragraph 842-10-25-19 is met, the relationship between the consideration in the contracts (that is, the price interdependence) is such that if those contracts were not combined, the amount of consideration allocated to the components in each contract might not faithfully depict the value of the goods (including rights of use) or services transferred to the customer. The Boards decided to include the criterion in paragraph 842-10-25-19(c) to avoid the possibility that an entity could effectively bypass the guidance for separating components depending on how the entity structures its contracts.

BC168. The Board clarified that, for two or more contracts to be combined, they should be with the same counterparty. However, the Board acknowledged that in some situations, contracts with related parties (as defined in Topic 850, Related Party Disclosures) should be combined if there are interdependencies between the separate contracts with those related parties. Thus, in those situations, combining the contracts with related parties results in a more appropriate depiction of the arrangement.

Lease Modifications

BC169. The guidance on lease modifications in Topic 842 was developed principally with the following in mind:

a. The accounting for lease modifications in previous GAAP was generally considered to be very complex (often explained only by flowchart). In the Board’s view, the lease modifications guidance in Topic 842 is less complex and more intuitive to apply than the previous guidance.
b. Contracts that contain leases frequently contain nonlease components (that is, other goods or services). This was particularly important to the Board’s considerations about lease modification accounting for lessors because Topic 606 contains a robust framework for accounting for modifications of contracts with customers to provide nonlease goods and services (for example, supplies for use with leased equipment or services such as maintenance or operation of the underlying asset).

c. From a lessee perspective, right-of-use assets and lease liabilities will be recognized for all leases (other than short-term leases) and the lease liability is, in effect, the cost of the right-of-use asset. Therefore, a lease modification that results in a change in the scope of, or the consideration for, the lease affects both the lease liability and the right-of-use asset (not always in the same way).

Modifications Accounted for as Separate Contracts

BC170. The Board decided that some modifications to existing contracts that are leases or contain leases should not affect the accounting for a lease in the original contract. The Board decided that if a modification grants the lessee additional rights of use (for example, the right to use an additional asset) and the lease payments increase commensurate with the standalone price for those additional rights, that lease should be accounted for as a separate contract (that is, separate from the original contract).

BC171. In those circumstances, the Board decided that accounting for the modification (or amendment) separate from the original contract is appropriate because the new lease does not affect the original contract. It does not change the scope or the consideration allocable to the lease and nonlease components in the original contract. The Board also concluded that accounting for modifications of this nature as separate contracts reduces complexity because it does not require an entity to adjust its established accounting for the original contract.

BC172. In contrast, a modification that does not meet the criteria to be accounted for as a separate contract changes the terms and conditions of the existing lease(s) between the parties. This includes a modification that grants the lessee additional rights of use but the increase in the lease payments is not commensurate with the standalone price for those additional rights. In that case, the modification changes the terms and conditions of the existing lease by changing the lease payments (after reallocation of the consideration in the contract).

Lessee Accounting for Lease Modifications

BC173. When a modification does not meet the criteria to be accounted for as a separate contract, the lessee remeasures the lease liability for the modified, existing lease as of the effective date of the modification as if the modified lease were a new lease that commences on that date. Because the Board decided that a modified lease is accounted for as if it were a new lease at the effective date of the modification, the lessee reassesses the classification of the lease and remeasures the right-of-use asset and the lease liability based on the changed terms and conditions of the modified contract (including the changed lease payments).

BC174. The lessee's accounting for the modification depends on the nature of the modification. The guidance in Topic 842 differentiates between the following types of modifications:

a. Those that (1) grant the lessee additional rights not included in the original lease, (2) extend or reduce the term of an existing lease, or (3) solely change the consideration in the contract
b. Those that fully or partially terminate an existing lease by reducing the assets subject to lease.

BC175. The Board concluded that for the types of modifications in paragraph BC174(a), a lessee should not recognize a gain or loss from the modification because there has been no termination, fully or partially, of the original lease. Instead, the modification solely changes the cost of the right-of-use asset resulting from the original lease. Consequently, the amount of the remeasurement of the lease liability for the modified lease is recorded as an adjustment to the right-of-use asset and, no amount is recognized in profit or loss. In deliberating this guidance, the Board noted that a lease may be modified even if the stated terms of the modification do not change the stated terms of the lease. For example, a stated change in the consideration to be paid for a nonlease component may change the remaining lease payments because the lessee must allocate that change in consideration on the same basis as the original consideration in the contract was allocated.

BC176. The Board also observed the following regarding modifications of the nature in paragraph BC174(a):

a. The right to use an additional underlying asset (for example, an additional floor of a building or an additional piece of equipment) will generally be a separate lease component, even if the modification granting that additional right of use is not a separate contract in accordance with paragraph 842-10-25-8. Consequently, after a modification of the type in paragraph BC174(a)(1), a lessee will typically have additional separate lease components than before the modification. Example 17 in Topic 842 demonstrates the effect of this conclusion.
b. A modification of the type in paragraph BC174(a)(2) does not grant an additional right of use. Rather, it merely changes an attribute of the lessee's existing right to use the underlying asset that it already controls. That is because the duration of the lessee's right of use (for example, 2, 5, or 10 years) is merely an attribute of that right of use in the same way that the specifications of a piece of equipment (for example, its color or functioning speed) are attributes of that tangible asset. That is why a lessee recognizes a lease liability for the full duration of the lease at lease commencement, regardless of the lease term.

BC177. For a modification that fully or partially terminates an existing lease by reducing the assets subject to lease, the Board decided that in some cases, a gain

or loss should result. That would be the case whenever the right-of-use asset does not equal the lease liability immediately before the effective date of the modification (for example, in a finance lease or in an operating lease in which the lease payments are not even throughout the lease term). The Board concluded that recognizing the difference between the change in the lease liability and the proportionate adjustment to the right-of-use asset in profit or loss is consistent with the accounting in other Topics that address terminations or extinguishments. Example 18 in Topic 842 illustrates two ways that a lessee might account for a modification of this nature, either of which would be acceptable to the Board.

Lessor Accounting for Lease Modifications

BC178. In Topic 842, a modification is accounted for prospectively by a lessor from the effective date of the modification (that is, no profit or loss is recognized) unless the modification, in effect, results in the sale of the underlying asset by transferring control of the asset to the lessee. This occurs when an operating lease or direct financing lease is modified and the modified lease is classified as a sales-type lease. Topic 842 provides guidance, including illustrative examples, on how to effect the prospective accounting (for example, specifying the effect of any prepaid or accrued rentals on the accounting for the modified lease and how to calculate the postmodification net investment in the lease for sales-type and direct-financing leases). This includes guidance for scenarios in which the lease classification changes as a result of the modification (for example, from operating lease to sales-type lease or from direct financing lease to operating lease). The Board decided to provide relatively detailed guidance and examples to ensure the guidance is understandable and can be applied in a consistent manner.

BC179. In deciding on the lease modification requirements for lessors applicable to operating leases, the Board considered that, based on the lessor accounting model (which is not symmetrical to the lessee accounting model), each period to which the right of use applies (for example, each day, month, or year) should be considered distinct from each other period. That is, based on the decision to substantially retain previous GAAP lessor accounting in Topic 842, which accounts for operating leases in the same manner as service contracts, a lessee generally benefits from its right to use the underlying asset each period it has those rights, and its ability to benefit from the right of use in one period is generally unaffected by its right-to-use the asset in any other period. As a result, prospective accounting for a modified lease that does not, in effect, sell the underlying asset is consistent with the revenue recognition guidance in Topic 606 for contract modifications in which the remaining goods or services to be provided after the modification are distinct from those provided before the modification. The Board decided that having a model for lease modifications that is generally consistent with that for contract modifications both (a) is appropriate on a conceptual basis given that leasing is fundamentally a revenue-generating activity for lessors and (b) will reduce complexity for lessors that regularly provide nonlease goods or services to their customers in conjunction with their leasing activities.

BC180. The Board considered but rejected approaches that would have either relied on or been based on the financial instruments guidance elsewhere in GAAP in accounting for modifications to sales-type and direct financing leases. The Board considered those alternative approaches principally because the lessor's lease receivable is a financial asset. However, the Board rejected those approaches because they would have been more complex than the approach in Topic 842 (that is, those approaches would have required additional steps to determine the significance of the modification) and because the Board decided that it is more important to align the modifications guidance to that in Topic 606, particularly for lessors that regularly provide nonlease goods or services. In addition, some stakeholders informed the Board that relying solely on the financial instruments guidance elsewhere in GAAP would not provide guidance on how to account for the nonfinancial unguaranteed residual asset in a modification. The Board's decision to align the lease modifications guidance with the contract modifications guidance in Topic 606 is conceptually consistent with the Board's decisions elsewhere in Topic 842 to align the lessor accounting guidance with the revenue recognition guidance where it is reasonable to do so.

Recognition and the Date of Initial Measurement

Inception versus Commencement of a Lease

BC181. Topic 842 requires that lessees and lessors recognize and measure lease assets and lease liabilities at the commencement date of the lease. The requirement in Topic 842 to recognize and measure the assets and liabilities arising from a lease at the commencement date is consistent with the Board's proposals in the 2013 Exposure Draft.

BC182. The Board concluded that recognizing assets and liabilities arising from a lease at the commencement date is consistent with the overall right-of-use model in which a lessee recognizes an asset representing its right to use an underlying asset for the period of the lease and a liability representing its obligation to make lease payments. A lessee does not obtain and control its right to use the underlying asset until the commencement date, that is, the date on which the lessor makes the underlying asset available for the lessee's use. Before that date, the lessor has not yet performed under the contract. Although a lessee may have an obligation to stand ready to make lease payments if the lessor performs under the contract, the lessee is unlikely to have an obligation to make lease payments before the asset is made available for its use. Similarly, from the lessor's perspective, although the lessor may have an obligation to stand ready to deliver the right to use the underlying asset from the date of inception, the lessor is unlikely to have a right to receive lease payments before the asset is made available for the lessee's use. Nonetheless, if the costs of meeting an obligation under the lease exceed the economic benefits expected from the lease, an entity should consider the guidance

in Topic 450 on contingencies to determine whether the entity has a liability before the commencement date.

BC183. Having concluded that the commencement date is the appropriate date for an entity to recognize assets and liabilities arising from a lease, the Board decided that aligning the date of initial measurement with the recognition date has the following benefits:

a. It clarifies that, other than any gain or loss to be recognized by a lessor with sales-type leases, a gain or loss should not arise on initial recognition of lease assets and lease liabilities by a lessee or a lessor.
b. It removes the need to add requirements (and, thus, potentially reduces complexity) on how to account for changes to the terms and conditions of a lease or assumptions used in measuring lease assets and lease liabilities between the date of inception and the commencement date. Any changes to a lease that occur after the date of inception are taken into account when initially measuring the asset and liability at the commencement date.
c. It clarifies that an entity should capitalize initial direct costs incurred before the commencement date. Some respondents to the 2010 Exposure Draft had noted that the previous proposals on initial measurement implied that an entity would not be permitted to capitalize any initial direct costs incurred after the date of inception.
d. It is more consistent with the measurement date for other transactions, such as business combinations and the acquisition of property, plant, and equipment.

BC184. In deciding on the date of initial recognition and measurement, the Board noted that for some leases, the rights and obligations that arise from entering into a lease could be significant. Without any disclosure, a user of financial statements would have no information about those rights and obligations before the commencement date (assuming that the entity did not recognize a liability in accordance with Topic 450). Accordingly, Topic 842 requires that a lessee disclose information about leases that create significant rights and obligations between the date of inception and the commencement date. Those disclosures will inform users of financial statements of significant cash commitments made relating to leases for which assets and liabilities will be recognized by the lessee in future periods. This recognition and disclosure requirement is consistent with that proposed in the 2013 Exposure Draft.

BC185. The 2010 Exposure Draft proposed that a lessee and a lessor recognize lease assets and lease liabilities at the commencement date of a lease but initially *measure* those assets and liabilities at the date of inception of the lease. Respondents to the 2010 Exposure Draft generally agreed that the commencement date is the appropriate date on which to recognize lease assets and lease liabilities but questioned whether an entity should measure the lease as of contract inception. Although for most leases the time between the date of

inception and the commencement date is usually short, some respondents noted that there are contracts for which that is not the case (for example, some leases are signed before the underlying asset is constructed). When that is the case, the proposals raised a number of questions:

a. How should an entity account for any changes to the terms and conditions of the lease between the date of inception and the commencement date?
b. Should an entity account for the time value of money, changes in indexes, and changes in the fair value of the underlying asset between the date of inception and the commencement date? If so, how?

BC186. The Board noted that its intention in proposing to initially measure lease assets and lease liabilities at inception was that the measurement would reflect the nature of the transaction and the terms and conditions of the lease. The Board concluded that this would require an entity to look to the terms and conditions agreed to in the contract at the date of inception. However, the Board had not intended that an entity would recognize a gain or loss relating to changes between the dates of inception and commencement when recognizing lease assets and lease liabilities at the commencement date.

Measurement: Lessee

Measurement Bases of the Lease Liability and Right-of-Use Asset

BC187. The Board decided on a cost measurement basis for the lease liability and right-of-use asset, with cost measured at the present value of the lease payments. The Board concluded that this would provide useful information to users of financial statements while minimizing costs as compared with other approaches.

BC188. The Board considered whether to refer to existing GAAP rather than specify in the lease proposals the initial and subsequent measurement of the lease liability and right-of-use asset. The Board rejected that approach for a number of reasons:

a. The approach would be inconsistent with the Board's decision not to apply a components approach to lease accounting. For example, existing requirements on financial instruments would require separate accounting for options in a lease.
b. Leases often have unique features compared with other financial liabilities and nonfinancial assets and, therefore, should have accounting that reflects those unique features.
c. The approach would be more complex to apply, particularly when a lease contains features such as options, variable lease payments, and residual value guarantees.

d. Previous leases guidance specified how to measure capital lease assets and capital lease obligations initially and throughout the lease term such that users of GAAP are accustomed to having the measurement guidance contained in the leases Topic.

Initial Measurement of the Lease Liability

Lease Term: Options to Extend or Terminate a Lease

BC189. Leases often grant the lessee a right to extend a lease beyond the initial noncancellable period or to terminate a lease before the end of the lease period. Depending on the terms and conditions of the option, a three-year lease with an option to extend for two years may or may not be economically similar to a three-year noncancellable lease or a five-year noncancellable lease. However, a lease with options would never be exactly the same as a lease without any options.

BC190. There are a number of different ways that a lessee and lessor could reflect options that exist in leases:

a. *A components approach*, in which options in a lease are recognized and measured as separate components of the lease. The Board rejected a components approach to lease accounting because such an approach would be complex, would ignore the interrelationship between the term of a lease and the exercise of options, and would be difficult to apply because options may be difficult to measure reliably.
b. *A disclosure approach*, in which an entity recognizes a lease liability or lease receivable for the noncancellable period and discloses the existence of any options to extend the term. Although simple to apply, the Board rejected this approach because, as compared with previous GAAP, it would provide less useful information to users of financial statements. The measurement of lease assets and lease liabilities would ignore the existence of options, including those that are reasonably certain of being exercised and, thus, would potentially misrepresent the assets and liabilities arising from a lease.
c. *A measurement approach*, in which options in a lease are included in the measurement of lease assets and lease liabilities using a particular method. That method could be, for example:
    1. A probability-weighted measurement method (in which the measurement of lease assets and lease liabilities reflects the probability of each possible lease term)
    2. A probability threshold method (in which an entity includes optional periods in the lease term if the exercise of the options meets a specified threshold, for example, reasonably certain, virtually certain, or more likely than not)

3. An economic incentive method (in which an entity includes optional periods in the lease term if an entity has an economic incentive to exercise the option).

BC191. The Discussion Paper and the 2010 Exposure Draft proposed determining the lease term on the basis of a *most likely* measurement approach; that is, the lease term would be the longest possible term that is more likely than not to occur. That is because the Board thought that the lease term should reflect an entity's reasonable expectation of what the term would be. The 2010 Exposure Draft also proposed that, at each reporting date, the lessee or lessor should reassess which outcome it considered to be most likely to occur on the basis of any new facts or circumstances that indicate that there would be a significant change in the recognized lease liability or lease receivable since the previous reporting period.

BC192. Many respondents to the Discussion Paper and the 2010 Exposure Draft disagreed with the proposals because:

a. Some said that determining the present value of lease payments on the basis of the most likely lease term would result in the recognition of a liability (for the lessee) and an asset (for the lessor) that does not meet the definition of a liability or an asset in Concepts Statement 6. That is because the lessee is not obliged to make lease payments and the lessor does not have a right to receive lease payments beyond the initial noncancellable period until the lessee has exercised the option.
b. Some disagreed because the approach would not distinguish between a five-year noncancellable lease and a three-year lease with an option to extend for two years that is likely to be exercised. In their view, an entity is in a different economic position when it has entered into a five-year noncancellable lease rather than a three-year lease with an option to extend that it may or may not exercise, and that difference should be reflected in the measurement of lease assets and lease liabilities.
c. Some suggested increasing the threshold at which an entity would include options to extend in the measurement of lease assets and lease liabilities. They suggested thresholds such as "reasonably assured" (used in existing GAAP), "reasonably certain" (used in existing IFRS), and "virtually certain" (which would be a higher threshold that would almost equate to including only contractual minimum lease payments in the measurement of lease assets and lease liabilities).
d. Others suggested including options in the measurement of lease assets and lease liabilities only when a lease includes economic incentives for an entity to exercise an option.
e. Most preparers highlighted the cost and complexity of not only determining the lease term at the commencement date but also reassessing the lease term at each reporting date. Preparers reiterated this message at workshops held in 2010 to discuss the proposals.

BC193. On reconsideration, the guidance in the 2013 Exposure Draft affirmed the view that the lease term should reflect an entity's reasonable expectation of what the term would be. However, the basis of that expectation was linked to a lessee having a "significant economic incentive" to exercise an option. The Board considered that applying the concept of significant economic incentive would provide a threshold similar to the concepts of "reasonably assured" in previous GAAP and "reasonably certain" in IFRS. However, the proposals would have emphasized that there needed to be a significant *economic* incentive for the lessee to exercise the option to include optional periods in the lease term. An expectation of exercise alone (and without a significant economic incentive to do so) would not be sufficient. The Board concluded that requiring an economic incentive would provide a threshold that could be applied more objectively than a threshold based solely on management's estimates or intent.

BC194. Most respondents to the 2013 Exposure Draft, including most financial statement users that did not like the uncertainty of management estimates based only on a "more likely than not" threshold that could change frequently, understood that "significant economic incentive" was a high threshold and said that the proposals were an improvement to those in the Discussion Paper and in the 2010 Exposure Draft. Some respondents continued to express a variety of opinions on whether *any* options should be included in determining the lease term and whether or how management intent should be considered in evaluating options to extend a lease. However, the most prevalent feedback from many respondents was that if the Board intended for the significant economic incentive threshold to be applied in a similar manner to the "reasonably assured" threshold in previous GAAP, the Board should retain the "reasonably assured" threshold in the final leases guidance. Those respondents stated that retaining the previous threshold rather than rearticulating it in a different manner, if it was the Board's intention that it should be applied similarly, would reduce the costs of implementing and applying a new leases standard.

BC195. Therefore, on the basis of the feedback received and because it was the Board's intention that "significant economic incentive" should result in similar lease term conclusions as the "reasonably assured" guidance in previous GAAP, the Board decided that the lease term should include only optional periods to extend the lease if either (a) the lessee is *reasonably certain* to exercise that option or (b) exercise of the option is controlled by the lessor. The Board decided to use the term *reasonably certain* rather than *reasonably assured* to remain converged in this respect with IFRS. The Board was informed that the guidance on lease term in previous GAAP and IFRS, which use the terms *reasonably assured* and *reasonably certain*, respectively, are applied consistently in practice. Therefore, the Board views *reasonably certain* and *reasonably assured* as synonyms that should be applied in the same way. There is little in leasing guidance in previous GAAP (or IFRS) on the application of either of these terms; therefore, the Board decided it will be useful to continue, as in the 2013 Exposure Draft, to provide some implementation guidance in the form of factors for entities to consider in applying

the reasonably certain threshold. The Board considered which factors should be considered when determining the lease term at the commencement date. The Board affirmed that at the commencement date, an entity should take into account all relevant *economic* factors (contractual, asset, entity, and market-based factors) when assessing whether an entity is reasonably certain to exercise an option to extend a lease. The factors to consider when reassessing the lease term are discussed in paragraphs BC227–BC232.

BC196. Consistent with the 2013 Exposure Draft, the Board also affirmed that options to extend a lease and options to terminate a lease should be accounted for in the same way. Accordingly, payments to be made during the period after which a lessee can terminate a lease are included when measuring lease assets and lease liabilities if the lessee is reasonably certain not to exercise the option to terminate the lease.

BC197. Some Board members agree with those respondents (as discussed in paragraph BC192(a)) that indicated that recognizing renewal options as a liability by a lessee or an asset by the lessor results in recognizing liabilities and assets that separately do not meet the conceptual definitions of assets and liabilities. However, those Board members acknowledge that renewal options create an asset for the lessee and a liability for the lessor. Those Board members observe that either including or not including renewal options in the measure of assets and liabilities will be inconsistent in one way or another with the conceptual definitions of assets and liabilities and, therefore, accept the approach in Topic 842. That approach accounts for renewal options only when it is reasonably certain that they will be exercised or when exercise is outside the control of the entity (such as when a lessor controls a lessee's exercise of a renewal option or a termination option). Those Board members view the approach in Topic 842 as a practical way, consistent with that in previous GAAP, to account for renewal options where the form is optional, but it is clear that there is economically little or no choice but to extend or not to terminate the lease.

Discount Rate

BC198. The 2010 and 2013 Exposure Drafts proposed that a lessee should discount the lease liability using the rate the lessor charges the lessee (which would often be the rate implicit in the lease), if that rate can be readily determined. If the rate the lessor charges the lessee cannot be readily determined, the lessee would use its incremental borrowing rate, which would take into account the credit standing of the lessee, the length of the lease, the nature and quality of the security provided, and the economic environment in which the transaction occurs.

BC199. There was broad support among those stakeholders that provided feedback on the discount rate for a lessee to use its incremental borrowing rate in the absence of information about the rate the lessor charges the lessee. Stakeholders also generally supported this approach because it is similar to the discount rate requirements for capital leases in previous GAAP.

BC200. Therefore, in Topic 842, the Board, in general, affirms the previous proposals about the discount rate to be used by the lessee at initial measurement. However, in affirming the previous proposals, the Board decided to eliminate the use of the phrase *rate the lessor charges the lessee*. In the 2010 and 2013 Exposure Drafts, the rate the lessor charges the lessee included possible discount rates other than the rate implicit in the lease (for example, a property yield). In redeliberating the proposals in the 2013 Exposure Draft, the Board decided that the rate the lessor charges the lessee should always be the rate implicit in the lease and, therefore, that the final leases guidance should simply refer to the *rate implicit in the lease*.

BC201. As discussed in paragraphs BC120 and BC121, the Board noted that it may be acceptable to apply the leases guidance at a portfolio level by lessees and lessors in some circumstances. In redeliberating the discount rate proposals in the 2013 Exposure Draft, the Board noted that this decision would include the ability to use a portfolio approach to determine the discount rate for a lessee's leases. The Board considered that this would substantially address the concerns of those stakeholders that commented that calculating the incremental borrowing rate for individual leases would impose a significant administrative burden on their organizations. The Board also considered that, in some cases, it might be reasonable for a subsidiary to use a parent entity or group's incremental borrowing rate as the discount rate. Depending on the terms and conditions of the lease and the corresponding negotiations, the parent entity's incremental borrowing rate may be the most appropriate rate to use as a practical means of reflecting the interest rate in the contract, assuming the implicit rate is not readily determinable. For example, this might be appropriate when the subsidiary does not have its own treasury function (all funding for the group is managed centrally by the parent entity) and, consequently, the negotiations with the lessor result in the parent entity providing a guarantee of the lease payments to the lessor. Therefore, the pricing of the lease is more significantly influenced by the credit standing of the parent than that of the subsidiary.

BC202. The Board also considered and rejected the view that the "cost of money" would be an appropriate discount rate for lessees that are required to comply with the Cost Accounting Standards and the Federal Acquisition Regulation to use in applying the guidance in this Update. The "cost-of-money" rate used to reimburse those entities is not necessarily linked to the rate the lessor considers in pricing the lease, and it is not necessarily linked to the lessee's incremental borrowing rate. Consequently, it is not an appropriate proxy for the interest rate in the contract.

Lease Payments

In Substance Fixed Payments

BC203. The guidance in the 2013 Exposure Draft stipulated that lease payments include in substance fixed payments. In substance fixed lease payments are payments that may, in form, appear to contain variability but are, in effect, fixed and unavoidable. The Board decided to include in substance fixed payments in the measurement of lease assets and lease liabilities because those payments are unavoidable and, thus, are economically indistinguishable from fixed lease payments. The majority of those that participated in outreach on the 2013 Exposure Draft (which included preparers, users, accounting firms, and others) supported including in substance fixed payments in the definition of lease payments. Accounting firms and regulators noted the importance of defining and providing examples of in substance fixed payments to ensure consistent application and comparability between entities.

BC204. In response to this feedback, the Board affirmed in Topic 842 that in substance fixed lease payments are included in the measurement of lease assets and lease liabilities. The Board discussed whether to leave this as a principle or provide further requirements. The Board concluded that providing a principle rather than an extensive list of possible scenarios, which could never capture every situation, was generally sufficient, however, it included some additional implementation guidance in Subtopic 842-10 as compared with the 2013 Exposure Draft to assist in identifying in substance fixed payments. In affirming its decisions reached in the 2013 Exposure Draft, the Board also considered that the concept of in substance fixed payments existed in practice in previous GAAP, and, in the Board’s view, the guidance on in substance fixed payments included in this Update is substantially similar to the interpretive guidance that existed in previous GAAP. Consequently, the examples that exist in practice and that are included in various pieces of interpretive guidance provide useful information on how the Board intends this concept to apply in Topic 842. The Board also noted that the concept of capturing items that are in substance fixed payments because they are readily determinable exists elsewhere in existing guidance (for example, on the determination of whether a notional amount exists in accounting for derivatives in Topic 815).

Variable Lease Payments

BC205. Some or all of the lease payments for the right to use an asset can be variable. That variability can arise because lease payments are linked to:

a. Price changes due to changes in an external market rate or the value of an index. For example, lease payments might be adjusted for changes in a benchmark interest rate or the Consumer Price Index.

b. The lessee's performance derived from the underlying asset. For example, a lease of retail property may specify that lease payments are based on a specified percentage of sales made from that property.
c. The use of the underlying asset. For example, a car lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.

BC206. There are various views on whether variable payments linked to future performance or use of an asset meet the definition of a liability. Some are of the view that a lessee's liability to make and a lessor's right to receive variable lease payments do not exist until the future event requiring the payment occurs (that is, when the underlying asset is used or a sale is made). Accordingly, some are of the view that entities should only provide disclosure about variable lease payments linked to performance or use and should not include those payments in the measurement of lease assets and lease liabilities.

BC207. However, some note that a lessee's obligation to make and a lessor's right to receive variable lease payments exist at the commencement date by virtue of the lease contract. Consequently, they are of the view that all variable lease payments meet the definition of a liability for the lessee and an asset for the lessor. It is the amount of the liability or asset that is uncertain, rather than the existence of the liability or asset. Accordingly, some would suggest that lessees and lessors should estimate variable lease payments and include that estimate in the measurement of lease assets and lease liabilities.

BC208. The 2010 Exposure Draft proposed a probability-weighted estimation approach in which a lessee and lessor would include estimated variable lease payments in the measurement of lease assets and lease liabilities at the commencement date. Those proposed amendments also would have required the reassessment of estimates if there was a significant change in the measurement of the lease liability. Many respondents to that Exposure Draft disagreed with those proposals. Preparers stated and demonstrated at workshops why this approach would be extremely costly to apply, especially for longer term leases with payments linked to the lessee's performance or use of the underlying asset (for example, a 25-year retail store lease). They noted that the reason that they often enter into leases with variable lease payments based on performance or use is because of the uncertainty associated with that future performance or use; that is, they wish to share the risks of the uncertainty about the economic benefits to be derived from using an underlying asset with the lessor and also, often, to incentivize the lessor to perform (for example, to incentivize a mall owner to bring entertainment to the mall that will attract additional shoppers). Accordingly, it often would be difficult for a lessee to estimate variable lease payments reliably. Similarly, it often would be difficult for the lessor to estimate the future performance from or use of an asset with precision when it has little or no control over that use. Consequently, respondents, including some users of financial statements, questioned the relevance of the information that would be included in the measurement of lease assets and lease liabilities.

BC209. On the basis of that feedback, the Board agreed that the cost and complexity of estimating and measuring all variable lease payments could not be justified by the benefit. The 2013 Exposure Draft, therefore, proposed to include in the measurement of lease assets and lease liabilities only those variable lease payments that depend on an index or a rate. For some Board members, the decision about variable lease payments linked to future performance or use was made solely for cost-benefit reasons, that is, they are of the view that all variable lease payments meet the definition of an asset (for the lessor) and a liability (for the lessee). However, those Board members were convinced by the responses to the 2010 Exposure Draft that the benefits of those proposals would not justify the costs, particularly because of the concerns expressed about the precision of the measurement that would result from the proposals. Other Board members concluded that variable lease payments linked to future performance or use do not meet the definition of an asset (for the lessor) or a liability (for the lessee) until the performance or use occurs. They consider those payments to be avoidable by the lessee and, accordingly, would conclude that the lessee does not have a present obligation to make those payments. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future profits to be derived from the use of the asset. Accordingly, the 2013 Exposure Draft proposed that those variable lease payments would not be included in the measurement of lease assets and lease liabilities.

BC210. The Board affirmed its decision to include only those variable lease payments that depend on an index or a rate in the measurement of lease assets and lease liabilities. The Board's reasoning remains consistent with that underlying its decision in the 2013 Exposure Draft. The Board also considered that most respondents to the 2013 Exposure Draft, including most users with whom outreach was conducted, agreed with the proposals about the accounting for variable lease payments. Those respondents generally said that variable payments contingent on future events (for example, performance or use) do not represent a present obligation of the lessee or a right of the lessor and, therefore, do not meet the definition of an asset or a liability. Many stakeholders, including most users with whom outreach was conducted, said that they would not want subjective estimates about variable lease payments reflected in the measurement of lease assets and lease liabilities.

BC211. For reasons similar to those for including in substance fixed payments in the measurement of lease assets and lease liabilities, the Board also decided to include variable lease payments that depend on an index or a rate in the measurement of lease assets and lease liabilities. Those payments meet the definition of assets (for the lessor) and liabilities (for the lessee) because they are unavoidable (that is, a lessee has a present obligation to make, and the lessor has a present right to receive, those lease payments). Any uncertainty, therefore, relates to the measurement of the asset or liability that arises from those payments and not to the existence of the asset or liability.

BC212. In the Board's view, in principle, forecasting techniques should be used to determine the effect of changes in an index or a rate on the measurement of lease assets and liabilities. However, forecasting changes in an index or a rate requires macroeconomic information that entities may not have readily available, and forecasts often can be imprecise. In the Board's view, the usefulness of the additional information obtained using such a forecast would not justify the costs of obtaining it. The 2010 Exposure Draft proposed using forward rates when measuring lease assets and lease liabilities if they are readily available. However, respondents to that Exposure Draft commented that this would reduce comparability between those using forward rates and those not doing so and that determining whether a rate would be "readily available" requires judgment. In response to this feedback, in the 2013 Exposure Draft, the Board decided to require an entity to determine payments that depend on an index or a rate using the index or rate that exists at the commencement date. Most respondents to that Exposure Draft agreed with the Board's proposal and, consequently, the Board affirmed that decision in Topic 842. Subsequent measurement of variable lease payments that depend on an index or a rate is discussed in paragraphs BC234–BC237.

Residual Value Guarantees

BC213. The 2010 and 2013 Exposure Drafts proposed that a lessee should estimate the amount payable to the lessor under residual value guarantees and account for that amount as a lease payment. Many respondents supported those proposals, noting that the amounts payable under residual value guarantees should be included in the measurement of lease assets and lease liabilities because they are unconditional and meet the definition of a liability.

BC214. Similarly, Topic 842 requires that a lessee include the amount probable of being owed under residual value guarantees in the measurement of the lease liability (and the right-of-use asset). In the Board's view, payments probable of being owed under residual value guarantees meet the definition of a liability and are part of the cost of the right-of-use asset and, thus, should be recognized and measured as part of the lease liability and the right-of-use asset. That is because those payments cannot be avoided by the lessee—the lessee has an unconditional obligation to pay the lessor if the market price of the underlying asset moves in a particular way. Accordingly, any uncertainty does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary on the basis of movements in the market price for the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee.

BC215. The Board considered whether a lessee should account for residual value guarantees separately because they are linked to the value of the underlying asset and may meet the definition of a derivative. However, the Board notes that residual value guarantees are often so interlinked with other terms and conditions in a lease

that it could be misleading and potentially costly to recognize such guarantees separately. That also is consistent with the Board's decision not to adopt a components approach to lease accounting.

Options to Purchase the Underlying Asset

BC216. The Board considered whether a purchase option is:

a. The ultimate renewal option and, thus, should be accounted for similar to other options to extend or terminate a lease. This approach would include the exercise price of a purchase option in the determination of lease payments on a basis similar to the inclusion of lease payments to be made during optional periods.
b. A means of terminating the lease that should be accounted for only when it is exercised as a sale or purchase of the underlying asset. This approach would exclude the price of a purchase option from the determination of lease payments.

BC217. The guidance in the 2010 Exposure Draft would have viewed a purchase option as a means of terminating the lease and, thus, proposed that the price of a purchase option is not a lease payment. Respondents had mixed views about the proposal to account for purchase options only when they are exercised. Some respondents agreed with the proposals, but others proposed that the accounting for purchase options should be consistent with the accounting for options to extend or terminate a lease.

BC218. On reconsideration, in issuing the 2013 Exposure Draft, the Board decided that purchase options should be accounted for in the same way as options to extend the term of a lease (that is, the exercise price of a purchase option would be included in the measurement of lease assets and lease liabilities if the lessee had a significant economic incentive to exercise that option). Topic 842 affirms that decision but, instead, consistent with the Board's decision about options to extend (or not to terminate) a lease, refers to whether the lessee is reasonably certain to exercise the purchase option on the basis of an evaluation of relevant economic factors. The Board concluded that a purchase option is the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the Board decided that those two options should be accounted for in the same way.

Initial Measurement of the Right-of-Use Asset

BC219. Consistent with the 2010 and 2013 Exposure Drafts, Topic 842 requires a lessee to initially measure the right-of-use asset at cost, the calculation of which is included in paragraph 842-20-30-5.

BC220. The Board considered whether a lessee should initially measure the right-of-use asset at fair value because some note that it may provide more relevant information about the economic benefits to be derived from the use of the underlying asset. However, initial measurement of a right-of-use asset at cost is consistent with the measurement of most other nonfinancial assets, such as assets within the scope of Topics 360 and 350, Intangibles—Goodwill and Other. Initially measuring right-of-use assets on a basis similar to that of the underlying asset would increase comparability of leased and owned assets and, thus, improve the information provided to users of financial statements. Furthermore, initial measurement of the right-of-use asset at cost is less complex and less costly for entities to apply than fair value measurement because there is rarely an active market for right-of-use assets. For many leases, a cost measurement basis also will provide a reasonable approximation of the fair value of the right-of-use asset at the commencement date.

Initial Direct Costs

BC221. In the 2010 and 2013 Exposure Drafts, the Board decided that initial direct costs for a lessee should include costs that are directly attributable to negotiating and arranging a lease that would not have been incurred without entering into the lease. A lessee would capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset. The Board concluded that capitalizing initial direct costs would be consistent with the treatment of costs associated with acquiring other nonfinancial assets (for example, property, plant, and equipment and intangible assets). Maintaining consistency in the accounting for leased and owned assets increases comparability, thereby providing better information for users of financial statements.

BC222. Topic 842 affirms the Board's decision to capitalize initial direct costs by treating them as part of the cost of the applicable right-of-use asset. Topic 842 also states that initial direct costs should be allocated to the separate lease components on a relative standalone price basis. To be consistent with the Board's decision on lessor accounting, which is explained in paragraphs BC304–BC307, the Board decided that initial direct costs for a lessee also should include only incremental costs that an entity would not have incurred if the lease had not been obtained (that is, executed). Initial direct costs should, therefore, generally include commissions or payments made to existing tenants to obtain a lease but should not include costs that are not incremental (for example, lessee payroll costs that would have been incurred regardless of the lease) or incremental costs that would have been incurred regardless of whether the parties execute the lease (for example, external legal costs to draft or negotiate a lease).

Subsequent Measurement of the Lease Liability

BC223. The Board concluded that the lease liability should at all points during the lease (whether a finance lease or an operating lease) reflect the present value of the remaining lease payments. In this way, the lessee measures lease liabilities in

a similar manner to other similar financial liabilities (that is, on an amortized cost basis).

BC224. A lessee remeasures the lease liability to reflect changes to the lease payments resulting from a change in any one of the following:

a. The lease term (see paragraphs BC227–BC232).
b. The assessment of an option to purchase the underlying asset (see paragraphs BC227–BC232).
c. The resolution of a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term.
d. The amount probable of being owed under a residual value guarantee (see paragraph BC239).

BC225. A lessee recognizes the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. Although entities recognize changes in most other liabilities in profit or loss, Topic 842 stipulates that a lessee should adjust the carrying amount of the right-of-use asset to reflect changes in the measurement of the related lease liability arising unless the carrying amount of the right-of-use asset is reduced to zero, in which case the lessee should recognize any remaining amount of the remeasurement in profit or loss. That is because:

a. A change in one or more of items (a), (b), or (d) in paragraph BC224 reflects the lessee's expectation that it has acquired more or less of the right to use the underlying asset. Regarding items (a) and (b) in paragraph BC224, the lessee expects to acquire either (1) the right to use the underlying asset for more or less time or (2) the underlying asset in its entirety. Regarding item (d) in paragraph BC224, a change in the amount probable of being owed under a residual value guarantee will often reflect the lessee's expectation of the remaining benefits of the underlying asset that it will consume (for example, a lessee's expectation of a lower residual value may be directly related to its decision about how it will use that asset during the remainder of the lease term).
b. In the Board's view, the adjustments are made to measure the total cost of the asset accurately.

In concept, a right-of-use asset previously reduced to zero could be remeasured at an amount greater than zero in the event of a reassessment of the lease term (if the lease term increases) or a lessee purchase option that increases the lease liability. However, the Board observed that a right-of-use asset will only measure at zero before the end of the lease term if it has been fully impaired. It would, therefore, be highly unlikely that a lessee would reassess upward the lease term

or conclude that it is reasonably certain to exercise an option to purchase the underlying asset when it has previously impaired the right-of-use asset. However, in that unlikely event, the right-of-use asset would only be increased above zero if the lessee is expected to realize future economic benefits from the lease as a result of the revised expectation.

BC226. The Board decided that a lessee should not be required or permitted to measure lease liabilities at fair value after initial measurement because that would be:

a. Inconsistent with the subsequent measurement of many other nonderivative financial liabilities, thus decreasing comparability for users of financial statements
b. More complex and costly for entities to apply than a cost-based approach because it requires the use of both current expected cash flows and current interest rates
c. Inconsistent with the proposal that the initial measurement of assets and liabilities arising from a lease should not be at fair value.

Reassessment of Options to Extend or Terminate a Lease or to Purchase the Underlying Asset

BC227. In principle, the Board is of the view that users of financial statements receive more relevant information when entities reassess options on a regular basis because reassessment reflects current economic conditions. For example, using a lease term established at lease commencement throughout the lease could be misleading if there has been a change in facts or circumstances from those that existed at lease commencement.

BC228. However, requiring reassessment at each reporting date would be costly for a lessee with many leases. To address that concern, the 2010 Exposure Draft proposed that a lessee would be required to reassess the lease term only when there has been a change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability.

BC229. Respondents to the 2010 Exposure Draft expressed concern about the costs associated with such reassessment. They noted that it could be difficult to interpret when a change would be significant. Many interpreted the proposals as requiring an entity to demonstrate that there had not been a change in facts and circumstances that would indicate a significant change in the lease asset or lease liability to avoid having to reassess options. The costs of demonstrating that any change would not be significant could be as costly as reassessing options at each reporting date.

BC230. The proposals in the 2013 Exposure Draft attempted to address concerns about the cost of the reassessment proposals in the 2010 Exposure Draft, while still retaining the principle that a lessee should reassess options for changes in circumstances or economic conditions. The 2013 Exposure Draft would have

required an entity to reassess options only when a lessee has or no longer has a significant economic incentive to exercise an option. The “significant economic incentive” threshold for including the effect of an option in the measurement of the lease liability was higher than the “more likely than not” threshold in the 2010 Exposure Draft. Therefore, the Board concluded that a lessee should be required to remeasure lease assets and lease liabilities as a result of changes relating to options relatively infrequently, thus reducing costs associated with reassessment from the 2010 proposals. In addition, the Board decided that a change in market conditions alone (for example, an option moving in or out of the money) should not trigger reassessment because of concerns about the possibility of frequent changes to the lease term as market prices increased or decreased. The Board concluded that such an outcome would add unnecessary complexity and cost to the accounting and may not provide useful information to users of financial statements.

BC231. Even with the change to the reassessment proposals in the 2013 Exposure Draft, many respondents expressed concerns about the proposal to reassess extension, termination, and purchase options. Many of those respondents stated that they understood the Board’s objective in requiring reassessment but that the cost of applying the reassessment proposals would exceed any benefit. They stated that reassessment would be costly because of:

a. *The frequency of reassessment*. Some respondents were concerned that an entity would have to continually assess and monitor relevant factors that may give rise to a significant economic incentive even though there may be no change in those factors or a change in one or more of those factors might not result in a change in the lease term or the assessment of a purchase option. They noted that a lessee often makes a decision on the exercise of an option close to the end of the lease term or at the time its business strategy changes. Therefore, a lessee might incur significant costs to continually monitor relevant factors or reassess the options, although a change in the entity’s assessment of an option might occur only at the end of the initial noncancellable period or when the lessee’s business strategy changes. In situations in which a lessee determines that remeasurement of the lease assets and lease liabilities is not necessary, those respondents also mentioned that there would be costs involved in demonstrating to their auditors that assumptions on a significant economic incentive have not changed.
b. *The volatility of lease assets and lease liabilities in the financial statements*. Some of those stakeholders expressed concern that the factors referred to in the 2013 Exposure Draft (that is, contract-based, asset-based, market-based, and entity-based factors) potentially could change multiple times within a given reporting period resulting in continuous reassessment of a lease liability.
c. *The administrative challenge to track the data to assess whether the lessee has a significant economic incentive*. Because of the subjective

nature of the proposed reassessment criteria, some stakeholders noted that it might not be possible to apply the proposed reassessment requirements within their information technology systems. Rather, they fear that reassessment would have to be computed manually. Also, because lease administration often would be decentralized, the new guidance would require involvement from various departments such as real estate, contract management, legal, treasury, tax, and internal audit.

BC232. The Board considered the feedback from respondents to the 2013 Exposure Draft, in particular, those concerns about the cost of reassessing options and whether there are substantial benefits to reassessment. In redeliberations of the proposals in the 2013 Exposure Draft, the Board decided that Topic 842 should include a reassessment requirement. In the Board's view, not requiring a reassessment of options under *any* circumstances could reduce the usefulness and relevance of the financial information provided to users and could invite structuring to avoid recognition of options at initial measurement. However, the Board decided to reduce the costs of reassessment as compared with earlier proposals by further clarifying the reassessment provisions and limiting how often they would need to be applied. Therefore, Topic 842 requires a lessee to reassess an option to extend or terminate a lease or an option to purchase the underlying asset only (a) upon the occurrence of a significant event or a significant change in circumstances that both is within the control of the lessee and directly affects whether the lessee is reasonably certain to exercise or not to exercise the option or (b) upon the occurrence of an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease. In the Board's view, this reassessment guidance should not require a lessee to reassess the lease term on a continual basis. Instead, the lessee's ongoing efforts should consist solely of monitoring for significant events or changes in circumstances ("triggering events") of which it should be aware (because those events or changes in circumstances are within the lessee's control) or for specified events that are explicit in the contract, and only then should it reassess an option. As such, this approach can be applied at a reasonable cost to preparers. Changes in market-based factors will not, in isolation, trigger the reassessment of an option because market-based factors (for example, a change in the real estate market) are not, in general, within the control of the lessee. In addition to reducing the costs of applying the requirements in Topic 842, for some Board members, the decision to limit the circumstances in which reassessment will be required is consistent with their view that options, such as those to purchase the underlying asset or to extend a lease, generally do not result in obligations for the option holder unless the option holder has little or no choice economically but to exercise the option. Consequently, in those Board members' view, generally, a significant event or a significant change in circumstances or an event that contractually obligates the lessee to exercise (or not to exercise) an option should be required to change the assessment of a lessee option.

Exercise of an Option to Purchase the Underlying Asset

BC233. Previous GAAP stipulated that if the lessee purchases the underlying asset subject to a capital lease, any difference between the purchase price and the carrying amount of the capital lease liability immediately before the purchase should be recorded by the lessee as an adjustment of the carrying amount of the asset. The Board decided to carry forward this guidance to Topic 842 as well as to specify that this guidance would apply to finance and operating leases. The Board concluded that the previous guidance was still relevant and resulted in the appropriate accounting but that it also should apply to operating leases now that there will be lease liabilities recognized for those leases.

Reassessment of Variable Lease Payments That Depend on an Index or a Rate

BC234. Paragraphs BC209–BC212 describe the Board's reasons for requiring both lessees and lessors to include variable lease payments that depend on an index or a rate in the measurement of lease assets and liabilities.

BC235. Both the 2010 and 2013 Exposure Drafts proposed that an entity should reassess the measurement of lease assets and lease liabilities to reflect changes in the index or rate that is used to determine variable lease payments that depend on an index or a rate. In issuing that proposal, the Board decided that reassessment was necessary to provide relevant information to users of financial statements about a lessee's lease liabilities at the reporting date. For example, if lease liabilities are not remeasured for changes in an index or a rate, measuring the lease liability for a 20-year property lease, for which lease payments are linked to a price index, may not provide users of financial statements with useful information about the entity's future cash outflows relating to that lease throughout the lease term.

BC236. Feedback from stakeholders on the reassessment proposals in both Exposure Drafts indicated concerns about the cost of performing reassessments and questioned whether the benefits for users of financial statements would justify the costs for preparers. For example, some stakeholders noted that the total lease-related expenses recognized in profit or loss by a lessee would be the same for operating leases and substantially the same for finance leases, regardless of whether the lessee remeasures the lease liability for changes to an index or a rate. In contrast, stakeholders acknowledge that the measurement of the lease liability and the right-of-use asset with or without reassessment of these variable lease payments may differ significantly.

BC237. On balance, the Board decided that the benefits of what would effectively be solely a gross-up to the balance sheet (that is, because the increase in the lease liability for increases in the reference index or rate would result in a corresponding increase to the right-of-use asset) do not justify the costs to preparers of doing so. The Board further concluded that users should be able to

reasonably assess the effect of future rent increases dependent on an index or a rate on the basis of the disclosures that a lessee will provide about (a) its variable lease expense each period and (b) the terms and conditions of its variable lease payment arrangements. However, Topic 842 does contain one exception to this decision. The Board decided that a lessee *should* remeasure variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for another reason. For example, if a lessee remeasures the lease liability for an updated lease term, the lessee will measure the remaining lease payments on the basis of the index or the rate as of the remeasurement date and not on the basis of the rate or the index as of the lease commencement date. The Board concluded that it would be illogical to remeasure the lease liability in those circumstances using an outdated index or rate.

Resolution of a Contingency upon Which Future Lease Payments Are Based

BC238. The Board decided to specify that a lessee should remeasure its lease liability if a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments. In deciding to enact this requirement, the Board considered scenarios whereby entities might attempt to circumvent the lessee right-of-use asset and lease liability recognition and measurement requirements by initially structuring the lease payments at only a nominal amount (for example, $10 for Year 1 of a 10-year lease) and then making those payments fixed (or partially fixed) after Year 1 for the remainder of the lease term based on, for example, a percentage of Year 1 sales using a leased building or based on Year 1 production using a piece of leased equipment. Absent this requirement, some stakeholders suggested that the guidance would not require the lessee to reassess the lease payments and update its lease liability and right-of-use asset in those scenarios, meaning the lessee might not recognize a meaningful right-of-use asset or lease liability throughout the lease term even though the terms of the lease would require fixed payments after resolution of the contingency. Therefore. the Board decided to specify that if variability in some or all of the remaining lease payments is resolved (such as in the examples above, in which, after Year 1, some or all of the lease payments become fixed for the remainder of the lease term), those amounts now meet the definition of lease payments and should be reflected, from that point forward, in the right-of-use asset and the lease liability.

Reassessment of Amounts Payable under Residual Value Guarantees

BC239. The Board decided that lessees should reassess the amounts probable of being owed under residual value guarantees because that provides more

relevant information to users of financial statements and reflects current economic conditions. The Board noted that this is similar to the requirements in previous GAAP for leases classified as operating leases. In accordance with previous GAAP on operating leases, a lessee did not consider payments expected to be made to satisfy a residual value guarantee in determining its lease expense until it became probable that there would be a deficiency in the residual value of the underlying asset at the end of the lease term. At that time, the lessee also would record a liability for the amount of the expected payment. Therefore, an operating lessee was required to reassess payments expected to be made to satisfy a residual value guarantee based on changes in facts or circumstances. Capital lessees in previous GAAP already included the full amount of any residual value guarantee in the capital lease obligation.

Reassessment of the Discount Rate

BC240. The Board decided that the discount rate used to measure the remaining lease payments at present value is the discount rate established at lease commencement unless the lease liability is remeasured as a result of a change in the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset. The lessee updates the discount rate at the date of the remeasurement of the lease liability on the basis of the remaining lease term and the remaining lease payments.

BC241. The Board decided that in most cases a lessee should not reassess the discount rate during the lease term. That is generally consistent with amortized cost accounting for other, similar financial liabilities. In other GAAP in which the discount rate is required to be reassessed, it is usually because the liability to which the discount rate relates is measured on a current measurement basis.

BC242. Nonetheless, the Board concluded that there are limited circumstances in which a lessee should update the discount rate. These circumstances occur when there is either a change in the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset. In the Board’s view, in those circumstances, the economics of the lease have changed and those changes should be reflected in the discount rate. For example, if a lessee previously accounted for a lease on the basis that it has a remaining term of 5 years and that remaining lease term changes to 10 years, it would be appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of lease assets and lease liabilities and the change in the rate of interest that the lessee would likely incur to borrow the funds necessary to obtain the right-of-use asset for that period of time. However, the Board decided that such a change to the discount rate should be required only if the lessee had not taken into account the optionality in the contract when determining the discount rate at the commencement date. It is not necessary to update the discount rate if that rate already reflects that the

lessee has an option to extend or terminate the lease or to purchase the underlying asset.

BC243. Because a lessee will, in general, reassess the lease term and purchase options only infrequently—that is, only when a significant event or significant change in circumstances within the control of the lessee results in a change to the lease term or the assessment of a purchase option—the Board noted that a lessee should be required to reassess the discount rate only infrequently.

BC244. The Board decided that a lessee should only remeasure variable lease payments that depend on an index or a rate when the lease liability is remeasured for another reason (see paragraph BC237). The Board also decided that a lessee should not update the discount rate whenever the reference interest rate on which the variable lease payments are determined changes (as was proposed in the 2013 Exposure Draft). Because the change in the variable lease payments does not affect the lease liability, that change should not affect the rate used to discount that lease liability.

Foreign Currency Exchange

BC245. The 2010 Exposure Draft did not provide specific requirements on how an entity should account for the effects of foreign currency exchange differences relating to a lessee's lease liabilities (for a lessee) or a lessor's lease receivable that are denominated in a foreign currency.

BC246. Some respondents to the 2010 Exposure Draft suggested that an entity should recognize any foreign currency exchange differences as an adjustment to the carrying amount of the right-of-use asset. This approach would treat translation adjustments as a correction of or update to the cost of the right-of-use asset, which is initially measured on the basis of the initial measurement of the lease liability. Those respondents were of the view that lease payments denominated in a foreign currency are, in effect, another form of variable lease payments and should be accounted for in a similar manner to variable lease payments that are determined using an index. Those respondents also questioned whether useful information would be provided as a result of the profit or loss volatility created by recognizing foreign currency exchange differences on a lessee's lease liability in profit or loss (profit or loss volatility might arise because any foreign-currency-denominated lease liability is remeasured to reflect the rate of exchange at the end of each reporting period, whereas the carrying amount of the right-of-use asset, being a nonmonetary asset, is not remeasured to reflect movements in exchange rates).

BC247. A lessee's lease liability and a lessor's net investment in the lease are monetary items (as defined in GAAP) that, therefore, in accordance with Topic 830, Foreign Currency Matters, are required to be remeasured using exchange rates at the end of each reporting period if denominated in a foreign currency. Consequently, any foreign currency exchange gains and losses relating to lease liabilities (for the lessee) and a lessor's net investment in the lease denominated in a foreign currency should be recognized in profit or loss, consistent with existing

requirements on foreign currency exchange differences. A lessee's right-of-use asset is a nonmonetary asset as defined in GAAP. Therefore, subsequent changes to a foreign exchange rate should not have any effect on the cost of the right-of-use asset, and, thus, it would be inappropriate under existing requirements on foreign currency exchange differences to include such changes in the remeasurement of the right-of-use asset. Although the approach could result in volatility in profit or loss from the recognition of foreign currency exchange differences, those changes would be disclosed separately as foreign currency exchange gains or losses. Accordingly, it would be clear to users of financial statements that the gain or loss results solely from movements in exchange rates. Because that is consistent with the existing requirements for foreign currency exchange in accordance with other Topics, the Board concluded that it was unnecessary to include any specific requirements in Topic 842.

Subsequent Measurement of the Right-of-Use Asset

BC248. The Board decided that a lessee should not be permitted to measure a right-of-use asset at fair value after initial measurement because that will be:

a. Inconsistent with the subsequent measurement of many other nonfinancial assets.
b. More complex and costly for entities to apply than a cost-based approach because it requires the use of both current expected cash flows and current interest rates. There is rarely an active market for right-of-use assets, which would add to the complexity.
c. Inconsistent with the proposal that initial measurement of assets and liabilities arising from a lease should not be at fair value.

The Right-of-Use Asset in a Finance Lease

BC249. Paragraphs BC32–BC74 include a detailed discussion of the feedback received on the lessee accounting model and the basis for the Board's decisions on lessee accounting, including that, in the Board's view, finance leases are economically similar to the acquisition of other nonfinancial assets. Consequently, the Board decided that a lessee should amortize the right-of-use asset resulting from a finance lease on a straight-line basis from the commencement date to the end of the lease term unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits, consistent with the depreciation and amortization of other nonfinancial assets.

BC250. Subtopic 842-20 also specifies that if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee should amortize the right-of-use asset to the end of the useful life of the underlying asset.

BC251. Therefore, after lease commencement, a lessee will measure the right-of-use asset resulting from a finance lease at cost less accumulated amortization and impairment (see paragraphs BC255–BC259).

The Right-of-Use Asset in an Operating Lease

BC252. Subtopic 842-20 sets out that the right-of-use asset in an operating lease is measured after lease commencement at the amount of the lease liability and is adjusted for the following, unless the right-of-use asset has been previously impaired, in which case the right-of-use asset is measured as described in paragraphs BC255–BC259 after the date of the impairment:

a. Prepaid or accrued lease payments
b. The remaining balance of any lease incentives received, which is the amount of the gross lease incentives received net of amounts recognized previously as part of the single lease cost
c. Unamortized initial direct costs
d. Impairment of the right-of-use asset (see paragraphs BC255–BC259). This item (d) refers to measurement of the right-of-use asset at the time of impairment. That is, at the point in time an impairment is recognized, the corresponding adjustment to the carrying amount of the right-of-use asset is the amount of the impairment. After recognizing an impairment, the lessee will measure the right-of-use asset based on alternative guidance (see paragraph 842-20-35-10).

BC253. In Topic 842, operating leases are not equivalent to other purchases of nonfinancial assets; they grant different rights and impose different obligations on the lessee. Operating leases grant the lessee a right to use the lessor's asset over the lease term, such that the total cost of the lease payments should be recognized on the basis of the pattern in which the benefits conveyed by the lease are consumed, which is generally (but not always) on an equal basis over the lease term. In theory, the carrying amount of the right-of-use asset in an operating lease determined in this manner would represent and approximate the present value of the remaining benefits to the lessee at each measurement date.

BC254. The Board received a substantial amount of feedback from stakeholders about the subsequent measurement of operating (or "Type B") right-of-use assets after the issuance of the 2013 Exposure Draft. Many stakeholders said that measurement of operating lease right-of-use assets with reference to the associated lease liability (as per the guidance in Subtopic 842-20) would alleviate many of the systems and process concerns those stakeholders saw in the Type B accounting proposals in the 2013 Exposure Draft. Those stakeholders said that most of the data necessary to calculate the lease liability (for example, scheduling of future lease payments), as well as information on prepaid or accrued lease payments and initial direct costs, were accumulated and maintained to do the accounting and prepare the required disclosures in previous GAAP on leases. Consequently, measuring operating lease right-of-use assets in this manner would

not require lessees to implement new systems or processes to account for those assets. In addition to the views expressed in paragraph BC253, the Board's decisions on the subsequent measurement of operating lease right-of-use assets, and on the lessee accounting model more broadly, were significantly influenced by this feedback. The Board concluded that measuring the right-of-use assets resulting from operating leases in this manner should significantly reduce the costs to preparers of enacting the primary improvement resulting from Topic 842 (that is, the recognition of lease assets and lease liabilities for all leases other than short-term leases).

Impairment of the Right-of-Use Asset

BC255. Consistent with the proposals in the 2010 and 2013 Exposure Drafts, Topic 842 requires that lessees apply the impairment requirements of Topic 360 to the lessee's right-of-use assets. The right-of-use asset is a long-lived, nonfinancial asset and, therefore, should be within the scope of the Impairment or Disposal of Long-Lived Assets Subsection of Topic 360. In the Board's view, it would be inappropriate to continue to recognize a right-of-use asset from which the lessee does not expect to derive future economic benefits (for example, a right to use a building that the lessee has abandoned) or to recognize that asset at an amount the lessee does not expect to recover. Furthermore, the Board noted that the Topic 360 model is the appropriate impairment model to apply to a lessee's right-of-use assets because there are substantial benefits for users of financial statements in having comparability in the accounting for all of an entity's long-lived nonfinancial assets (that is, because a right-of-use asset is a long-lived nonfinancial asset, there is no compelling reason that it should not be assessed for impairment consistent with the model for other long-lived nonfinancial assets).

BC256. Respondents to the 2010 and 2013 Exposure Drafts generally agreed with the Board's proposal. Some respondents to the Exposure Drafts noted that it could be difficult for lessees to implement an impairment model for right-of-use assets that is different from other nonfinancial assets, particularly if a lessee's owned assets and right-of-use assets have significantly interrelated and interdependent cash flows.

BC257. The guidance in Subtopic 842-20 as it pertains to impairment of the right-of-use asset and subsequent accounting for a finance lease is generally consistent with the requirements in previous GAAP for capital leases. In addition, Subtopic 842-20 includes specific guidance for operating leases on:

a. Calculating the single lease cost each period after the right-of-use asset is impaired (paragraph 842-20-25-6)
b. Measuring the right-of-use asset after an impairment (paragraph 842-20-35-10).

The Board decided that this specific guidance is necessary to ensure that entities can calculate the periodic lease cost and determine the carrying amount of the

right-of-use asset for an operating lease after an impairment of the right-of-use asset and that those amounts are calculated in a consistent manner.

BC258. The single lease cost that will be recognized each period after an impairment of an operating lease right-of-use asset equals the combined sum of (a) the amortization of the right-of-use asset for the period on a generally straight-line basis and (b) accretion of the lease liability in accordance with the interest method. The right-of-use asset will be measured at its carrying amount immediately after the impairment less accumulated amortization at each reporting date.

BC259. The guidance on how to recognize lease cost and measure the right-of-use asset for an operating lease after an impairment of the right-of-use asset reflects a combination of the following:

a. First, a conclusion by the Board that the link that many perceive between the economic benefits to be derived from the lease and the lease payments, and reference in support of a single, generally straight-line lease cost for operating leases, is effectively "broken" after the right-of-use asset is impaired because the lessee will no longer obtain future economic benefits from the lease equal to (or greater than) the payments it is required to make to the lessor. In other words, the lease payments no longer have any direct correlation to the economic benefits the lessee is able to derive from the lease but, instead, represent a liability reflective of a past expectation of economic benefits that could be derived from the lease.
b. Second, consideration that operating lease cost was not recognized on a straight-line basis in previous GAAP after a lessee recognized a liability related to an operating lease in accordance with Topic 420, Exit or Disposal Cost Obligations. In those cases, the lease cost each period of the remaining lease term reflected a combination of the (1) straight-line recognition of the remaining economic benefits to be derived from the lease (for example, $75,000 each year if the lease payments were $100,000 annually, but the lessee expected to be able to obtain only $75,000 from a sublessee) and (2) interest method accretion of the discounted Topic 420 liability. In that way, the guidance in Topic 842, which recognizes a single lease cost that combines (i) recognition of the remaining economic benefits to be realized from the lease and (ii) accretion of the discounted lease liability, is similar to the guidance in previous GAAP and results in a similar pattern of profit and loss. In addition, the net effect of the difference between the lease liability and the impaired right-of-use asset on the statement of financial position in accordance with Topic 842 is similar to the effect a Topic 420 operating-lease-related liability had on the statement of financial position in previous GAAP.

Presentation: Lessee

BC260. Paragraphs BC44 and BC45 discuss the Board's decisions and rationale for the lessee accounting model in Topic 842. Those decisions and rationale are integral to the Board's decisions on how a lessee should present items in the financial statements.

Statement of Financial Position

BC261. The Board decided that a lessee should either present as separate line items in the statement of financial position or disclose in the notes to the financial statements each of the following:

a. Finance lease assets
b. Operating lease assets
c. Finance lease liabilities
d. Operating lease liabilities.

If a lessee discloses those amounts in the notes, it also should disclose in which line items the amounts are included in the statement of financial position.

BC262. The Board decided that it did not want to mandate separate presentation of each of those amounts. However, the Board noted that there are differences between a right-of-use (lease) asset and other, owned nonfinancial assets and that users of financial statements may benefit from disclosure of the carrying amount of a lessee's right-of-use assets. For example, right-of-use assets may be viewed as being (a) less risky than owned assets because a right-of-use asset may not embed residual asset risk or (b) more risky than owned assets because the lessee may need to replace the right-of-use asset at the end of the lease term but may not be able to secure a favorable rate for the replacement lease. Accordingly, Topic 842 requires that a lessee provide information about the carrying amount of right-of-use assets separately, either in the statement of financial position or in the notes. Similarly, a lease liability is a unique class of liability that is linked to a corresponding asset and may have features, such as options and variable lease payments, that differ from those in other liabilities. Therefore, presenting the carrying amount of the lessee's lease liabilities separately from other financial liabilities either in the statement of financial position or in the notes provides users of financial statements with information that is important to understanding the extent to which an entity uses lease arrangements and highlights the relationship between the lessee's lease liabilities and its right-of-use assets.

BC263. The Board concluded that separate presentation or disclosure of right-of-use assets resulting from finance leases and right-of-use assets resulting from operating leases will be useful because those right-of-use assets are measured in a different way after the commencement date and arise from what are, in the Board's view, economically different transactions. Similarly, the Board decided to require the presentation or disclosure of lease liabilities arising from finance leases

separately from lease liabilities arising from operating leases. Although all lease liabilities are measured in the same way, the Board concluded that separate presentation or disclosure should help a user to understand the liability balance to which the lessee's lease costs, which differ in terms of recognition and presentation for finance and operating leases, relate.

BC264. The Board further decided that to the extent a lessee does not present items (a)–(d) in paragraph BC261 as separate line items in the statement of financial position, it should not include:

a. Finance lease assets in the same line item as operating lease assets (for example, if finance lease assets are included within the property, plant, and equipment line item, operating lease assets must be presented in a different line item)
b. Finance lease liabilities in the same line item as operating lease liabilities.

In reaching this decision, the Board concluded that presenting the assets and liabilities that result from these two different types of transactions in the same line item in the statement of financial position would be misleading; it would convey an economic similarity that, in the Board's view, does not exist. For example, because of how operating lease obligations are generally treated in lessee bankruptcy, which is generally different from how finance lease obligations are treated in lessee bankruptcy, the Board concluded that it would be inappropriate to present those two different types of liabilities in the same line on the statement of financial position. While both types of lease liabilities are financial liabilities, finance lease liabilities are the equivalent of debt, and operating lease liabilities are not "debt like" but, rather, operating in nature.

BC265. The presentation guidance in the 2013 Exposure Draft would have required a lessee to present right-of-use assets not presented separately in the statement of financial position within the same line item as if the corresponding underlying assets were owned. The Board did not include this requirement in Topic 842. The Board decided that it was unnecessary to prescribe where right-of-use assets must be presented (if not presented separately) because the notes would provide that information. In addition, some Board members said that presenting operating lease assets together with owned property, plant, and equipment may be inappropriate given the Board's conclusion that operating leases convey rights and carry risks substantially different from those of owned property, plant, and equipment.

Statement of Comprehensive Income

BC266. Topic 842 requires that for operating leases, a lessee recognize a single lease cost. That cost should, to the extent it is not capitalized as part of the cost of another asset, be included in the lessee's income from continuing operations, in a manner generally consistent with such presentation in previous GAAP.

BC267. In contrast, for finance leases, a lessee should present amortization of the right-of-use asset and the interest on the lease liability in separate line items, in a manner consistent with how the entity presents depreciation or amortization of similar assets and other interest expense.

BC268. The Board's decisions on presentation of lease cost in the statement of comprehensive income are directly linked to the Board's rationale for the lessee accounting model. Paragraphs BC59–BC65 provide information on the Board's basis for (a) recognizing a single lease cost for operating leases that is operating in nature and (b) recognizing separately calculated amortization and interest for finance leases.

Statement of Cash Flows

BC269. The requirements for presenting cash outflows in the statement of cash flows are linked to the presentation of expenses arising from a lease in the statement of comprehensive income. In the Board's view, it would be inconsistent to present payments in one manner in the statement of comprehensive income and in another manner in the statement of cash flows.

BC270. Consequently, Topic 842 requires a lessee to classify cash repayments of the principal portion of the lease liability for finance leases as financing activities in the statement of cash flows. Cash paid relating to interest should be classified in operating activities in accordance with Topic 230, Statement of Cash Flows. This requirement results in comparability between interest paid for finance leases and interest paid on other financial liabilities.

BC271. In addition, the Board decided that cash flows from operating leases and variable lease payments that are not included in the lease liability should be classified as operating activities because the corresponding lease costs, if recognized in the statement of comprehensive income, will be presented in income from continuing operations. The previous sentence notwithstanding, Topic 842 states that lease payments capitalized as part of the cost of another asset (for example, inventory or a piece of property, plant, or equipment) should be classified in the same manner as other payments for that asset.

Disclosure: Lessee

BC272. In determining the disclosures for leases, the Board considered the disclosure requirements in previous GAAP and the Board's current decisions in the disclosure framework project.

BC273. When selecting the disclosure objective, the Board considered work in other related projects. The Board also considered that including a disclosure objective allows an entity to understand the purpose of the disclosure requirements and the extent to which information about its leases should be disclosed. As a result, the Board proposed that the disclosures about leases should enable users

of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.

BC274. In Topic 842, the Board decided to retain the guidance in the 2013 Exposure Draft that an entity should consider the level of detail necessary to satisfy the disclosure objective as well as how much emphasis to place on various requirements. While some respondents to the 2013 Exposure Draft expressed concern that this guidance could introduce diversity in practice and create some challenges for auditors and regulators, the Board concluded that the guidance is merely part of the disclosure objective and that it provides useful information on the Board's view about the level of information that would meet the disclosure objective.

BC275. The Board rejected the idea of including an explicit statement about materiality in the disclosure guidance. In rejecting this idea, the Board noted that recently issued disclosure guidance in Topic 606 includes a similar disclosure objective and a similar statement about the level of detail that would meet that objective without providing any further guidance on materiality; the Board noted that no additional guidance is necessary in Topic 842 as compared with Topic 606 in this regard. The Board reached this conclusion notwithstanding its current decision to propose guidance that would result in the inclusion of an explicit statement about materiality in future standards as a part of its disclosure framework project.

BC276. The Board also rejected including an explicit statement that the disclosure requirements are not required in all circumstances. That is because it is implicit to the overall disclosure objective that the level of detail in the disclosures should equate to the significance of an entity's leasing activity (for example, if leasing is a significant part of an entity's business activities, the disclosures would be more comprehensive than for an entity whose leasing activities are less significant to its business activities).

Qualitative Disclosures

BC277. Topic 842 requires a lessee to provide qualitative information about its leases in the context of the overall disclosure objective. This guidance is substantially unchanged from the qualitative disclosure proposals in the 2013 Exposure Draft. Most respondents to the 2013 Exposure Draft did not comment on the qualitative disclosure proposals. However, some respondents to the 2013 Exposure Draft expressed concerns about the proposals. The principal concerns included the following:

a. Some preparers stated that the qualitative disclosures might be so generic that they do not provide meaningful information. Therefore, they questioned the application and usefulness of the qualitative disclosures.

b. Compiling, summarizing, and providing the information would be costly for some entities and may not provide significant additional benefit to users, especially if the disclosures were generic.
c. Some users expressed concern that the disclosure requirements might result in "boilerplate" statements rather than providing useful, entity-specific information.

BC278. The Board noted that while preparers' concerns were focused on the perceived cost of producing the disclosures, users' concerns were principally that the qualitative disclosures would not be detailed or entity-specific enough. This was confirmed in additional outreach with users. The Board decided to include qualitative disclosure requirements in Topic 842 because it views those disclosures as an essential tool to allowing a user to gain an understanding of a lessee's leasing activities. In the Board's view, the disclosure objective and level of detail guidance discussed in paragraphs BC272–BC276 should assist entities in determining the appropriate qualitative information to provide.

BC279. The Board considered but rejected requiring lessees to provide qualitative disclosures about the existence and terms and conditions of significant nonlease commitments the lessee has taken on as a result of entering into lease contracts. Similar to its rationale for eliminating the requirement proposed in the 2013 Exposure Draft to disclose a maturity analysis of the entity's nonlease components included in a contract that contains a lease, the Board decided that a lessee should not be required to provide disclosures about nonlease components solely because they are obtained together with a lease.

Quantitative Disclosures

Lease Cost and Cash Flow Information

BC280. Topic 842 requires a lessee to provide quantitative information about its leasing activities. Paragraph 842-20-50-4 specifies the required information to be disclosed, and Example 6 (paragraph 842-20-55-53) in the implementation guidance to Subtopic 842-20 demonstrates how the disclosure requirements might be fulfilled.

BC281. User outreach conducted throughout the development of Topic 842 confirmed that users have various strategies to evaluate an entity's leasing activities. Users' leasing information needs may vary depending on the type of user they are (for example, credit analyst or equity analyst) and the industry in which the entity operates or in which the user principally follows, as well as for other reasons. A single user may conduct multiple analyses of an entity for different purposes. The following is a list of the principal information needs communicated by users and how the items required for disclosure in paragraph 842-20-50-4 meet those needs:

a. *Information about interest*. Many users treat all leases as finance leases in their analyses because they want to compare an entity that leases its assets with one that purchases those same assets (for example, an airline that leases its airplanes and an airline that purchases its airplanes). Presently, users make imprecise adjustments in their analyses. The disclosure requirements in paragraph 842-20-50-4 will provide those users with significantly improved information for their analyses by providing separate interest and amortization information for finance leases, the beginning (end of prior reporting period) and ending balances of the lessee's operating lease liabilities, and the weighted-average discount rate for the entity's operating leases as of the beginning and the end of the reporting period.
b. *Information about cash paid for leases.* Users have communicated that they want information about a lessee's cash payments during a period for leases but that this information is often not presented or disclosed separately in the financial statements. The disclosures required by paragraph 842-20-50-4 will provide users with information about cash paid for leases during each reporting period presented. Specific cash flow information is provided for cash payments to settle amounts included in the lessee's lease liability, broken out between financing and operating activities. This cash flow information, together with the required disclosures of short-term lease costs and variable lease costs (for which cash flows should approximate those costs), will provide improved information to users from what they received under previous GAAP.
c. *Alternative measurement information.* Some users will continue to adjust the reported right-of-use assets and lease liabilities (for example, to produce a "whole asset" view of the entity). In previous GAAP, users often made adjustments on the basis of the reported operating lease expense, capitalizing a multiple of that operating lease expense. The disclosure requirements in paragraph 842-20-50-4 include more detailed lease cost information (which, unlike operating lease expense information disclosed in previous GAAP, will include lease costs capitalized as part of the cost of other assets) for those users that may still make adjustments on the basis of lease cost, as well as information on the weighted-average remaining lease term for the lessee's finance and operating leases. The Board decided to include weighted-average remaining lease term information to provide users with a better understanding of both (1) the period of time the lessee's capitalized lease obligations would allow the lessee to continue its current operations and (2) the lessee's renewal risk. A user will be able to adjust the reported lease obligations depending on how it wants to analyze the entity.
d. *New leasing activity during the reporting period.* One of the disclosure requirements in paragraph 842-20-50-4 is to disclose the right-of-use assets obtained during the period in exchange for lease liabilities. A similar disclosure was required in previous GAAP on capital leases, but the disclosure requirement in paragraph 842-20-50-4 will address all

leases (other than short-term leases for which the lessee elects the recognition and measurement exemption).

BC282. In addition to considering the information needs of users, the Board considered the cost of obtaining and reporting the information. Integral to the Board's decisions on the lessee accounting model included in Topic 842 was the information provided by stakeholders that this lessee accounting model would achieve what many said to be the primary improvement to the lessee accounting guidance (that is, recognizing lease assets and lease liabilities for all leases other than short-term leases) without requiring entities to implement significant new systems or processes. Similarly, the Board noted that the costs to produce the disclosures required in paragraph 842-20-50-4 will not be excessive because each of the items is either (or both):

a. Already being disclosed in accordance with previous GAAP on leases.
b. Can be produced or obtained using existing systems or processes (for example, by adding a column or a calculation to the schedule a lessee maintains to produce the maturity analysis disclosure required in previous GAAP). It was already necessary in previous GAAP, for example, to track cash payments made for leases (that are not variable lease payments), to:
   1. Properly recognize the required straight-line operating lease expense
   2. Properly recognize any prepaid or accrued rent in the balance sheet
   3. Prepare the required maturity analysis disclosure.

Reconciliation of Opening and Closing Balances

BC283. The 2010 and 2013 Exposure Drafts both included a proposed requirement for lessees to produce and disclose a reconciliation of the opening and closing balance of the lessee's lease liabilities. That reconciliation would inform users of financial statements about changes to the lessee's lease liabilities during the reporting period. Users indicated that such a reconciliation would provide them with information that is useful to their analyses. The 2010 Exposure Draft also proposed that this reconciliation should be provided by class of underlying asset, while the 2013 Exposure Draft did not. The elimination of the class of underlying asset requirement between the 2010 and 2013 Exposure Drafts was principally for cost-benefit reasons.

BC284. The proposal to require a reconciliation of lease liabilities was the most pervasive disclosure concern expressed by respondents to both Exposure Drafts. In response to the 2013 Exposure Draft, preparers said that this reconciliation would be especially onerous to create and costly to implement, particularly if there is a need to make substantial investments in more robust information technology systems. Some of those preparers indicated that new system capabilities would be required to meet the proposed lease liabilities' reconciliation disclosure requirement that would otherwise not be required.

BC285. In contrast, many users supported the proposal for a lessee to provide a reconciliation of the opening and closing balances of its lease liabilities. In their view, this disclosure would provide valuable information when analyzing the changes that occurred during the period in the related account. However, users typically focused on certain amounts that would be disclosed rather than on the reconciliation as a whole. Users were generally interested in the liabilities created because of leases commencing or being extended in the section of the reconciliation, which would depict new leases entered into during the reporting period. They also were interested in the cash paid amount that would be included in the lease liabilities reconciliation, because this information would assist in analyzing an entity's cash flows related to its leases.

BC286. In deciding not to retain the proposed reconciliation requirement as part of Topic 842, the Board considered that the information users were most interested in obtaining could be provided without requiring a reconciliation and that the information would be provided by the lease cost and cash flow information disclosures required by paragraph 842-20-50-4. The Board also considered that creating and providing reconciliations are generally costly for preparers, particularly when the information required is not available centrally within the department producing the financial statements, which is often the case for leases. Lastly, the Board considered that some of the information that would be required for the reconciliation of lease liabilities would require systems and/or process capabilities that would not be required to apply the lessee accounting model (for example, the ability to calculate, on an effective interest method basis, the periodic unwinding of the discount on the entity's operating lease liabilities), and, therefore, the reconciliation disclosure requirement might negate a significant portion of the cost relief stakeholders have communicated would be achieved as a result of the Board's changes to the lessee accounting model since the 2013 Exposure Draft.

Maturity Analyses

BC287. Topic 842 requires that a lessee disclose a maturity analysis of the contractual lease payments included in its lease liabilities at the reporting date to assist users of financial statements in understanding and evaluating the nature and extent of liquidity risks. A lessee should disclose, at a minimum, the amounts due on an annual basis for each of the first five years after the reporting date, plus a lump sum for the remaining years. Those maturity analyses are similar to the maturity analyses that were required in previous GAAP. This requirement was previously proposed in both the 2010 and 2013 Exposure Drafts. While a few respondents to the Exposure Drafts expressed the view that this disclosure should not be necessary in a final leases standard because of the increased reporting of a lessee's lease obligations in the financial statements, users have generally communicated that information about the maturities of lease payments is useful to users of financial statements and that they support reconciling the undiscounted future lease payments to the lessee's lease liabilities. The Board noted that because a substantially equivalent disclosure was already required in previous

GAAP, there should be minimal, if any, incremental costs to continuing to provide this disclosure in Topic 842.

BC288. The 2013 Exposure Draft also included a proposal to require the disclosure of a maturity analysis of nonlease (for example, service) components of a contract that also contains a lease. The Board included this proposal because it would provide information about the committed future cash flows of the entity based on the total future payments arising from contracts that contain a lease. For example, if an entity has an unconditional obligation to make payments of $100 each month ($70 for the lease and $30 for nonlease components) for the next 5 years, it would be more useful to provide a maturity analysis of all of those payments rather than provide a maturity analysis relating only to the lease payments of $70 each month.

BC289. The Board did not retain the proposed requirement to include a maturity analysis of nonlease components as part of Topic 842. Consistent with feedback from some stakeholders, the Board concluded there is not a substantive difference between a nonlease component obtained from a lessor and a substantially identical good or service obtained from another supplier. Because entities are not required to produce a maturity analysis for their noncancellable service or supply contracts with parties that are not lessors, the Board decided that a lessee should not be required to do so for substantially similar contracts just because it also has entered into a lease with that supplier. The Board further considered that because entities are not currently required to track future fixed payments associated with nonlease components, it may be costly for those entities to develop a system and a process to prepare this disclosure.

Other Disclosures

BC290. Some users told the Board that they would like to see disclosed a sensitivity analysis of the range of possible cash outflows related to all leases (including short-term leases) aggregated by major class of underlying asset. This sensitivity analysis would take into account management's expectations for renewal options and variable lease payments.

BC291. The Board rejected this proposal on the basis that it would be costly for preparers to provide and would include subjective, forward-looking information that could not easily be prepared or audited. In the Board's view, the historical information that will be disclosed in accordance with Topic 842 for each period presented in the financial statements will provide users with a sufficient base of information from which to make their own projections about possible future cash outflows of the entity for leases.

Measurement: Lessor

Sales-Type and Direct Financing Leases

BC292. In Topic 842, a lessor recognizes a net investment in the lease for any sales-type or direct financing lease. For a sales-type lease, the lessor initially measures the net investment in the lease at the sum of (a) the lease receivable and (b) the unguaranteed residual asset. For a direct financing lease, the net investment in the lease is measured at the sum of (1) the lease receivable and (2) the unguaranteed residual asset, the sum of which is reduced by any deferred selling profit. The *rate implicit in the lease* is defined in such a way that any initial direct costs eligible for deferral in certain sales-type leases or in direct financing leases are included automatically in the net investment in the lease. The initial measurement approach for the net investment in the lease and its components is broadly consistent with the initial measurement guidance in previous GAAP (with the exception of the treatment of selling profit for direct financing leases).

BC293. The lessor measurement guidance in Topic 842 is substantially changed from the lessor measurement guidance that was previously proposed in the 2010 and 2013 Exposure Drafts. The discussion of the lessor measurement guidance in Topic 842 that follows does not recount the previous proposals or the Board's previous basis for those proposals. That is because the changes to the lessor measurement guidance since the previous proposals are explained by the Board's broader decisions on the appropriate lessor accounting model, in particular, its decisions to (a) substantially retain the lessor accounting model in previous GAAP and (b) align certain aspects of the lessor accounting guidance with the related revenue recognition guidance in Topic 606. The Board's decisions on the lessor accounting model are discussed in paragraphs BC75–BC109.

Initial Measurement of the Lease Receivable

BC294. At the commencement date, the lease receivable is measured at the sum of (a) the present value of the *lease payments* not yet received by the lessor and (b) the present value of any portion of the estimated residual value at the end of the lease term that is guaranteed (either by the lessee or any other third party unrelated to the lessor).

Lease Term: Options to Extend or Terminate a Lease

BC295. The Board decided that a lessor should determine the lease term in the same way that the lessee does. Although the assessment of whether the lessee is reasonably certain to exercise an option to extend a lease or is reasonably certain not to exercise an option to terminate the lease may be more difficult for the lessor (because the decision to extend or terminate is made by the lessee), the Board decided that it would complicate the final leases guidance to add different requirements for lessees and lessors in this respect. In addition, the Board

considered that because the assessment of whether the lessee is or is not reasonably certain to exercise an option is based on relevant *economic* factors, the lease term guidance would not inappropriately require a lessor to consider noneconomic factors such as the lessee's intent. The reasons for the Board's decisions on the lease term are set out in paragraphs BC189–BC197.

Options to Purchase the Underlying Asset

BC296. The Board decided that a lessor should account for options provided to the lessee to purchase the underlying asset by applying the same requirements that are applied by a lessee when accounting for those options. The reasons for the Board's decisions on how to account for options to purchase the underlying asset are set out in paragraphs BC216–BC218.

Discount Rate

BC297. Topic 842 requires that a lessor use the rate implicit in the lease (that is, the rate of interest that, at a given date, causes the present value of the net investment in the lease to equal the sum of the fair value of the underlying asset and any capitalized initial direct costs of the lessor) when discounting its lease assets and when assessing lease classification (that is, in determining the present value of the lease payments and the present value of any guaranteed residual value). Consistent with the rationale in previous GAAP, the Board concluded that the rate implicit in the lease is the most appropriate discount rate for lessors to use because it most directly affects, in most cases, the lessor's pricing of the lease. In contrast to lessees, the Board decided that the rate implicit in the lease should always be available to lessors.

Lease Payments

BC298. The lease payments for a lease are the same for the lessee and the lessor, except that for a lessee only, lease payments include amounts probable of being owed by the lessee under residual value guarantees. The Board's rationale for what are or are not lease payments for a lessor, other than those about residual value guarantees, is discussed in paragraphs BC203–BC212. Lease payments for the lessor do not include any amounts related to residual value guarantees because under the lessor accounting model, the lease receivable (and, therefore, the net investment in the lease) includes residual value guarantees separately (see paragraphs BC213–BC215).

Variable Lease Payments

BC299. The Board decided that a lessor should apply the same requirements when determining which variable lease payments to include in the measurement of the lease receivable (and, therefore, the net investment in the lease) as a lessee does when measuring its lease liability. Accordingly, a lessor should include in the measurement of the lease receivable only those variable lease payments that

depend on an index or a rate. Although estimating variable lease payments to be paid in the future may be easier or more difficult for the lessor than the lessee in particular situations, the Board decided that it would complicate the guidance to propose different lessee and lessor accounting for variable lease payments; that is, it would be difficult to understand why variable lease payments would represent a liability for the lessee and not an asset for the lessor or vice versa. In addition, the feedback received on previous proposals in the 2010 and 2013 Exposure Drafts about variable lease payments was similar for both lessees and lessors. The reasons for the Board's decisions on variable lease payments are set out in paragraphs BC205–BC212.

Residual Value Guarantees

BC300. Consistent with previous GAAP, the lessor's lease receivable (and, therefore, the lessor's net investment in a sales-type or direct financing lease) includes the present value of any residual value guarantee, whether provided by the lessee or another third party unrelated to the lessor. The Board considered that any guaranteed residual amount is, in effect, a final payment resulting from the lease and, therefore, should be accounted for in a similar manner to the lease payments (that is, as part of the lease receivable, which is a financial asset).

BC301. The Board considered but rejected accounting for residual value guarantees separate from a lease. The Board noted that residual value guarantees are often so interlinked with lease payments, particularly when the guarantor is the lessee, that it could be misleading to recognize such guarantees separately.

Selling Profit or Selling Loss

BC302. Topic 842 defines selling profit or selling loss as the difference between (a) the fair value of the underlying asset or the lease receivable, if lower, and (b) the carrying amount of the underlying asset net of any unguaranteed residual asset, further reduced by any deferred initial direct costs of the lessor. Any initial direct costs eligible for deferral are subtracted from the selling profit that would otherwise be calculated because those costs are automatically included in the measurement of the net investment in the lease (because of how the rate implicit in the lease is defined) and, therefore, would result in overstating the selling profit on the lease. Case C of Example 1 (paragraphs 842-30-55-31 through 55-39) in Subtopic 842-30 demonstrates the determination of selling profit or selling loss when initial direct costs are eligible for deferral.

BC303. The Board's rationale for deferring selling profit (and recognizing selling loss) at lease commencement for direct financing leases is discussed as part of the basis for the lessor accounting model in paragraph BC97.

Initial Direct Costs

BC304. The Board decided that initial direct costs should include only those costs that are incremental to obtaining a lease and that would not have been incurred if the lease had not been obtained (that is, executed). This generally includes costs such as brokers' commissions that are incurred only upon successful execution of the lease and excludes any other costs that would have been incurred even if, at the last minute, the lessee or the lessor failed to execute the lease. Those costs that do not meet the definition of initial direct costs might include legal costs incurred to negotiate or draft the lease agreement if the lessor would have owed fees for those services even if the lessee did not execute the lease. In an arrangement that includes multiple components, lessors should allocate initial direct costs, as well as any other capitalizable costs (for example, contract costs capitalizable in accordance with Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers) to the separate lease components or nonlease components to which those costs relate.

BC305. The Board further decided that initial direct costs should be deferred as part of the net investment in the lease in the case of a direct financing lease or a sales-type lease in which the fair value of the underlying asset is equal to its carrying amount. Initial direct costs are included in the lessor's net investment in the lease by virtue of how the rate implicit in the lease is defined. If a lessor incurs initial direct costs, the rate implicit in the lease is the rate of interest that, at initial measurement, causes the present value of the net investment in the lease to equal the sum of the fair value of the underlying asset and the initial direct costs. Any initial direct costs incurred in connection with a sales-type lease in which the fair value of the underlying asset is different from its carrying amount are expensed as incurred, except to the extent they are allocable to one or more nonlease components.

BC306. The Board's decisions on defining, allocating, and accounting for initial direct costs were intended to align the accounting for initial direct costs by a lessor with the accounting for costs to obtain a contract by a seller of similar goods. The cost deferral guidance in Subtopic 340-40 (a) recognizes as a contract cost asset only those incremental costs of obtaining the contract that an entity incurs that would not have been incurred if that contract had not been obtained, (b) allocates those capitalized costs to the goods and services to which they relate, and (c) recognizes that contract cost asset into income when (or as) the related goods or services are transferred to the customer. The Board concluded that expensing initial direct costs upfront for sales-type leases in which the fair value of the underlying asset is different from its carrying amount (that is, expensing those costs at lease commencement—when the underlying asset is effectively "sold" to the customer) and over the lease term for direct financing leases, operating leases, and sales-type leases in which the fair value of the underlying asset is equal to its carrying amount is consistent with Subtopic 340-40. When a lessor enters into a direct financing lease or a sales-type lease in which the fair value of the underlying asset is equal to its carrying amount, the good or service to which the asset (initial

direct costs) relates is the lessor's service of providing finance to the lessee. In an operating lease, based on the Board's decisions about the lessor accounting model, the good or service to which the initial direct costs relate is the entity's provision of access to the underlying asset, which the lessor satisfies over the lease term. In contrast, in a sales-type lease in which the fair value of the underlying asset is different from its carrying amount, the lessor is generally a manufacturer or a dealer and leasing represents another means for the lessor to sell its products. The good or service to which the initial direct costs relate in those transactions is the underlying asset; control of which is effectively transferred to the lessee at lease commencement.

BC307. The Board concluded that a lessor and a seller of the same good, including an entity that both sells and leases assets, should account for similar costs in the same way. In addition, the Board noted that the guidance on initial direct costs in previous GAAP was aligned with one of the two acceptable methods for accounting for costs to obtain a contract in previous revenue recognition guidance, and, therefore, the Board's decision on initial direct costs in Topic 842 maintains alignment between the leases and revenue recognition guidance for these types of costs.

Initial Measurement of the Unguaranteed Residual Asset

BC308. The unguaranteed residual asset is initially measured at the present value of the portion of the estimated residual value of the underlying asset that is not guaranteed by the lessee or another third party unrelated to the lessor. The discount rate that is used to measure the unguaranteed residual asset is the rate implicit in the lease.

Subsequent Measurement of the Net Investment in the Lease

BC309. A lessor measures its net investment in a sales-type or direct financing lease on an amortized cost basis after initial measurement. That measurement basis is consistent with the subsequent measurement guidance for lessors in previous GAAP and similar to but not exactly the same as the measurement basis applied to other financial assets and hybrid financial assets. For example, there are some differences in (a) the measurement of variable lease payments in Topic 842 and (b) how similar features would be measured for a financial asset measured at amortized cost in accordance with the financial instruments requirements. Nonetheless, this approach would result in accounting for the net investment in a sales-type or direct financing lease on a basis similar to that applied to other similar receivables.

Impairment of the Net Investment in the Lease

BC310. Topic 842 requires assessment of the net investment in a sales-type or a direct financing lease for impairment in accordance with the subsequent measurement guidance in Topic 310 on receivables. The lease receivable is a

financial asset. Even though the unguaranteed residual asset does not meet the definition of a financial asset in GAAP, the Board decided that it would be overly complex and provide little benefit to require entities to separately assess those components of the net investment for impairment (for example, assess the lease receivable only in accordance with Topic 310 and assess the unguaranteed residual asset in accordance with Topic 360).

BC311. The Board concluded that there would likely be little incremental benefit to requiring a separate impairment analysis for the components of the net investment because to be classified as a sales-type or direct financing lease the unguaranteed residual asset must, in general, be minor as compared with the lease receivable. In some cases, for example, when the lease transfers ownership of the asset to the lessee by the end of the lease term or grants the lessee a purchase option it is reasonably certain to exercise, there is no unguaranteed residual asset. Therefore, because most of the net investment in a sales-type or direct financing lease will comprise the financial lease receivable, the Board concluded that assessing impairment of the entire net investment in accordance with the impairment guidance for financial instruments is appropriate. The Board also considered that, in general, lessors entering into sales-type and direct financing leases will not re-lease the asset after the lease term. Those lessors will look to realize any expected residual value from the asset through a sale of the asset to the lessee or another party. Therefore, treating the entire net investment in the lease as a future cash flow stream when evaluating impairment is consistent with how lessors generally view their net investment in that lease.

BC312. The Board concluded that the incremental costs of requiring a lessor to assess the lease receivable and the unguaranteed residual asset for impairment separately would be significant based largely on feedback from respondents to the 2013 Exposure Draft. In the 2010 and 2013 Exposure Drafts, the Board proposed that a lessor should assess the lease receivable for impairment in accordance with Topic 310 and the residual asset (which included the guaranteed and unguaranteed portions) in accordance with Topic 360. Respondents stated that it would be complex to have a "split" impairment assessment of that nature (that is, to assess the lease receivable for impairment in the financial instruments guidance and to assess the residual asset for impairment in Topic 360). Those respondents mostly requested that the Board allow the entire net investment in the lease to be assessed for impairment in accordance with the financial instruments model.

BC313. As noted in paragraphs BC308 and BC309, the measurement basis for a lessor's net investment in a lease is similar to but not exactly the same as the measurement basis applied to other financial assets. Although the measurement of some net investments in a lease would be different from other financial assets measured at amortized cost, the Board previously concluded that this was not a reason to apply a different impairment model. The impairment model being proposed by the Board always would require a lessor to measure all expected losses relating to net investments in leases. Additional information is available in

the basis for conclusions of the December 2012 proposed FASB Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15).*

Reassessment of Options, the Discount Rate, and Variable Lease Payments That Depend on an Index or a Rate

BC314. As a consequence of its decision to substantially retain the lessor accounting model in previous GAAP, the Board decided that a lessor should not reassess lessee options to extend or terminate a lease or to purchase the underlying asset. Similarly, a lessor should not reassess either (a) the discount rate in the lease for sales-type or direct financing leases or (b) the lease payments for changes in a reference index or rate on which some or all of the lease payments are determined unless there is a lease modification that does not result in a separate contract. Any changes in payments made to the lessor as a result of the latter are accounted for as variable lease payments within the period earned.

Sale of the Lease Receivable

BC315. The Board considered whether lease receivables held for sale (or securitization) should be measured at fair value. Fair value measurement of those receivables would be similar to the principles in existing financial instruments requirements on the measurement of financial assets held for the purposes of sale. Fair value measurement also would eliminate the recognition of gains or losses upon sale (assuming the transfer occurs at fair value) because the asset being transferred would be recognized at fair value immediately before sale.

BC316. However, the Board decided not to require or permit a lessor to measure lease receivables held for sale at fair value because:

a. There would be two measurement bases for lease receivables in the final leases guidance, thus, increasing complexity and reducing comparability.
b. The measurement requirements would need to specify whether a lessor would be required to measure at fair value only the part of the lease receivable being transferred or all of the cash flows included in the lease receivable, including those relating to variable lease payments and options that meet the recognition criteria for those items. That would be relevant, for example, if a lease contains a renewal or extension option that it is reasonably certain to exercise; however, the cash flows to be sold relate only to lease payments to be received during the noncancellable period of the lease. In that case, a part of the lease receivable (that is, the lease payments to be received during the extension period) would not be held for sale. Both alternatives (that is, measuring the entire lease receivable or only the part to be transferred at fair value) would be complicated in this situation. Measuring only the part of the lease receivable to be transferred at fair value would require splitting the lease receivable into two parts with two different measurement bases for the same receivable. Alternatively, measuring all

of the lease receivable at fair value would result in a lessor measuring lease payments not held for sale at fair value, which would be inconsistent with the Boards' other decisions on the measurement of lease payments.

c. If the fair value requirement was a "held-for-sale" requirement, it would not be entirely consistent with the financial instruments guidance.

d. Applying different measurement bases to different parts of a lease receivable also could introduce opportunities for structuring.

BC317. The Board decided that a lessor should apply the derecognition requirements in Topic 860, Transfers and Servicing, to lease receivables. Developing derecognition requirements specifically for lease receivables would add complexity to the lease guidance and reduce comparability between lease receivables and other similar financial assets. The Board did not identify any particular feature of lease receivables that would suggest that the financial instruments derecognition requirements would be inappropriate. In particular, Topic 860 includes requirements that address the sale of only a part of a larger financial asset.

BC318. The Board also decided to retain the guidance in previous GAAP on leases that says if a lessor sells the lease receivable associated with a sales-type or a direct financing lease and retains an interest in the unguaranteed residual asset, the lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term. The lessor should report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

Measurement of the Underlying Asset at the End of the Lease Term or on Termination of a Lease

BC319. The Board decided that if a lessee returns the underlying asset before the end of the lease term (for example, because of a premature termination of the lease), the lessor should account for the returned asset as a reclassification of the net investment in the lease (that is, the lease receivable and the unguaranteed residual asset) and, therefore, measure the returned asset at the carrying amount of the net investment in the lease at that date. In reaching that decision, the Board noted that the net investment in the lease would be required to be assessed for impairment immediately before the underlying asset is returned to the lessor, and that this approach is consistent with how that impairment assessment would be performed. The Board concluded, however, that a lessor should continue to recognize a receivable for any amounts that it expects to receive relating to the lease. Accordingly, a lessor should initially measure the returned asset at the carrying amount of the net investment in the lease (after impairment), excluding any amounts that the lessor expects to receive, which the lessor will continue to recognize as a receivable.

BC320. The Board considered two other alternatives for measuring the returned asset:

a. *Fair value:* A lessor would derecognize the net investment in the lease and recognize the returned asset at fair value.
b. *Retrospective measurement:* A lessor would calculate a revised rate implicit in the lease (the rate actually earned on the shortened lease term) on the basis of the fair value of the returned asset at the time the lease terminates prematurely.

BC321. The Board rejected fair value because, in rare circumstances, it could potentially result in a lessor recognizing a gain from a repossession of the underlying asset. The Board noted that it is counterintuitive for a lessor to recognize a gain as a result of what most would view as an unfavorable circumstance (that is, the termination of a lease before the end of the lease term).

BC322. The Board rejected retrospective measurement because:

a. The approach would be complex to apply. It requires the use of hindsight to recalculate the transaction as if the lessor had known at the commencement date that the lease would be terminated prematurely.
b. The measurement methodology is not consistent with the way in which a lessor would assess the net investment in the lease for impairment immediately before recognition of the returned asset.
c. In rare circumstances, it could potentially result in a net gain from a repossession of the underlying asset in situations in which the fair value of the asset has increased over the lease term.

Operating Leases

Initial Measurement

BC323. The Board decided that a lessor should continue to recognize and measure the underlying asset in accordance with other Topics and recognize lease income over the lease term for operating leases. A lessor does not recognize a receivable. That is consistent with a lessor's accounting for operating leases in previous GAAP.

BC324. The Board also decided that lessors should defer initial direct costs as a result of entering into an operating lease. The rationale for the Board's decisions on the deferral and subsequent recognition of initial direct costs are discussed in paragraphs BC304–BC307.

Subsequent Measurement

BC325. The Board decided that a lessor should recognize lease income arising from operating leases on a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the

underlying asset. In reaching that decision, the Board considered two other alternatives:

a. Recognizing lease income on the basis of the contractual cash flows
b. Recognizing lease income on a straight-line basis exclusively.

BC326. Recognizing lease income on the basis of the contractual cash flows might be an appropriate method of recognizing lease income if the lessor measured the underlying asset at fair value, recognizing changes in fair value through profit or loss. That is because the fair value of the asset would be estimated on the basis of future cash flows, taking into account both the timing and amount of contractual and noncontractual cash flows. However, the Board concluded that recognizing lease income on a contractual cash flow basis would not be appropriate when the underlying asset is measured at cost because, under such an approach, the amount of lease income recognized would be entirely dependent on the contractual timing of lease payments, rather than on the pattern in which the benefit is expected to be derived by the lessee from use of the underlying asset.

BC327. Although in the Board's view, recognizing rental income on a straight-line basis often will reflect the pattern in which income is earned from the underlying asset, it noted, consistent with previous GAAP, that will not always be the case. For example, the Board concluded that it would be simpler and more consistent with its proposals on variable lease payments to recognize lease income arising from variable lease payments for operating leases in the period in which the changes in facts and circumstances on which the payments are based occur, rather than on a straight-line basis. Consequently, the Board decided that a lessor should recognize rental income on a systematic basis that is not straight line if that basis was more representative of the pattern in which income is earned from the underlying asset. Nonetheless, a lessor is expected to recognize uneven fixed lease payments on a straight-line basis when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (for example, when there is significant front loading or back loading of payments or when rent-free periods exist in a lease).

Presentation: Lessor

BC328. As outlined in the discussion of the lessor accounting model in paragraphs BC75–BC109, the Board decided to retain most aspects of the lessor accounting model in previous GAAP. Consequently, lessors' presentation of leases in the statement of financial position, in the statement of comprehensive income, and in the statement of cash flows is substantially the same as in previous GAAP.

Statement of Financial Position

Sales-Type and Direct Financing Leases

BC329. A lessor in a sales-type lease or a direct financing lease should recognize and present in the statement of financial position its net investment in sales-type and direct financing leases. A lessor should also disclose its aggregate amount of lease receivables and unguaranteed residual assets (and for direct financing leases, deferred selling profit, if any).

BC330. In deciding that lessors should present a single net investment in sales-type and direct financing leases in the statement of financial position rather than separately present the components of the net investment (that is, the lessor's lease receivables, unguaranteed residual assets [and for direct financing leases, any deferred selling profit]), the Board principally considered the following:

a. In the vast majority of sales-type and direct financing leases, the estimated residual value (whether guaranteed or unguaranteed) is realized by a sale or re-lease of the asset, and, for that reason, the residual value should be looked at as a last payment, similar to the lease payments.
b. Combined presentation of a net investment in the lease helps to explain the rationale for discounting, and then accreting, the unguaranteed residual asset. While the unguaranteed residual asset is defined in GAAP as a nonfinancial asset, it is, in substance, a final cash flow at the end of sales-type and direct financing leases and, therefore, is reasonably accounted for like a financial asset when part of the lessor's net investment in the lease. Conversely, it would generally not be appropriate to present the nonfinancial unguaranteed residual asset with other nonfinancial assets (for example, with property, plant, and equipment), when they are not accounted for in a similar way (that is, unless the unguaranteed residual asset is no longer accreted, which is what occurs after a sale of the lease receivable) and do not share the same economic characteristics (for example, a lessor cannot use or sell—without the lease being attached—an asset while it is the subject of a lease).
c. This presentation is consistent with the Board's decision to assess impairment of the unguaranteed residual asset in a lease together with impairment of the lease receivable (see paragraphs BC310–BC313).

BC331. While users generally said that the lessor accounting model in previous GAAP provided them with the financial information they needed, many users indicated that they needed more information about the lessor's residual assets and exposure to residual asset risk. The latter (exposure to residual asset risk) is addressed by the lessor disclosure requirements discussed in paragraphs BC339 and BC340. Regarding the former (information about the lessor's residual assets), the Board noted that users will benefit from the disclosure of a lessor's unguaranteed residual assets separate from the lessor's lease receivable. That is

because, although linked, those assets (that is, the unguaranteed residual asset and the lease receivable) have different natures, risks, and liquidity. Separate disclosure of those assets will improve the transparency of information provided to users of financial statements about a lessor's exposure to credit risk (relating to the lease receivable, which includes any guaranteed portion of the underlying asset's estimated residual value) and asset risk (relating to the unguaranteed residual asset).

Operating Leases

BC332. A lessor in an operating lease should present the underlying asset subject to an operating lease in accordance with other Topics (for example, in accordance with Topic 360 if property, plant, or equipment or Topic 330 if inventory).

Statement of Comprehensive Income

BC333. A lessor should present any profit or loss on a sales-type lease that is recognized at the commencement date in a manner that best reflects the lessor's business model(s). Examples of presentation include the following:

a. If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor should present revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of the fair value of the underlying asset at the commencement date and the sum of the lease receivable and any lease payments prepaid by the lessee. Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the unguaranteed residual asset.
b. If a lessor uses leases for the purposes of providing financing, the lessor should present the profit or loss in a single line item.

BC334. Business models vary among lessors with sales-type and direct financing leases. For example, many financial institution lessors use leasing solely as a means of providing financing to lessees. Other lessors, for example, manufacturer or dealer lessors, use leasing as an alternative means of realizing value from assets that they would otherwise sell, and also provide financing to lessees. Topic 842 permits a lessor to present profit recognized at the commencement date either gross or net to reflect its business model(s) (if the lessor has different leasing businesses). That would enable a lessor to present the effects of leases in a way that is consistent with how the lessor generates its income.

Statement of Cash Flows

BC335. The Board decided that in the statement of cash flows, a lessor should classify lease payments received on all leases within operating activities because leasing is generally part of a lessor's revenue-generating activities.

Disclosure: Lessor

BC336. The lessor disclosure objective is the same as that for lessees. The lessor disclosure guidance also includes the same guidance about the appropriate level of detail for the disclosures. The Board's basis for its decisions to include the disclosure objective and the level of detail guidance are explained in paragraphs BC272–BC276.

Qualitative Disclosures

BC337. The basic qualitative disclosures required by Subtopic 842-30 are the same as those required for lessees. That is, a lessor should disclose:

a. Information about the nature of its leases
b. Information about significant assumptions and judgments made in applying the lessor accounting requirements
c. Lease transactions between related parties.

BC338. The Board's rationale for requiring qualitative lessor disclosures is the same as its rationale for requiring qualitative lessee disclosures, which is explained in paragraphs BC277–BC279.

Residual Asset Risk Disclosures

BC339. Topic 842 requires a lessor to provide information about how it manages its risk associated with the residual value of its leased assets, including its risk management strategy for residual assets, the carrying amount of residual assets covered by residual value guarantees, and any other means by which it reduces its residual asset risk.

BC340. A primary concern of users on the disclosure requirements in previous GAAP is the lack of transparency about how the lessor manages its exposure to residual value risk. While users generally said that the lessor accounting model in previous GAAP provided them with the financial information they needed, many users indicated that additional information was needed about the lessor's residual assets and exposure to residual risk. Uncertainty about the residual value of the underlying asset at the end of the lease is a lessor's primary risk, particularly for a lessor of equipment and vehicles. This is because a decline in the market value of leased equipment and vehicles at a rate greater than the rate the lessor projected (on the basis of its policy on residual value measurement) would adversely affect the profitability of the lease. Residual value realization at the end of the lease term might be affected by several factors (for example, rapid technological or economic obsolescence, unusual wear and tear, excess use, or manufacturer's warranties). Consequently, the Board decided that a lessor should disclose how it manages its residual value risk to enable users to assess the uncertainty of cash flows arising from a lessor's leases and from its leased assets. The Board considered that producing residual risk disclosures will carry an incremental cost to preparers, but

it decided to require the disclosures on the basis that this is an area in which users have consistently requested additional information and told the Board that the financial reporting for lessors in previous GAAP was inadequate for their information needs in many cases.

Information on Underlying Assets

BC341. The Board decided that a lessor should treat assets subject to operating leases as a major class of depreciable assets, further distinguished by significant class of underlying asset. Accordingly, a lessor should provide the required property, plant, and equipment disclosures for assets subject to operating leases separately from owned assets held and used by the lessor. In the Board's view, leased assets often are subject to different risks than owned assets that are held and used (for example, the decrease in the value of the underlying asset in a lease could be due to several factors that are not within the control of the lessor), and, therefore, users will benefit from lessors segregating their disclosures related to assets subject to operating leases from disclosures related to other owned property, plant, and equipment. The Board further considered that to provide useful information to users, the lessor should disaggregate its disclosures in this regard by significant class of underlying asset subject to lease because the risk related to one class of underlying asset (for example, airplanes) may be very different from another (for example, land or buildings).

Table of Lease Income

BC342. Topic 842 requires a tabular disclosure of lease income, which will provide information about the different components of lease income recognized during the reporting period (for example, profit recognized at the commencement date, interest income on sales-type and directing financing leases, lease income arising from the lease payments for operating leases, and variable lease income). In the Board's view, this disclosure highlights for users the different nature of the components of lease income.

Maturity Analysis

BC343. Topic 842 requires that lessors disclose a maturity analysis of the timing of the future cash flows arising from its leases, separately for sales-type and direct-financing leases and operating leases. In the Board's view, such disclosure helps users of financial statements to assess the expected timing and amount of future cash flows arising from leases. In deciding to require the maturity analyses, the Board considered that the requirements are substantially the same as those that were required in previous GAAP.

Reconciliation of Opening and Closing Balances

BC344. The 2013 Exposure Draft included a proposal that a lessor should provide reconciliations of the lease receivable and residual asset for sales-type and direct

financing leases because those reconciliations inform users of financial statements about changes to those assets during the reporting period. Users of financial statements have informed the Board that such reconciliations are useful in their analyses. However, the Board decided not to include this requirement in Topic 842. The Board's rationale for not including this requirement is generally consistent with its rationale for not including a requirement for lessees to provide a reconciliation of the opening and closing balance of their lease liabilities. Paragraphs BC283–BC286 provide further detail.

BC345. In lieu of the reconciliation requirement, which would have provided quantitative information about the changes in a lessor's lease receivables and residual assets, the Board decided that lessors should provide qualitative information about the change in the balance of their unguaranteed residual assets and deferred selling profit (for direct financing leases) during the reporting period. The Board decided not to require this information for the lease receivable because it would be inconsistent with the disclosure requirements for similar financial assets.

Sale and Leaseback Transactions

BC346. In a sale and leaseback transaction, one entity (the seller-lessee) sells an asset that it owns to another party (the buyer-lessor) and immediately leases back that same asset. Lease accounting requirements in previous GAAP include specific requirements on sale and leaseback transactions involving real estate assets (for example, land, buildings, or integral equipment) to determine whether, when a real estate asset is sold and immediately leased back, an entity should account for the transaction as a sale and leaseback or account for the entire transaction as a financing arrangement. Those requirements were largely derived from guidance specific to sales of real estate in previous GAAP that preceded Topic 606. Previous GAAP did not include specific requirements to determine whether sale and leaseback transactions involving assets other than real estate should be accounted for as sale and leaseback transactions. However, in general, practice developed such that sale and leaseback transactions involving assets other than real estate were accounted for as sale and leaseback transactions unless the arrangement provided the seller-lessee with a bargain option to repurchase the asset.

BC347. Previous GAAP also included specific requirements on recognizing the gain or loss resulting from the sale of the asset in a sale and leaseback transaction. Those requirements were the same for sale and leaseback transactions involving real estate and non-real-estate assets. In general, most gains or losses were deferred at the time of sale of the asset and recognized over the term of the leaseback.

BC348. The requirements in previous GAAP were substantially different from those under IFRS, both regarding whether a sale of the asset occurs (for sale and leaseback transactions involving real estate assets) and how to recognize any gain

or loss on that sale in a sale and leaseback transaction. More transactions were accounted for as sale and leaseback transactions under IFRS than GAAP, while gains and losses (if the transaction was entered into at market terms) were generally recognized at the time of the sale in previous IFRS.

BC349. Topic 842 represents a substantial change from previous GAAP, and the basis for the decisions made on those changes is discussed in paragraphs BC350–BC358.

Determining Whether a Sale Occurs

BC350. Consistent with the 2010 and 2013 Exposure Drafts, a transaction should be accounted for as a sale and leaseback transaction in Topic 842 only if there is a sale of the asset that is the subject of the contract. In determining whether a sale has occurred, Subtopic 842-40 specifies that an entity consider both of the following from Topic 606:

a. The guidance on identifying the contract
b. The guidance on when an entity satisfies a performance obligation by transferring control of an asset.

Subtopic 842-40 relies on the guidance in Topic 606 in substantially the same way as the guidance in Topic 610, which applies to sales of nonfinancial assets to parties other than customers.

BC351. Topic 606 requires that for a sale of an asset to occur, a contract must exist between the parties and the buyer must obtain control of the asset from the seller. The Board decided that the presence of the leaseback in a sale and leaseback transaction should not affect those requirements. If no contract exists based on the guidance in Topic 606 or the buyer does not obtain control of the asset as a result of the transaction, no sale has occurred.

BC352. Because the revenue recognition guidance in Topic 606 is different from the guidance on determining whether a sale occurs in a sale and leaseback transaction in previous GAAP, and also because the presence of the leaseback is a unique feature specific to these transactions, the Board decided to provide some additional guidance about how to apply the transfer of control requirements in Topic 606 to a sale and leaseback transaction. Accordingly, Topic 842 includes the following guidance:

a. *The existence of the leaseback does not, in isolation, prevent the buyer-lessor from obtaining control of the asset*. That is because a lease is different from the purchase or sale of an asset in that a lease does not transfer control of the underlying asset to the lessee; instead, it transfers the right to control the use of the underlying asset for the period of the lease. Consequently, assuming that there are no features in a sale and leaseback transaction that would prevent sale accounting, the buyer-

lessor would be considered to obtain control of the asset and immediately transfer the *right to control the use of* that asset to the lessee for the lease term (the Board's conclusion in this regard also significantly influenced its decision on how to account for the sale; see paragraphs BC359 and BC360). The lease payments received by the buyer-lessor during the lease term, together with the benefits that the buyer-lessor can generate from the residual asset after the lease term, would represent substantially all of the remaining benefits from the asset immediately before the asset is leased to the seller-lessee. Consequently, in such cases, the buyer-lessor obtains control of the asset. The Board further noted that the buyer-lessor in many sale and leaseback transactions is no different from many other lessors in terms of its control of the asset. Many lessors purchase an asset that will be the subject of a lease from a third party only when the terms and conditions of the lease have already been negotiated. The lessor may not receive physical possession of the asset until the end of the lease term (for example, a vehicle could be delivered directly by a manufacturer to the lessee, even though the lessor purchases the vehicle from the manufacturer). In a sale and leaseback transaction, the buyer-lessor also may not receive physical possession of the asset until the end of the lease term. However, in both of those situations, the Board concluded that it is appropriate for the lessor to be deemed to control the asset before the commencement of the lease.

b. *The buyer-lessor does not obtain control of the asset in accordance with the guidance in Topic 606 if the leaseback would be classified as a finance lease (by the seller-lessee) or a sales-type lease (by the buyer-lessor)*. The Board has concluded that, in a finance/sales-type lease, the lessee, in effect, obtains the ability to direct the use of, and obtain substantially all the remaining benefits from, the underlying asset. Consequently, if a transaction in which the leaseback would be classified as a finance/sales-type lease were determined to be a sale and a leaseback, one would effectively conclude that the seller-lessee transferred control of the asset to the buyer-lessor and immediately re-obtained control of the asset. The FASB decided that no sale should occur in that scenario because it would be inappropriate for a seller-lessee to account for a concurrent (similar in nature to a "round trip") sale and, in effect, repurchase of the same asset.

c. *An option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale of the asset unless both (1) the exercise price of the option is the fair value of the asset at the time the option is exercised and (2) there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace*. Topic 606 states that a customer does not obtain control of an asset if the seller has the obligation or the right to repurchase the asset. Therefore, in general, the presence of a seller-lessee option to repurchase the asset precludes accounting for the transaction as a sale and a leaseback. However, the Board decided to specify that repurchase options that meet

criteria (1) and (2) do not preclude sale accounting. In the Board's view, a buyer-lessor is not constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset if the seller-lessee can only repurchase the asset at its then-prevailing fair market value and the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace. This notion was expressed in a similar manner in the basis for conclusions in Update 2014-09. When the Board discussed this provision, Board members generally observed that real estate assets would not meet criterion (2). This is because real estate is, by nature, "unique" (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is "substantially the same."

BC353. The Board further noted that there may be substantial judgment involved in determining whether a sale has occurred in some cases. That judgment will depend on the specific facts and circumstances of the contract. For example, in determining when and whether a sale occurs, a seller-lessee may conclude that the buyer-lessor has obtained control of the asset if the buyer-lessor has obtained legal title to the asset, the seller-lessee has a present right to payment for the asset for the sale price, and the buyer-lessor has accepted the significant risks and rewards of ownership. In contrast, an entity may not reach the same conclusion if, for example, the seller-lessee provides a significant residual value guarantee such that the buyer-lessor has not accepted the significant risks and rewards of ownership. If the buyer-lessor has not accepted the significant risks and rewards of ownership and the seller-lessee has not relinquished physical possession of the asset, careful evaluation of the facts and circumstances to determine when and whether a sale occurs in accordance with the principle in Topic 606 may be required.

BC354. The guidance on determining whether a sale has occurred in Subtopic 842-40 is generally consistent with the proposals in the 2013 Exposure Draft. Changes from that proposed guidance were principally along the lines of the following:

a. Updates to the guidance resulting from changes to the revenue recognition proposals after the issuance of the 2013 Exposure Draft (for example, Topic 606 includes enhanced guidance on identifying the contract that was included in the revenue recognition proposals after the issuance of the 2013 Exposure Draft)
b. Updates to the guidance resulting from changes to the lessee and lessor accounting proposals in the 2013 Exposure Draft (for example, updating the proposed requirement that a sale does not occur if the seller-lessee obtains substantially all the remaining benefits of the asset with the requirement that a sale has not occurred if the seller-lessee effectively retains control of the underlying asset as a result of the terms of the leaseback—that is, because the leaseback would be classified as a finance/sales-type lease)

c. Clarifications to address stakeholders' requests for additional guidance on how to consider the transfer of control guidance in Topic 606 in the context of sale and leaseback transactions.

BC355. Most respondents that commented on the Board's sale and leaseback proposals in the 2013 Exposure Draft supported aligning the determination of a sale in a sale and leaseback transaction with the guidance in Topic 606. However, some respondents disagreed with the repurchase options accounting that results, because they noted that only a bargain purchase option should preclude sale accounting that would align with U.S. tax and legal requirements. However, the Board ultimately decided that it was important to determine whether a sale occurs in the context of a sale and leaseback transaction in the same manner as for any other sale transaction, which would be subject to the contract identification and transfer of control guidance in Topic 606.

BC356. The Board previously considered substantially different requirements in the 2010 Exposure Draft, but it ultimately rejected those proposed requirements in favor of the guidance included in Topic 842. The proposal in the 2010 Exposure Draft included a list of conditions that would have typically precluded sale and leaseback accounting. Those conditions would have set a higher threshold in terms of achieving sale accounting than the requirements in Topic 606 (as well as the revenue recognition proposals at that time). Respondents to the 2010 Exposure Draft raised the following concerns about those proposals:

a. Many questioned why there was a need for a higher threshold in relation to sale and leaseback transactions, especially in light of the proposals in the revenue recognition project to remove the higher threshold that existed in previous GAAP for sales of real estate. Consequently, those respondents questioned why a higher threshold for revenue recognition should be retained only within the context of sale and leaseback transactions.
b. Many were concerned about whether the sale recognition conditions in the 2010 Exposure Draft were operational. They expected the proposals to be applied very strictly so that almost all sale and leaseback transactions would be treated as financing arrangements.

BC357. The Board ultimately agreed with those respondents and abandoned the proposal in the 2010 Exposure Draft in favor of the requirements in Topic 842, which determine whether a sale has occurred in accordance with the guidance in Topic 606. The Board decided that applying the revenue recognition requirements to sale and leaseback transactions will simplify the sale determination as compared with the proposal in the 2010 Exposure Draft and increase comparability between sales entered into as part of sale and leaseback transactions and all other sales. The Board concluded that this will be beneficial to both preparers and users of financial statements.

BC358. Earlier in the project, the Board also considered whether the transferred asset must be an entire leased asset (a "whole asset" approach) or whether a

bundle of rights and obligations associated with an asset could qualify for sale and leaseback accounting (a "partial asset" approach). For example, under a partial asset approach, in a sale and leaseback of an office building, the lessee would continue to recognize a portion of the building representing the right to use the building during the leaseback period and derecognize that portion of the building relating to the rights transferred to the lessor (for example, ownership rights and the right to use the building after the end of the leaseback period). However, the Board decided not to propose a partial asset approach because it would be complex to apply and would not provide a proportionate benefit in improved information to users of financial statements.

Accounting for a Sale and Leaseback Transaction

BC359. The Board decided that the seller-lessee should account (a) for the sale of the asset, including determining the transaction price for the sale, in accordance with the guidance in Topic 606 if the buyer-lessor is a customer or Topic 610 if the buyer-lessor is not a customer, and (b) for the lease in accordance with the lessee guidance in Topic 842. The Board decided that the buyer-lessor should account for the purchase of the asset in accordance with other Topics (that is, as it would account for the purchase of the asset without the leaseback) and account for the lease in accordance with the lessor guidance in Topic 842.

BC360. The proposals in the 2013 Exposure Draft would have accounted for the sale (purchase) and the leaseback in substantially the same manner as Topic 842. In response to the 2013 Exposure Draft, some stakeholders suggested that the Board should require deferral of the gain on a sale subject to a sale and leaseback transaction (more broadly consistent with previous GAAP). During redeliberations of the 2013 Exposure Draft, the Board considered but ultimately rejected an alternative that would have recognized only the amount of any gain or loss on sale of the asset that relates to the rights retained by the buyer-lessor at the end of the leaseback. In rejecting this alternative, the Board concluded that if an entity determines that a sale and leaseback of a nonfinancial asset has occurred, the accounting for the sale (that is, transfer of control of the underlying asset) and the leaseback (that is, the transfer of a right to *use* the underlying asset, which is separate and distinct from the underlying asset itself) should not be affected by one another if the transaction is entered into at market terms. For the same reasons, the Board concluded that the buyer-lessor's accounting for its purchase of the asset and for its accounting for the lease of that asset back to the seller-lessee should not be affected by one another.

Off-Market Terms

BC361. The lease payments and the sales price in a sale and leaseback transaction are interdependent because they are negotiated as a package (for example, as part of the same contract or in two or more contracts that will be

combined in accordance with the contract combinations guidance in paragraph 842-10-25-19). That is, the sales price might be more than the fair value of the asset because the leaseback lease payments are above a market rate; conversely, the sales price might be less than the fair value because the leaseback lease payments are below a market rate. That could result in the misstatement of both gains and losses on disposal of the asset for the seller-lessee and the carrying amount of the asset for the buyer-lessor, as well as result in misleading lease expense (for the seller-lessee) or lease income (for the buyer-lessor) related to the leaseback. Consequently, the Board decided that an entity should adjust the sale (purchase) price of the asset if the sale and leaseback occurs at other than a market rate. The entity should account for:

a. Any adjustment that increases the sale price of the asset, because the sale price paid by the buyer-lessor to the seller-lessee is below fair value, as a prepayment of rent (that is, as an adjustment to the right-of-use asset for the leaseback). The Board decided that a sale price below fair value was no different, in substance, from a prepayment of rent by the seller-lessee.
b. Any adjustment that reduces the sale price of the asset, because the sale price paid by the buyer-lessor to the seller-lessee is above fair value, as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and the buyer-lessor should account for the additional financing in accordance with other Topics. The Board decided that in cases in which the buyer-lessor, in effect, “overpays” for the asset, that overpayment is no different from the buyer-lessor granting the seller-lessee a loan in addition to purchasing the seller-lessee’s asset. The seller-lessee and the buyer-lessor should account for that financing in the same manner as any other financing arrangement.

BC362. However, the Board decided that if the transaction is between entities that are related, the lessee and the lessor should not adjust the lease assets or the lease liabilities and should make the appropriate disclosures in accordance with Topic 850. This is consistent in concept with the Board’s decision that an entity should account for a related party lease in accordance with the enforceable terms and conditions of that lease, rather than in accordance with a subjective determination of its economic substance.

BC363. An entity determines whether the sale and leaseback is not at a market rate by comparing the difference between either of the following, whichever is more readily determinable:

a. The sale price of the asset and the fair value of the asset
b. The present value of the lease payments and the present value of market rental payments.

BC364. The Board noted that an entity should maximize the use of observable prices and observable information in selecting the most appropriate benchmark to

use in determining if the sale and leaseback transaction is at a market rate and in calculating the accounting adjustment for any off-market terms.

BC365. The Board also noted that a sale and leaseback transaction should not be considered off market solely because the sale price or the lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) on the basis of all of the information (historical, current, and forecast) that is reasonably available to the entity. For a seller-lessee, this includes estimating any variable consideration to which it expects to be entitled in accordance with paragraphs 606-10-32-5 through 32-9. Variable payments are a part of the negotiated exchange between the parties; therefore, it is inappropriate to ignore that part of the negotiated exchange in determining whether the sale and leaseback transaction is at a market rate. Variable payments considered for purposes of this evaluation should not be *recognized* (that is, as part of the transaction price of the sale for the seller-lessee or the cost of the asset to the buyer-lessor, or included in the seller-lessee's measurement of the lease liability) except in accordance with the guidance in Topic 842 or other Topics (for example, Topic 606 or Topic 360).

BC366. The proposals in the 2013 Exposure Draft would have concluded that a sale and leaseback transaction was not at a market rate if *either* the sale price or the lease payment was not at fair value. Respondents to the 2013 Exposure Draft generally said that it was excessive to have to consider both the fair value of the asset and the market rental payments to make the off-market determination and suggested that the fair value of the asset will typically be more readily determinable. In response to that feedback, the Board decided it could simplify the guidance, without a significant diminution in the benefits that would result, by clarifying that an entity does not necessarily need to determine the fair value of both the underlying asset and the market rental payments. The Board decided that requiring an entity to determine the fair value of both the underlying asset and the market rental payments is likely to be unnecessary given that any overpayment for the underlying asset by the buyer-lessor would often be accompanied by above-market rental payments, and vice versa. In addition, requiring measurement of both the underlying asset and the market rental payments would be inconsistent with guidance in other Topics that generally directs an entity to select the single benchmark measure that is most readily determinable.

Accounting for a Failed Sale and Leaseback Transaction

BC367. If the transfer of the asset is determined not to be a sale:

a. The seller-lessee should not derecognize the transferred asset and should account for any amounts received as a financial liability in accordance with other Topics.

b. The buyer-lessor should not recognize the transferred asset and should account for the amounts paid as a receivable in accordance with other Topics.

BC368. These requirements for a failed sale and leaseback transaction are effectively unchanged from the proposals in the 2010 and 2013 Exposure Drafts. The Board decided, in affirming that guidance in Topic 842, that if there is no sale, the seller-lessee should not derecognize the asset (and continue to depreciate the asset) but, instead, should recognize any proceeds from the buyer-lessor as a financial liability. The Board's decision in this regard is consistent with both of the following:

a. The accounting for a failed sale in Topic 606. For example, if a transaction includes a repurchase option that prevents the customer from obtaining control of the asset, the transaction is accounted for as a financing arrangement.
b. The accounting for most failed sale and leaseback transactions on lease accounting requirements in previous GAAP.

BC369. As the seller-lessee makes the scheduled payments in the contract, it will allocate those payments between interest expense on the financial liability and repayment of principal on the financial liability. At the end of the "leaseback" period (or at the point in time the buyer-lessor obtains control of the underlying asset), the seller-lessee will recognize any remaining balance of the financial liability as the proceeds on the sale of the asset. The gain or loss recognized at that point will reflect any difference between those proceeds and the carrying amount of the asset.

BC370. The Board further decided that, in accounting for the financing transaction, the seller-lessee should adjust the interest rate on the financial liability as necessary to ensure that both:

a. Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term and the term of the financing. The term of the financing may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term.
b. The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term and the date at which control of the asset will transfer to the buyer-lessor.

The Board concluded that either of the results in (a) or (b) above would be inappropriate, and that inclusion of the guidance requiring adjustment of the seller-lessee interest rate was necessary to prevent those results. The guidance requiring adjustment of the seller-lessee interest rate is generally consistent with practice in previous GAAP.

BC371. In response to feedback from some stakeholders, the Board considered whether the buyer-lessor also should, like the seller-lessee, account for a failed sale and leaseback as a financing transaction. Some stakeholders had suggested that even if the seller-lessee does not recognize a sale, the buyer-lessor should account for the purchase. Those stakeholders said that accounting for the transaction as a financing would obscure the residual risk the buyer-lessor has in the lease because it paid for the asset's fair value but that the leaseback will be for less than that fair value. In addition, previous GAAP did not specify accounting for the buyer-lessor in a failed sale and leaseback transaction such that the failed sale and leaseback accounting for the buyer-lessor required by Subtopic 840-40 may represent a change for some entities. However, the Board decided to affirm its decision that both the seller-lessee and the buyer-lessor should account for a failed sale and leaseback transaction as a financing arrangement. The Board concluded that a buyer-lessor should not recognize an asset it does not control; to do so would be incompatible with the definition of an asset in Concepts Statement 6 and would result in both parties to the transaction recognizing the same underlying asset concurrently.

BC372. The Board observed that the guidance in Topic 606 specifies that if a seller-lessee repurchase option prevents transfer of control of the asset to the buyer-lessor in a sale and leaseback transaction, the seller should account for the contract as a financing arrangement. In making that decision in Topic 606, the Board noted that the application of the guidance on repurchase agreements in Topic 606 for other than sale and leaseback transactions could have required the seller-lessee to account for some sale and leaseback transactions as a lease and leaseback transaction. The Board also noted that applying lease and leaseback accounting in those situations would be complex and difficult to understand and, thus, the cost would not justify the potential benefit.

Sale and Leaseback Disclosures

BC373. The sale and leaseback disclosure requirements in Topic 842 are generally consistent with the sale and leaseback disclosure proposals in the 2010 and 2013 Exposure Drafts. The disclosure requirements in Topic 842 prescribe that lessees should disclose the main terms and conditions of sale and leaseback transactions and the net gain or loss arising from sale and leaseback transactions for each period presented in the financial statements. Those disclosures will inform users of financial statements about transactions that could give rise to significant nonrecurring gains and losses and cause a significant change in the capital structure of the entity.

Related Party Leases

BC374. The Board decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties on the basis of legally enforceable terms and conditions of the arrangement, acknowledging that some related party transactions are not documented and/or the terms and conditions are not at arm's length. In addition, lessees and lessors are required to apply the disclosure requirements for related party transactions in Topic 850. In previous GAAP, entities were required to account for leases with related parties on the basis of the economic substance of the arrangement, which may be difficult when there are no legally enforceable terms and conditions of the arrangement. Examples of difficulties include related party leases that are month to month and related party leases that have payment amounts dependent on cash availability. In these situations, it is difficult and costly for preparers to apply the recognition and measurement requirements. Even when applied, the resulting information often is not useful to users of financial statements.

Short-Term Leases—Lessees

BC375. In the 2010 Exposure Draft, the Board proposed that a lessee and lessor could elect to apply simplified accounting to leases that met the definition of a short-term lease. A lessee would recognize, but would not need to discount, lease assets and lease liabilities arising from short-term leases. A lessor could apply an approach similar to existing operating lease accounting to short-term leases. A short-term lease was defined in the 2010 Exposure Draft as a lease that, at the commencement date, has a maximum possible lease term, including all options to extend, of 12 months or less.

BC376. Respondents to the 2010 Exposure Draft noted that the proposals for short-term leases did not offer much relief for entities because the discount element of short-term leases is often immaterial. In addition, the proposals would still require an entity to track a possibly large volume of leases with little value and to separate nonlease components from lease components for those leases, which could be cumbersome.

BC377. On reconsideration, the Board agreed that applying the full proposals did not justify the costs. Consequently, in the 2013 Exposure Draft, the Board simplified the accounting for short-term leases to offer more relief. The Board proposed that both lessees and lessors need not apply the recognition and measurement requirements to short-term leases. The definition of *short-term lease* was refined from that in the 2010 Exposure Draft such that a lease would not meet the definition of a short-term lease if it included an option for the lessee to purchase the underlying asset (at any exercise price).

BC378. During redeliberations of the proposals in the 2010 Exposure Draft, the Board rejected increasing the short-term lease exemption beyond leases of 12

months because, for example, 2-year leases and 3-year leases are more likely to give rise to material assets and liabilities and the objective of the project was to ensure greater transparency about an entity's leasing activities. Some Board members continue to believe that with the short-term lease exemption, even when limited to leases of 12 months or less, there is the potential for significant assets and liabilities (in aggregate) not to be recognized in the balance sheet and, therefore, do not support the short-term lease exemption despite supporting this Update overall.

BC379. The Board affirmed a recognition and measurement exemption for a lessee's short-term leases in finalizing the guidance in Topic 842. The Board affirmed the short-term lease threshold of 12 months or less that was previously proposed but decided to permit the recognition and measurement exemption to apply to any lease for which the lease term (as defined in Topic 842) is 12 months or less, rather than only to a lease with a maximum possible term of 12 months or less. That decision was largely a consequence of feedback on the 2013 Exposure Draft that suggested that use of a "maximum possible lease term" would not permit the exemption to be applied to "evergreen" leases that may typically only be for a matter of only weeks or even days, because there is no stated maximum lease term (that is, the lease may contain terms that permit the lessee to continue to extend the lease on a day-to-day, week-to-week, or month-to-month basis). The Board also decided that the presence of a lessee option to purchase the underlying asset should not preclude short-term lease designation unless the lessee is reasonably certain to exercise that option. Short-term leases, like all other leases of lessees, are subject to the lease term and purchase option reassessment requirements in Subtopic 842-10.

BC380. Because the Board decided to substantially retain the lessor accounting model in previous GAAP, which accounts for nearly all short-term leases as operating leases, the Board concluded that it was not necessary to include a short-term lease exemption in Topic 842 for lessors.

BC381. The Board considered that leases could be structured to obtain short-term lease accounting. For example, a lease that ultimately extends for 10 years or more could be structured as a 1-year lease with a series of 1-year renewal options, which could result in the lease never being recognized on a lessee's statement of financial position. However, the Board concluded that there are significant economic disincentives to both parties to entering into a series of short-term leases in place of longer-term leases such that there is not a significant structuring risk throughout the system. For example, lessees may have to pay a premium rental price to compensate the lessor for its increased residual asset risk, and some lessors will be unable to enter into short-term leases depending on the terms of the financing they obtained to acquire the underlying asset.

Effective Date

BC382. The Board decided that the amendments in this Update will be effective for public business entities and any not-for-profit entity that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and any employee benefit plan that files or furnishes financial statements with or to the SEC for fiscal years beginning after December 15, 2018, including interim reporting periods within those fiscal years. For all other entities, the amendments in this Update will be effective for fiscal years beginning after December 15, 2019, and for interim reporting periods beginning after December 15, 2020. In addition, the Board decided to allow early application of the amendments in this Update upon issuance.

BC383. In deciding on the effective date of Topic 842, the Board considered a number of factors. The following considerations most significantly influenced the Board's conclusion that an effective date later than that provided would not represent an appropriate balance between costs to preparers and the effect on users of such a significant delay in obtaining the improved, more representationally faithful information they will receive as a result of Topic 842:

a. Extensive feedback from preparers and industry groups that the amendments in this Update could be implemented without any significant systems or process changes. That is not to say that no systems or process changes will be necessary but, rather, that those changes are not expected to be extensive or costly.
b. The Board has provided approximately three-and-a-half years between the issuance of Update 2014-09 and the mandatory effective date of the amendments therein (principally, Topic 606 and Subtopic 340-40). The extent of the accounting changes for most entities that will result from the amendments in this Update are less significant than the extent of the accounting changes for those same entities that will result from adopting the guidance in Topic 606 (and Subtopic 340-40). Consequently, the Board concluded that entities would not, in general, need as much time to implement Topic 842 as they will need to implement Topic 606 (and Subtopic 340-40).
c. Issues on the effect of Topic 842 on entities' covenants in existing debt/loan agreements are not likely to be significant based on all of the following:
    1. A significant portion of lease agreements contain "frozen GAAP" or "semifrozen GAAP" clauses such that a change in a lessee's financial ratios resulting solely from a GAAP accounting change either would not result in a debt covenant default or would solely require both parties to renegotiate in good faith.
    2. Banks with whom outreach has been conducted state that they are unlikely to dissolve a good customer relationship by "calling a loan" because of a "technical" default of this nature, even if the loan

agreement did not have a "frozen GAAP" or "semifrozen GAAP" provision.

3. The Board's decision that operating lease liabilities are operating obligations rather than debt. Based on outreach, this decision may substantially alleviate issues for some smaller entities with certain debt covenants.
4. The average life of most commercial and industrial loans, based on data obtained by the staff, is less than the period of time between the issuance of this Update and the first time an entity, especially a private company, will report under Topic 842.

BC384. In contrast, the following considerations most significantly influenced the Board's decision not to enact an effective date earlier than that provided:

a. An effective date earlier than that provided would likely have resulted in the beginning of the earliest comparative period presented that is affected by Topic 842 beginning before the issuance of this Update. Even though, because of the simplified requirements in Topic 842 (as compared with earlier proposals), including those as to transition, such an outcome would likely not have been overly burdensome, the Board considered it preferable to enact an effective date that would result in the earliest comparative period presented in the first set of financial statements issued in accordance with Topic 842 beginning after the issuance of this Update.
b. Most entities will be implementing both Topic 842 and Topic 606 (and Subtopic 340-40) over the next few years such that, given limited resources, staggering the effective dates of those two Topics would permit entities to better assign and allocate resources and perform more effective implementations of each Topic. The Board expressed concern about the availability of appropriate internal and external resources to implement both Topics at the same time. The Board also considered that some entities will be implementing new financial instruments guidance during this timeframe. While this was considered in determining that the effective date for Topic 842 was reasonable, it had less of an effect on the Board's decision than considerations relative to Topic 606 because the financial instruments standards are expected to significantly affect a much smaller population of entities than Topics 842 and 606.

BC385. The IASB established the same effective date for IFRS 16. Despite some important differences between IFRS 16 and Topic 842, the Board concluded it will significantly assist U.S. entities that have to report under both GAAP and IFRS to be able to adopt both standards concurrently. Both Boards decided to permit some form of early application such that it is generally within the control of each entity whether it wants to adopt IFRS 16 at the same time as it adopts Topic 842.

BC386. The Private Company Decision-Making Framework recommends that amendments in FASB Accounting Standards Updates be effective for private

companies one year after the first fiscal year for which public business entities are required to adopt them and that the amendments be required for the first time only in those entities' *annual* reporting (that is, the entity is not required to adopt the amendments for its interim reporting until the following fiscal year). The Board decided that no additional deferral was necessary for private companies for the following reasons:

a. Because the Private Company Decision-Making Framework recommendation does not require private companies to adopt a new accounting standard until its first fiscal year following the effective date, private companies generally will not report under Topic 842 until two years after most public business entities first report under Topic 842. Consequently, many calendar-year private companies will not issue financial statements in accordance with Topic 842 until sometime in 2021, more than five years after the issuance of this Update.
b. Topic 842 will be no more complex for private companies to apply than it will be for public business entities and, in fact, may be simpler for many of those entities to apply because most private companies do not have IFRS reporting obligations (which might require them to account for their leases under the different Topic 842 and IFRS 16 models) and generally have smaller lease portfolios.

BC387. The Board decided to permit early application of Topic 842 on the basis that if entities are willing and can provide users of financial statements with the significantly improved information Topic 842 will provide sooner than the mandatory effective date, they should be permitted to do so. Also of importance, early application permits lessors to adopt Topic 842 at the same time as Topic 606. The Board also concluded that users should not have any significant difficulties with comparability from early application because the financial statements of lessors, as well as the statements of comprehensive income and cash flows of lessees, will be mostly unchanged as a result of adopting Topic 842 and because nearly all users already adjust lessees' statements of financial position for operating leases. The financial statement and disclosure information required by Topic 842 will generally permit users to easily adjust an entity's statement of financial position as necessary to compare an entity that early applies Topic 842 with an entity that does not.

Transition: Modified Retrospective Method

Lessee and Lessor Transition

BC388. The primary improvement in Topic 842, as compared with previous GAAP, is the recognition of lease assets and lease liabilities for all leases. A lessee's accounting for finance leases in Topic 842 will be substantially unchanged from a lessee's accounting for capital leases in previous GAAP. In addition, the accounting effect of operating leases in a lessee's statement of comprehensive

income or statement of cash flows in Topic 842 will be substantially the same as that in previous GAAP. The accounting for lessors is substantially unchanged from previous GAAP, except to align various aspects of the lessor accounting guidance with the guidance in Topic 606 and to certain aspects of the new lessee accounting guidance.

BC389. Consequently, the Board decided to mandate the modified retrospective transition method in Topic 842, with the option to elect a package of practical expedients. The Board decided on this rather than a more onerous transition approach (for example, a full retrospective approach), to reduce the cost of transition for preparers, while still reflecting the primary improvement of the lessee accounting guidance at each reporting date presented in the entity's comparative financial statements.

BC390. The practical effect of the modified retrospective transition method, particularly when combined with the practical expedients that are offered, is that an entity will "run off" those leases existing at the beginning of the earliest comparative period presented in accordance with previous GAAP with the *exception* that, for operating leases, a lessee will present a lease liability in the statement of financial position at each reporting date equal to the present value of the remaining *minimum rental payments* (as that term was applied in previous GAAP) and a right-of-use asset that is derived from the lease liability in the manner described in paragraph 842-20-35-3. Entities will, in effect, "run off" existing leases, as described, *unless* the lease is either modified (and that modification is not accounted for as a separate contract) or, for lessees only, the lease liability is remeasured in accordance with the subsequent measurement guidance in Subtopic 842-30 on or after the effective date. To ensure that the financial statements provide relevant and reliable financial information, lessees and lessors should apply the subsequent measurement guidance in Topic 842 beginning on the effective date. For lessees, this includes the subsequent measurement guidance in Subtopic 842-30 on lease term and purchase option reassessments and assessing impairment of right-of-use assets. For lessors, applying the subsequent measurement guidance in Topic 842 is expected to result in little difference from applying the subsequent measurement guidance in previous GAAP.

BC391. While the Board acknowledges that the accounting result from applying the modified retrospective transition approach will not be the same as that from a full retrospective approach (for example, because of differences between what were *minimum rental payments* or *minimum lease payments* in previous GAAP and what are *lease payments* in Topic 842), the Board noted that the results will be similar such that the benefits of a more precise transition approach would not justify the costs.

BC392. The Board included the following two practical expedients as part of the transition guidance:

a. An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) when applying the transition guidance to leases that began before the effective date:
    1. An entity need not reassess whether any expired or existing contracts are or contain leases.
    2. An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).
    3. An entity need not reassess initial direct costs for any existing leases.
b. An entity also may elect a practical expedient, which must be applied consistently by that entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering options to extend or terminate the lease and purchase options) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with the practical expedients in (a).

BC393. The Board decided to require that the practical expedients in paragraph BC392(a) be elected as a package that will apply to all of the entity's leases (including those for which it is a lessee and those for which it is a lessor) to limit, for users, the potential number of combinations of transition methods entities might elect. That also is why the Board decided not to permit entities to adopt the guidance in Topic 842 on a fully retrospective basis, despite acknowledging that a full retrospective approach would produce the most comparable financial information for users. The following apply to each of the components of the practical expedient in paragraph BC392(a):

a. The Board decided to permit entities not to reassess whether any expired or existing contracts are or contain leases because the Board expects that, in most cases, entities will reach the same lease/nonlease conclusion in accordance with the guidance in Topic 842 as they did in previous GAAP. Where any difference is expected, the guidance in Topic 842 is likely to result in a nonlease conclusion where previous GAAP would have concluded that the entity has a lease. The Board noted explicitly that this practical expedient grandfathers the guidance on identifying a lease for expired and existing contracts in previous GAAP; this practical expedient does not grandfather an incorrect assessment determined in previous GAAP.
b. The Board decided to permit entities not to reassess the classification of their leases because the Board expects the vast majority of leases classified as operating leases in previous GAAP also will be classified as

operating leases in Topic 842, and, similarly, the vast majority of leases that would be classified as capital leases in previous GAAP will be classified as finance leases in Topic 842. Therefore, the cost of requiring entities to reassess lease classification will not be justified by the benefit, especially because all leases will be recognized in the statement of financial position.

c. The Board decided not to require reassessing whether unamortized initial direct costs would have qualified for capitalization in Topic 842. The Board decided that to do so would require entities to incur additional transition costs, while the effect of reassessing those initial direct costs will only be to write off some (or all) of those costs to equity. That means that those costs would never run through the statement of comprehensive income. The Board decided that if an entity does not want to incur the transition cost of reassessing its unamortized initial direct costs but, instead, is willing to continue to recognize those costs in the statement of comprehensive income, it should be permitted not to reassess those costs.

BC394. In deciding to provide the practical expedient in paragraph BC392(b), the Board considered that a similar practical expedient related to the use of hindsight in determining the transaction price (that is, estimating variable consideration) was provided in the transition requirements in Topic 606. Similar to the rationale for that expedient, the Board decided that reflecting expectations that an entity knows at the time of reporting are incorrect does not provide useful information to users. In the context of this practical expedient, the Board considered that it would generally not provide useful information to recognize a lease liability on the basis of a lease term that assumes the entity is reasonably certain to exercise an option to extend the lease when at the time of reporting the entity knows that it did not exercise that option. The Board decided not to include the use of the hindsight practical expedient into the package of the other practical expedients that must be elected together because the use of hindsight reduces the complexity of transition and provides more accurate, updated information to users such that the Board did not want an entity's ability to elect that expedient to be dictated by its decision on other expedients.

BC395. During the course of the leases project, some stakeholders suggested that the Board should adopt a prospective transition method (that is, applying Topic 842 only to leases that begin on or after the effective date). Although the approach would have been the least costly for preparers of financial statements to apply, the Board rejected this transition approach because information provided would not have been beneficial to users of financial statements, particularly for entities that enter into long-term operating leases (for example, a lessee with a 10-year lease, a 20-year lease, or even longer-term leases might not reflect a significant portion of its lease assets and lease liabilities in its statement of financial position until decades after the effective date of Topic 842). Instead, the Board focused on minimizing the cost of a modified retrospective approach, where appropriate.

Transition for Sale and Leaseback Transactions

BC396. Consistent with the transition proposals for lessees and lessors generally, the modified retrospective transition requirements applicable to sale and leaseback transactions were adopted by the Board with the objective to limit the cost and complexity of transition to preparers of financial statements while still providing useful information to users. With that objective, the key provisions of the sale and leaseback transition guidance and the Board's reasons for adopting those provisions are as follows:

a. An entity should not reassess whether a transaction previously accounted for as a sale and leaseback in previous GAAP would have qualified as a sale (or purchase) in accordance with the guidance for determining whether the transfer of the asset is a sale in Subtopic 842-40. The Board concluded that the cost, time, and effort to reassess those transactions could be significant, particularly if the entities entered into the transaction many years in the past. The Board decided that the benefits of changing the accounting for the subset of transactions in which a sale was deemed to occur in previous GAAP, but would not have occurred in accordance with the guidance in Subtopic 842-40, or would have occurred at a different point in time in accordance with that guidance, would not justify the costs of the reassessment.
b. An entity should reassess whether a transaction previously accounted for as a failed sale and leaseback in previous GAAP that remains a failed sale as of the effective date should be reassessed on whether a sale would have occurred in accordance with the guidance in Subtopic 842-40. In the Board's view, this is consistent with the transition guidance applicable to sales of assets in Topic 606. That is, under the modified retrospective transition guidance in Topic 606, an entity reassesses the accounting for any contract that is not completed before the effective date. In this case, a failed sale and leaseback is an uncompleted contract because the seller-lessee has not yet transferred control of the asset to the buyer-lessor.
c. For any transaction previously accounted for as a sale and capital leaseback transaction in previous GAAP, the seller-lessee will continue to amortize any deferred gain or loss in the same manner as in previous GAAP. In this respect, the Board decided that the accounting effect of retrospectively applying Subtopic 842-40 to the transaction would not be significantly different from the accounting effect of continuing to account for the sale and leaseback in accordance with the previous guidance. In Subtopic 842-40, a finance leaseback precludes accounting for the transaction as a sale and a leaseback. The net accounting effect of recognizing the underlying asset and a financial liability as compared with continuing to recognize a right-of-use asset, a lease liability, and deferred gain, would not justify the costs of doing so.

d. For any transaction previously accounted for as a sale and operating leaseback transaction in previous GAAP, the seller-lessee should recognize any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment at the later of the date of initial application (to equity) and the date of sale (to earnings of the comparative period presented). That will adjust the seller-lessee's financial statements as if the historical gain or loss resulting from the sale of the asset had been recognized in accordance with Subtopic 842-40.
e. For any deferred gain or loss on a sale and operating leaseback resulting from off-market terms, the seller-lessee will recognize a deferred loss as an adjustment to the leaseback right-of-use asset or account for any remaining deferred gain as a financial liability. Consistent with the basis for its decision in (d), the Board concluded that this will result in accounting that is consistent with the treatment of those items in Subtopic 842-40. The Board further concluded that in accounting for off-market deferred gains or losses differently from those in (d), off-market gains or losses reflect continued financing that should not be written off to equity in transitions.
f. An entity should account for the leaseback in any transaction that qualified as a sale and leaseback in previous GAAP in accordance with the general transition requirements applicable to lessees and lessors in Topic 842. This decision is consistent with the Board's conclusion on sale and leaseback accounting overall that if an entity determines that a sale and leaseback of an asset has occurred, the accounting for the sale/purchase (that is, the transfer of control of the underlying asset) and the leaseback (that is, the transfer of a right to use the underlying asset, which is separate and distinct from the underlying asset itself) should not be affected by one another if the transaction is entered into at market terms.

Leveraged Leases

BC397. The Board decided that the existing accounting model for leveraged leases should not be retained. That is, all leases should be accounted for in a consistent manner and special rules should not exist for leases with certain characteristics. One reason is because leveraged lease accounting provides net presentation and some Board members do not agree with allowing a net presentation for only a subset of certain lease transactions. Another reason is to limit some of the complexity in the lease accounting guidance by eliminating the unique accounting for leveraged leases. As such, lessors should not distinguish leveraged leases from other leases in Topic 842. This is consistent with the proposed requirements in the 2010 and 2013 Exposure Drafts. However, the Board decided to grandfather existing leveraged leases during transition. Respondents to the 2013 Exposure Draft noted that the transition of existing leveraged leases to the current lessor model would require particular challenges when unwinding the income tax effects of the leveraged leases and income

statement results on transition that would not properly depict the economics of the transaction. The Board recognized that there would be significant complexities relating to unwinding existing leveraged leases and that the outcome of doing so would not be beneficial to users. Therefore, the Board decided to grandfather the accounting under previous guidance for existing leveraged lease transactions.

Costs Incurred Relating to the Construction or Design of an Underlying Asset

BC398. Previous GAAP provided extensive requirements relating to a lessee's involvement in the construction of an asset that the lessee will lease when constructed (such contracts are typically build-to-suit leases, and are referred to as such in this section). This included detailed guidance with which to evaluate whether the lessee was the accounting owner of the asset during the construction period. If the lessee was the accounting owner of the asset during the construction period, it would recognize the asset in its statement of financial position as well as a financial liability for costs of the construction paid by the lessor. At the end of the construction period, the transaction was subject to the sale and leaseback guidance. The requirements in previous GAAP were initially written to address situations in which a lessee might attempt to keep assets "off balance sheet" by leasing an asset that it had constructed and avoiding applying the sale and leaseback requirements that would typically require the lessee to recognize the asset. In such transactions, the lessor sometimes would be a variable interest entity.

BC399. Topic 842 does not carry forward the requirements from previous GAAP for build-to-suit leases. In reaching this decision, the Board principally considered the following:

a. The requirements in previous GAAP were written primarily to address off-balance-sheet concerns at a time when leases classified as operating leases were not recognized in a lessee's statement of financial position. The accounting model changes that require a lessee to recognize lease assets and lease liabilities and the sale and leaseback accounting changes, together with more recent changes to the consolidation requirements for variable interest entities, would reduce the need for specific requirements in this area. For example, regardless of whether the lessee is considered to control the asset during construction, the lessee will recognize a right-of-use asset at the commencement date of the lease.
b. The requirements in previous GAAP made the assessment of whether the lessee is the accounting owner of the asset during the construction period on the basis of whether the lessee had substantially all of the construction period risks. The Board decided that this is not the appropriate basis on which to determine whether the lessee is, in effect, the owner of the asset before lease commencement. Rather, the lessee

should be considered the owner of the asset before lease commencement only if it controls that asset.

c. The requirements in previous GAAP were complex to apply, and even though they have existed for many years, they continue to present practice issues.

BC400. Despite not carrying forward the previous guidance on how to account for costs incurred by a lessee relating to the construction or design of an asset, the Board decided, in response to feedback from stakeholders, to include some guidance in Topic 842 related to those costs. Consequently, Topic 842 provides for the following:

a. If a lessee incurs costs relating to the construction or design of an underlying asset, the lessee should account for those costs in accordance with other Topics (for example, Topic 330 on inventory or Topic 360 on property, plant, and equipment). The Board included this guidance to ensure that entities recognize that even if they are no longer determined to be the accounting owner of an asset during construction, their costs incurred may qualify for recognition as an asset in accordance with other Topics. This may include assets like leasehold improvements that the lessee pays for during the construction period and that will benefit the lessee in future periods.
b. If the lessee controls the underlying asset before lease commencement, the transaction is a sale and leaseback transaction that is accounted for in accordance with Subtopic 842-40. In adding this guidance, the Board concluded that if the lessee controls the asset as it is being constructed, it should recognize that asset just as it would any other asset it controls. The Board decided to provide the implementation guidance in paragraph 842-40-55-5 and Example 3 in Subtopic 842-40 to assist entities in determining when a lessee controls an underlying asset that is under construction before the commencement date, understanding that this concept is new in the context of evaluating leases. It is the Board's view that in each of the circumstances provided, the lessee controls the underlying asset as it is being constructed and, therefore, should evaluate the transaction in accordance with the sale and leaseback guidance. Paragraph 842-40-55-5 further articulates that the circumstances provided are not an all-inclusive list; additional circumstances (individually or in combination), if present, could demonstrate that a lessee controls an underlying asset that is under construction before the commencement date. Therefore, some judgment will be involved in undertaking the evaluation in some cases. The Board observed that, in concept, the evaluation under Subtopic 842-40 on whether an entity controls an asset that is under construction is similar to the evaluation undertaken in the revenue recognition guidance in accordance with paragraph 606-10-25-27 to determine whether a performance obligation is satisfied over time. The Board recognizes that this provision is different

from the previous GAAP build-to-suit requirements and, therefore, different accounting conclusions may result from application of the new guidance as compared to previous GAAP. However, it was not necessarily the Board's intention to achieve similar accounting results with the guidance in Subtopic 842-40 but, rather, to communicate that (1) a lessee can be the owner of an asset before lease commencement and (2) control is the appropriate basis on which to make that determination.

BC401. Some respondents to the 2010 and 2013 Exposure Drafts noted that those proposals did not provide any transition guidance for existing build-to-suit leases. Those respondents stated that transition guidance was needed if the Board was eliminating the previous accounting guidance. In response to that feedback, Topic 842 includes transition guidance on how to account for build-to-suit leases. That guidance includes how to account for recognized assets and liabilities (for example, a recognized asset and financial liability), as well as how to account for the lease. Consistent with the general transition requirements, the Board decided that lessees should apply a modified retrospective transition approach. That will allow relief for lessees while ensuring consistent recognition and measurement for these types of transactions on the effective date and for all comparative periods presented.

Application to Private Companies—Specific Topics

BC402. Paragraphs BC29–BC31 discuss, broadly, the factors the Board considered for private companies. This section summarizes the Board's considerations in deciding whether to modify some of the specific requirements in Topic 842 for private companies. During the leases project, the Board carefully considered the different needs of private companies in deciding to modify some of the requirements. In making those decisions, the Board considered input from preparers, auditors, and users of private company financial statements and considered the different needs of those users of private company financial statements compared with users of public business entity financial statements.

BC403. This section considers the Board's decisions on the following topics:

a. Recognition
b. Measurement
c. Disclosures
d. Presentation
e. Transition.

Recognition

BC404. The Board considered feedback from preparers and users of private company financial statements to consider whether the requirement to recognize lease assets and lease liabilities on the balance sheet provides relevant information to users of a private company's financial statements at a reasonable

cost. In arriving at its decisions, the Board considered (as expressed in paragraph BC29) the Private Company Decision Making Framework; the Conceptual Framework; input from preparers, auditors, and users of private company financial statements; the different needs of users of private company financial statements compared with users of public business entity financial statements; and the recommendations of the PCC (as well as its predecessor, the PCFRC), including the recommendations of others, to have consistent accounting for public business entities and private companies. In this respect, and consistent with the feedback from private company financial statement users with whom outreach was performed, the Board concluded that the benefit to financial statement users of the requirement in Topic 842 to recognize lease assets and lease liabilities on the balance sheet for all entities justifies the costs to preparers to provide this information, particularly in light of the discussion in paragraphs BC9–BC11 and BC30.

BC405. In response to the 2010 Exposure Draft, the PCFRC noted that private companies should recognize lease assets and lease liabilities, consistent with public companies, subject to some limited practical expedients that the Board adopted in Topic 842 (for example, on determining a lessee's incremental borrowing rate, accounting for related party leases, and exempting private companies from disclosing a reconciliation of lease assets or lease liabilities). In response to the 2013 Exposure Draft, and again during redeliberations before issuing the amendments in this Update, the PCC suggested a classification approach for lessees that would be similar to that proposed in the 2013 Exposure Draft, based on the expected consumption of the underlying asset by the lessee during the lease term (see paragraphs BC52–BC55). However, under the PCC proposal, private company lessees would not be required to recognize lease assets and lease liabilities arising from those leases for which significant consumption of the underlying asset did not occur (effectively, what were classified as "Type B leases" in the 2013 proposals). The Board rejected this alternative because the Board concluded that all leases create assets and liabilities for lessees that should be recognized (that is, consumption of the economic benefits of the underlying asset is not a determinative factor in assessing whether the right of use conveyed by the lease is an asset to the lessee or whether the lessee has an obligation to pay for that right of use) and, consistent with paragraph BC29, there is no compelling rationale for a difference in this respect between public business entities and all other entities. The Board also observed that the PCC alternative would conflict with the feedback the Board received from private company lenders and a significant majority of other private company stakeholders with whom it had engaged that said that all leases—finance and operating—create liabilities for lessees. The PCC approach also would appear to result in income statement and statement of cash flows results more consistent with that in the 2013 Exposure Draft, which a majority of the respondents to that Exposure Draft rejected. Furthermore, most preparers, including those from private companies, in response to the 2013 Exposure Draft, said that the consumption-based

classification approach would be more costly and complex to apply than a classification approach substantially aligned with that in previous GAAP.

Measurement

BC406. Topic 842 includes a practical expedient for lessees that are private companies that allows an accounting policy election for the initial and subsequent measurement of all liabilities to make lease payments. Under that election, those liabilities could be discounted under the requirements of Topic 842 using a risk-free rate determined at lease commencement using a period comparable with the term of the lease. A private company that chooses to apply this practical expedient is required to apply it to all leases and to disclose that it has elected to use the practical expedient. As stated in paragraph BC121, a private company that elects the practical expedient might conclude that it can determine a single, risk-free rate to be applied to all leases within a particular portfolio because using that single rate will not result in a materially different answer than using a risk-free rate determined for each individual lease. This might, for example, permit a private company to use a single, risk-free rate, determined at lease commencement, to discount leases with similar but not identical lease terms.

BC407. Most private company stakeholders supported the practical expedient when it was first proposed in the 2013 Exposure Draft. The Board decided to provide this practical expedient in response to concerns of private companies and not-for-profit entities and their stakeholders. The Board concluded that it would be too costly for some entities to identify an incremental borrowing rate that takes into account the credit of the lessee and the effect of the leased asset as collateral. For certain private companies, particularly those with little or no comparable borrowings, the costs to determine and audit their incremental borrowing rate would not be justified by the incremental benefits of using that rate.

BC408. The Board considered whether to permit private company lessees to use a zero discount rate. However, several Board members were concerned that the approach would completely ignore the time value of money. Some Board members said that it was not necessary to provide practical expedients because the discount rate may not be as critical to determining the lease classification as it was in previous GAAP. However, the Board decided that the use of a risk-free rate will address the input from private company stakeholders to reach a reasonable balance between the costs and benefits and recognize the time value of money.

Disclosures

BC409. The 2013 Exposure Draft proposed an exception for private companies to the requirement that a lessee should provide a reconciliation of the opening and closing balances of the liabilities to make lease payments. The Board ultimately decided to eliminate that proposed disclosure requirement to Topic 842 for all entities (public or private). Paragraphs BC283–BC286 explain the Board’s decision to eliminate the reconciliation disclosure.

Presentation

BC410. The Private Company Decision-Making Framework states that, generally, both private and public companies should apply the same financial statement presentation guidance established by the Board because of the presumption that information that is important enough to be presented on the face of financial statements is relevant to most financial statement users. The only substantive difference in presentation between previous GAAP and Topic 842 is the addition of lease assets and lease liabilities to an entity's balance sheet.

BC411. At various points during the project, some have suggested that the Board could permit private companies to apply alternative presentation requirements (for example, presenting lease assets net of the related lease liabilities in an adjacent presentation). However, nonfinancial lease assets and financial lease liabilities do not meet the requirements for offsetting in GAAP. There are also different classification (current and noncurrent) requirements for financial and nonfinancial assets that would prevent an adjacent, net presentation. Therefore, the Board did not pursue this alternative.

BC412. When considering the Private Company Decision-Making Framework, the Board decided that the presentation in the financial statements should be the same for both public business entities and private companies and that there is no need for any presentation alternatives for private companies.

Transition

BC413. The Board decided to require lessees and lessors to apply a modified retrospective transition approach for capital and operating leases (as defined in previous GAAP on leases) existing at or entered into after the beginning of the earliest comparative period presented in the financial statements. The modified retrospective transition approach in conjunction with the practical expedients provided will substantially reduce the cost and complexity of transitioning to Topic 842 for preparers (as compared with the proposals in the 2013 Exposure Draft), while not significantly reducing the quality of the information provided to financial statement users.

BC414. The modified retrospective transition approach will provide a relatively noncomplex method of transition at a reasonable cost, especially when compared with a full retrospective approach because, in general:

a. Lessees will not need to restate their prior statements of comprehensive income or cash flows or have them audited (if they elect the practical expedients). Lessees will solely need to recognize right-of-use assets and lease liabilities at each prior reporting date presented in the financial statements (which, for private companies will generally only be one prior balance sheet). Lessees already should have most of the data necessary to do this based on their prior-period prepaid/accrued rent balances and

information maintained for their lease maturity table disclosure. This information was required to apply the leases guidance in previous GAAP.

b. Lessees will not need significant new systems capabilities to apply Topic 842, which means that lessees will not have to invest in or implement those systems.
c. Lessees will not need to, for example, load thousands of leases into a fixed asset or other system to apply operating lease accounting for most leases.

Because of the nature of the modified retrospective transition approach, the Board decided not to provide any transition alternatives for private companies. The Board concluded that, absent providing a purely prospective transition method, it cannot provide any further transition relief than that resulting from the modified retrospective method and the practical expedients that apply or are available to all entities. The Board's decision is consistent with the guidance in paragraphs 5.1–5.7 in Chapter 5, "Determining the Transition Method for Applying Guidance," of the Private Company Decision-Making Framework.

Consequential Amendments

Business Combinations

BC415. The Board decided that when the acquiree in a business combination is a lessee, the acquirer should measure the acquiree's lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the date of acquisition. Measuring the acquired lease as if it were a new lease at the date of acquisition includes undertaking a reassessment of all of the following:

a. The lease term
b. Any lessee options to purchase the underlying asset
c. Lease payments (for example, amounts probable of being owed by the lessee under a residual value guarantee)
d. The discount rate for the lease.

The acquiree's right-of-use asset should be measured at the amount of the lease liability, adjusted for any off-market terms (that is, favorable or unfavorable terms) present in the lease. Prepaid or accrued rent should not be recognized because such amounts do not meet the definition of an asset or a liability in Concepts Statement 6 under the acquisition method of Topic 805, Business Combinations. Instead, the remaining lease payments required under the terms of the lease are considered in evaluating whether the terms of the lease are favorable or unfavorable at the acquisition date.

BC416. The Board considered whether an acquirer should be required to follow the general principle in Topic 805 and measure the acquiree's right-of-use assets and lease liabilities at fair value on the date of acquisition. However, the Board

decided that the benefits associated with measuring lease assets and lease liabilities at fair value will not justify the costs because obtaining fair value information—particularly for the right-of-use asset—might be difficult and, thus, costly. The Board also noted that when the acquiree is a lessee, the guidance on the measurement of lease assets and lease liabilities will result in recognizing a net carrying amount for the lease at the date of acquisition that approximates the fair value of the lease at that date.

BC417. The Board decided that when the acquiree in a business combination is a lessor of sales-type or direct financing leases, an acquirer should recognize the acquiree's net investment in the lease on the basis of the present value of the remaining lease payments and the residual value of the underlying asset. The residual value is determined as the difference between the fair value of the underlying asset at the date of acquisition and the present value of the remaining lease payments. The portion of the residual value of the underlying asset that is guaranteed and the present value of the remaining lease payments are included in the lease receivable. The remaining portion of the residual value of the underlying asset is the unguaranteed residual asset. The Board considered requiring the measurement of the net investment in the lease and its components—both the lease receivable and the unguaranteed residual asset—at fair value at the date of acquisition. However, the Board noted that there will be costs associated with measuring each of those assets at fair value and that it had decided not to require such a measurement basis for the lease receivable and the unguaranteed residual asset more generally because of those costs. Although the proposed initial measurement of the lease receivable and the unguaranteed residual asset may not represent the fair value of those assets, the sum of the initial measurement of those assets (that is, the net investment in the lease) will equal the fair value of the underlying asset, which is consistent with the principles in Topic 805. Consequently, the Board concluded that the benefits of requiring an acquirer to measure the lease receivable and the unguaranteed residual asset at fair value will not justify the costs.

Comparison with IFRS 16, *Leases*

BC418. While Topic 842 and IFRS 16 are consistent in many areas, including, of most importance, the conclusion that all leases create assets and liabilities that should be recognized by lessees in the statement of financial position, there are a number of differences between them. The most important difference between Topic 842 and IFRS 16 is the lessee accounting model. Many but not all of the other differences between Topic 842 and IFRS 16 stem from the Boards' different decisions about the lessee accounting model. Some of the other key differences include gain or loss recognition in sale and leaseback transactions and when a lessor will recognize selling profit on some finance leases. There are some minor differences between Topic 842 and IFRS 16 in the accounting for foreign exchange, embedded derivatives, disclosures, business combinations, and transfer/transition of secured lease receivables. In addition, there are existing

differences in other areas of GAAP and IFRS that affect the accounting for leases including the existing requirements for impairment, the accounting for investment properties, and the revaluation of assets. The following paragraphs set out the main differences between Topic 842 and IFRS 16.

Lessee Accounting Model

BC419. Topic 842 and IFRS 16 include different lessee accounting models. Throughout the course of the leases project, the primary improvement envisioned for new leases guidance was the recognition of lease (right-of-use) assets and lease liabilities for those leases classified as operating leases in previous GAAP and IFRS. However, stakeholders of both the FASB and the IASB expressed concern that the Boards' earlier proposals (that is, in the 2010 and 2013 Exposure Drafts) would be costly to implement and complex to apply. Both Boards made significant changes to their earlier proposals in response to stakeholders' concerns about the cost of transitioning to and applying the new leases guidance, but those changes differed because the Boards' stakeholders provided significantly different feedback about the drivers of cost and complexity in the earlier proposals and what changes the Boards should make to address cost and complexity.

BC420. Topic 842 classifies leases as either finance or operating on the basis of a lease classification approach that is substantially similar to that in previous GAAP and previous IFRSs. This, combined with the recognition and subsequent measurement guidance applicable to lessees in Topic 842 for each type of lease, means that the effect of leases in the statement of comprehensive income and the statement of cash flows will be substantially the same as in previous GAAP and that most lessees will not have to implement significant new systems or processes to adopt the new guidance. The FASB's decisions on lease classification, as well as recognition and measurement for each type of lease, was significantly influenced by the following feedback from the FASB's stakeholders:

a. Determining lease classification, in a manner substantially similar to previous GAAP, would not be difficult and was not a significant area of cost or complexity in previous GAAP.
b. Retaining lease classification criteria substantially similar to that in previous GAAP, as well as recognition provisions of the nature included in Topic 842, would significantly reduce costs for U.S. preparers as compared with the previous proposals because it would preserve the alignment that existed in previous GAAP between GAAP and tax/regulatory reporting. Many U.S. stakeholders communicated that the Boards' earlier proposals would have broken that alignment and, therefore, required them to maintain multiple sets of books and records when they previously only maintained a single set.
c. The most significant cost of adopting new leases guidance on the basis of the Boards' previous proposals would be implementing new accounting systems (for example, to track and account for a significant number of new financial liabilities) and processes. Many U.S. stakeholders

communicated that a lessee accounting model of the nature included in Topic 842 would significantly reduce or eliminate those costs because lessees would be able to substantially retain their existing systems for tracking finance and operating leases (even if unsophisticated) and processes (that is, because the lease classification guidance is substantially the same and the effect of leases in the statement of comprehensive income and the statement of cash flows would be minimal).

BC421. IFRS 16 accounts for all leases in the same manner as finance leases, and, in addition to a lessee recognition and measurement exemption for short-term leases, it includes a similar lessee exemption for leases of "small assets" (that is, leases of underlying assets that are individually small, including being of low value, which the basis for conclusions in IFRS 16 indicates are assets of approximately $5,000 or less for all entities). Topic 842 does not include any recognition and measurement exemption for leases of small assets. In contrast to feedback received from U.S. stakeholders applying GAAP, the following feedback significantly influenced the IASB's decisions enacted in IFRS 16:

a. IFRS stakeholders generally communicated that eliminating lease classification would simplify the accounting for leases because it would remove a key area of judgment and eliminate the need to have a process for determining lease classification.
b. Many IFRS stakeholders stated that rather than retain a lease classification assessment, the concerns about implementing new systems and processes would be best addressed by exempting high-volume, low-dollar leases from the new recognition and measurement requirements. In this way, all significant leases would be accounted for in the same manner, but a lessee's systems and processes would, in effect, not need to be able to capture all of the lessee's leases. A lessee would continue to account for high-volume, low-dollar leases in the same manner as operating leases were accounted for in previous IFRS.
c. IFRS stakeholders generally did not comment on the effect of the leases proposals on tax or regulatory reporting. That is largely because IFRS stakeholders understand that IFRS is applied in numerous jurisdictions with different tax and regulatory reporting requirements such that it would be impossible to align IFRS with those disparate requirements.

BC422. There are other differences between Topic 842 and IFRS 16 that directly relate to the different decisions reached on the lessee accounting model.

Subleases

BC423. Topic 842 requires that when classifying a sublease, an intermediate lessor should determine the classification of the sublease with reference to the underlying asset and not with reference to the right-of-use asset arising from the head lease (for example, in classifying the sublease, the intermediate lessor would

evaluate whether the sublease is for a major part of the remaining economic life of the underlying asset, not the remaining term of the head lease). IFRS 16 requires an intermediate lessor to determine the classification of the sublease with reference to the right-of-use asset arising from the head lease. The Boards' different decisions in this regard stem largely from the differences in the lessee accounting model (that is, each Board considered the accounting effect that should result from a sublease in the context of accounting for the head lease). However, the Boards also differed on whether the same lease should be classified differently by a lessor solely because it is or is not a sublease. Under the approach in IFRS 16, a lessor might account for a lease as an operating lease, but an intermediate lessor entering into the same lease might account for the lease as a finance lease.

Presentation, Disclosure, and Transition

BC424. There are a number of differences in the presentation, disclosure, and transition requirements of Topic 842 and IFRS 16 that are primarily a consequence of the differences between the lessee accounting models.

Reassessment of Variable Lease Payments

BC425. IFRS 16 requires a lessee to reassess variable lease payments that depend on an index or a rate and, therefore, to remeasure the lease liability whenever there is a change in the contractual cash flows resulting from a change in the reference index or rate (for example, when a change in the Consumer Price Index takes effect under the contract). Topic 842 does not include this requirement; a lessee will only reassess variable lease payments that depend on an index or rate when the lease liability is remeasured for another reason independent of a change in a reference index or rate (for example, because of a change in the lease term). While the IASB decided that the requirements in IFRS 16 will more accurately reflect the lessee's lease liability throughout the lease term, the FASB decided that the benefits of reassessing variable lease payments that depend on an index or a rate and remeasuring the lease liability correspondingly would not justify the costs.

Lessor Accounting

BC426. The lessor accounting models in Topic 842 and IFRS 16 are substantially converged. However, some differences exist. Because both Boards decided to substantially retain the lessor accounting models in previous GAAP and IFRS, respectively, many of the relatively minor differences that existed between previous GAAP and IFRS exist between Topic 842 and IFRS 16. In addition to those differences, some additional differences resulted from the FASB's decision to align certain aspects of the lessor accounting guidance and the revenue recognition guidance in Topic 606, while the IASB decided that it wanted to change the lessor accounting guidance in previous IFRS as little as possible, even if that meant there were potential differences between the lessor accounting guidance in IFRS 16 and the revenue recognition guidance in IFRS 15.

Recognition of Selling Profit for Direct Financing Leases

BC427. Topic 842 precludes the recognition of any selling profit on direct financing leases. Selling profit, if any, is deferred at lease commencement and recognized as additional interest income over the lease term. IFRS 16 does not differentiate between sales-type and direct financing leases; all such leases are classified as finance leases. Consequently, any selling profit on leases accounted for under IFRS 16 that would be classified as direct financing leases in accordance with Topic 842 is recognized at lease commencement. The FASB concluded that recognizing selling profit at lease commencement for direct financing leases would be inconsistent with the sale guidance in Topic 606. Because selling profit is infrequent in direct financing leases, this difference between Topic 842 and IFRS 16 is not expected to significantly affect comparability between lessors applying GAAP and those applying IFRS.

Collectibility

BC428. Topic 842 includes explicit guidance about the effect on a lessor's accounting for a lease if collectibility of the lease payments is not probable. This guidance affects both recognition and lease classification. IFRS 16 does not include any explicit collectibility guidance. The FASB decided that explicit guidance on collectibility should be included in Topic 842 both (a) to align the collectibility guidance for sales-type leases with that for outright sales in Topic 606 and (b) because previous GAAP on lessor accounting included similar collectibility guidance to that in Topic 842. Previous IFRSs, in contrast, did not include collectibility guidance for lessors. As a result, the IASB decided that it was not necessary to include collectibility guidance specific to lessors in IFRS 16.

Modifications of Sales-Type and Direct Financing Leases

BC429. Previous GAAP and IFRS have significantly different models for accounting for lease modifications. Previous IFRS relied on the financial instruments guidance to account for modifications to finance leases (that is, those leases that would, in general, be classified as sales-type or direct financing leases in Topic 842) because the lessor's lease receivable in those leases is a financial asset. In keeping with the IASB's decision not to change the previous lessor accounting guidance, the IASB decided to retain the requirement that a lessor account for modifications to finance leases. The FASB, in contrast, decided that the guidance applicable to lessors for modifications, regardless of the classification of the original lease, should be similar to that in the revenue recognition guidance in Topic 606. The FASB decided it is preferable to have (a) similar modifications guidance for lessors and sellers of goods and services because many leasing contracts also include nonlease components and (b) similar guidance for lease modifications regardless of the classification of the original lease. In addition, the FASB concluded that the financial instruments guidance in GAAP would be more complex to apply than the modifications guidance in Topic 842 and, in any event, would not result in converged outcomes with IFRS because the financial

instruments guidance in GAAP is different from the financial instruments guidance in IFRS.

Sale and Leaseback Transactions

BC430. In a sale and leaseback transaction, Topic 842 requires a seller-lessee to account for any gain or loss on the sale of the asset consistently with the guidance that would apply to any other sale of the underlying asset. That is consistent with the Board's view that the right-of-use asset conveyed to a lessee in a lease is separate and distinct from the underlying asset itself (that is, the seller-lessee sells the entire underlying asset and then obtains a separate and distinct right-of-use asset as a result of the lease). In contrast, IFRS 16 requires a seller-lessee to recognize only the amount of any gain on sale that relates to the rights retained in the underlying asset at the end of the leaseback. The IASB concluded that from an economic standpoint, the seller-lessee has sold only a portion of the underlying asset (that is, its interest in the residual value of the underlying asset at the end of the leaseback); it has retained that portion of the underlying asset embodied in the right to use the asset for the duration of the leaseback.

Accounting for All Entities Other Than Public Business Entities

BC431. Topic 842 permits an accounting policy election for private companies to use a risk-free rate to discount the lease liability. IFRS 16 does not provide any accounting alternatives for private companies. IFRS maintains separate accounting standards for small and medium-sized entities and, therefore, does not include different accounting requirements for small and medium-sized entities within its standards applicable to entities that are not small or medium-sized entities.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). Those changes, which will be incorporated into the proposed 2017 Taxonomy, are available for public comment through ASU Taxonomy Changes provided at www.fasb.org, and finalized as part of the annual release process.