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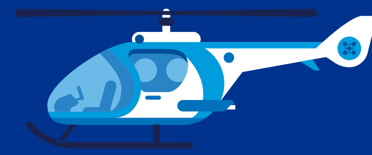

Defining Issues®

FASB proposes clarifications and technical corrections to the new leases standard

September 27, 2017

KPMG reports on the FASB's proposed ASUs on land easements[1] and corrections to the new leases standard.[2]

Applicability

Proposed ASU – land easements

Companies with land easements, particularly in the energy, utilities, transportation and telecom industries.

Proposed ASU – technical corrections

All companies within the scope of the new leases standard. [3]

Key facts and impacts

The proposed ASU on **land easements** would clarify that land easements are within the scope of the new leases standard. It also would provide a practical expedient to not assess at transition whether a land easement would meet the definition of a lease if a company had not previously evaluated whether it would be a lease under current US GAAP.[4]

The other proposed ASU includes 16 **technical corrections** to the new standard and other accounting topics. The technical corrections address issues raised by constituents and alleviate unintended consequences from applying the new guidance. The proposed ASU on technical corrections does not change core principles of the new standard, nor is it expected to significantly affect application of the new standard or require significant, additional costs to implement.

Proposed ASU – land easements

A land easement is, in general, a right to use and/or enter (or cross) land owned by another party for a specific purpose. Common examples of land easements include those used to convey space for electricity and telephone poles and wires, railways, access roads and oil and natural gas pipelines. Land easements may be perpetual or for a defined term, may be prepaid or paid for over time, and may provide for exclusive or nonexclusive (i.e. shared) use of the land.

There is significant diversity in practice in current US GAAP related to accounting for land easements. For example, some land easements are accounted for as the acquisition of land, particularly if they are perpetual or for a very long term such as 99 years. Others are accounted for as an acquired intangible asset, an executory contract or as a lease of the underlying land.

The proposed ASU would specify that land easements – as a right to use land – are within the scope of the new leases standard and should

[1] Proposed ASU, Land Easement Practical Expedient for Transition to Topic 842, issued September 25, 2017

[2] Proposed ASU, Technical Corrections and Improvements to Recently Issued Standards - Part II: Accounting Standards Update No. 2016-02, Leases (Topic 842), issued September 27, 2017

[3] ASC 842, Leases

[4] ASC 840, Leases

be analyzed to determine if they meet the new definition of a lease. If a company determines that the land easement is not a lease, only then should it apply other guidance (e.g. the guidance on intangible assets).

Some of the diversity in practice was caused by an example in the intangibles guidance that characterized certain perpetual land easements as intangible assets.[5] The proposed ASU would amend that example to clarify that those land easements were accounted for as intangible assets only after first determining that they did not meet the definition of a lease.

The proposed ASU also includes an optional practical expedient that would permit a company at transition to *not* assess whether expired or existing land easements are or contain leases that they had not previously assessed to determine whether they were or contained a lease under the current lease accounting guidance. This practical expedient would be available individually, or in conjunction with either or both of the existing transition practical expedients in the new standard – i.e. the 'package of practical expedients' and the use of hindsight.[6]

During transition, a company should continue to consistently account for contracts entered into before the effective date of the new standard by following its existing policies. This applies to existing land easements as well as new arrangements that might be entered into before a company adopts the new standard. For example, a new ground lease agreement (that could be characterized as a land easement) would not be eligible for the practical expedient if similar ground leases had been accounted for as within the scope of the current lease accounting guidance.

Any departure from a company's current accounting policy would be subject to the guidance on accounting changes.[7]

KPMG observation

The FASB decided to provide optional transition relief because many constituents said that it was not clear whether land easements were within the scope of the current leasing guidance in ASC 840. As a result, companies had not assessed whether their existing land easements met the current definition of a lease.

Constituents said that they may have thousands of land easements, some of which are nearly 100 years old. Those constituents stated that, consequently, it would be very difficult to evaluate all of their existing land easements under current US GAAP, which they would have to do in transition, even if electing the transition package of practical expedients. Many of those constituents further asserted that the effort may yield little financial reporting benefits because a significant portion of their easements would not be expected to meet the definition of a lease (see Questions 3.1.10, 3.2.20 and 3.3.90 of KPMG's Handbook, Leases).

Proposed ASU – technical corrections

In this section, we discuss six of the proposed technical corrections and list the ten others. The proposed amendments are not expected to significantly affect application, or change any of the core principles, of the new leases standard.

Rate implicit in the lease

The proposed ASU would clarify that the 'rate implicit in the lease' cannot be less than zero. If the rate implicit in the lease would be negative, a rate of zero should be used. A lessor should not, instead, use another discount rate such as the lessee's incremental borrowing rate or a rate that estimates the variable lease payments. For more information on the rate implicit in the lease, see Section 5.6.1 of KPMG's Handbook, Leases.

[5] ASC 350-30, General Intangibles Other than Goodwill, and Example 10 in ASC 350-30-55-29 – 55-32

[6] For further information on the existing transition practical expedients, see Section 13.2.3 of KPMG's Handbook, Leases

[7] ASC 250, Accounting Changes and Error Corrections

KPMG observation

Under the new standard, a lease for which the payments are mostly or entirely variable (e.g. based on production or use of the asset) can be classified as a sales-type lease if, for example, the lease term is for a major part of the remaining economic life of the asset or the asset is highly specialized.

For sales-type leases with significant variable lease payments, the undiscounted sum of the:

— lease payments; and
— estimated residual value of the underlying asset at the end of the lease term

may be less than the underlying asset's fair value.

Therefore, applying the existing definition of 'rate implicit in the lease' in the new standard could result in a negative implicit rate. The rate implicit in the lease would have to be negative for the aggregate present value of the:

— lease payments; and
— amount that a lessor expects to derive from the underlying asset following the end of the lease term

to equal the sum of (a) the fair value of the underlying asset minus related investment tax credits retained and expected to be realized by the lessor and (b) deferred initial direct costs of the lessor.

The proposed ASU's requirement to use an implicit rate of no less than zero may result in the net investment in a sales-type lease for which the payments are mostly or entirely variable being substantially less than the carrying amount of the underlying asset that must be derecognized at lease commencement. This could result in a significant 'day one loss' even for a lease arrangement that is expected to be profitable. It is to avoid this day one loss that some constituents suggested it might be appropriate to use a negative implicit rate, which would be prohibited by the proposed ASU.

Example: Effect of significant variable lease payments on the rate implicit in the lease

Assume the following for a 4-year equipment lease:

— variable lease payments: 3% of Lessee's monthly sales of units produced using the machine;
— lease term: 4 years;
— remaining economic life: 5 years;
— fair value of equipment: $20,000;
— carrying amount of equipment: $20,000; and
— estimated residual value at end of lease term: $2,000.

Lessor classifies the lease as a sales-type lease, even though all of the payments for the lease are variable, because the lease term is for a major part of the remaining economic life of the machine.

Lessor is unable to calculate a rate implicit in the lease that is greater than zero because the sum of (1) the lease payments (which are $0 because all of the payments for the lease are variable) and (2) the estimated residual value of the machine at the end of the lease term ($2,000) is less than the fair value of the underlying asset at the lease commencement date.

Consistent with the guidance in the proposed ASU, Lessor uses a 0% discount rate and records a commencement date loss of $18,000, which is the sum of the lease payments less the net of the carrying amount of the equipment and the unguaranteed residual asset amount. Because the discount rate is 0%, Lessor will not recognize any interest income from accretion of the unguaranteed residual asset during the lease term.

Example 7.3.30 of KPMG's Handbook, Leases, includes two expanded, additional scenarios demonstrating how to apply this zero discount rate guidance.

Impairment of net investment in the lease

A lessor assesses its entire net investment in the lease for impairment and recognizes impairment losses using the impairment guidance for financial instruments.[8] When determining the loss allowance for a net investment in the lease, the lessor considers the collateral relating to the net investment in the lease.

The proposed ASU would clarify that the collateral to be considered includes both the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (e.g. from the sale of the asset or the re-lease of the asset for the remainder of the term), as well as an expected lump-sum payment related to the residual value of the asset at the end of the lease term.

The existing guidance in the new standard – i.e. prior to the proposed ASU – limits the consideration of the collateral related to the net investment in the lease solely to the cash flows expected to be derived from the asset during the lease term. Further, it "excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term).[9]

Because a lessor assesses the entire net investment in the lease for impairment, which should include the guaranteed or unguaranteed residual value of the underlying asset, excluding the expected cash flows following the lease term could result in improper measurement of the loss allowance.

For more information on assessing impairment of the net investment in the lease, see Section 7.3.2 of KPMG's Handbook, Leases.

Recognition of transition adjustments

The proposed ASU would clarify that certain transition adjustments should be recognized in one of the comparative period income statements and not recognized as an adjustment to equity.

For example, if a company does not elect the package of transition practical expedients, the write-off of lease origination costs that do not meet the new standard's definition of 'initial direct costs' should be recognized as an adjustment to equity *only* if the costs were incurred before the date of initial application.

In contrast, the write-off should be recognized as an adjustment to profit and loss in the period the costs were incurred if they were incurred on or after the date of initial application.

For more information on transition, see Section 13 of KPMG's Handbook, Leases.

Variable lease payments that depend on an index or a rate

The resolution of a contingency on which some or all future variable lease payments are based may result in those payments prospectively meeting the definition of lease payments. For example, if the payments for Years 2-10 of a retail store lease are based on 10 percent of Year 1 retail store sales, at the end of Year 1 the lease payments for Years 2-10 become fixed payments. In this scenario, a remeasurement of the lease payments is required.[10]

The guidance on the resolution of contingencies was not intended to apply to variable lease payments that depend on an index or rate. For example, even when the periodic lease payments increase based on the change in the Consumer Price Index (CPI), and the lease specifies that the periodic lease payments will never decrease after they have increased (i.e. even if CPI decreases), the proposed ASU would clarify that the payment increase linked to the change in CPI is not captured by this contingency resolution guidance. Variable lease payments that depend on an index or rate are only remeasured when the lease payments are remeasured for another reason unrelated to a change in a reference index or rate (e.g. a change in the lease term).

The proposed ASU would clarify that the contingency resolution guidance applies only to variable lease payments that do *not* depend on an index or a rate (e.g. those related to usage or performance of the underlying asset). For more information, see Question 5.4.50 and Example 5.4.20 of KPMG's Handbook, Leases.

8 ASU 2016-13, Measurement of Credit Losses on Financial Instruments

9 ASC 842-30-35-3

10 ASC 842-10-35-4(b)

Lessee reassessment of lease classification

The proposed ASU would clarify that a company should reassess lease classification based on the facts and circumstances (and the modified terms and conditions, if applicable) as of the date a reassessment is required (for lessees only) or as of the effective date of a modification that was not accounted for as a separate contract (lessees and lessors). This change reflects feedback from some constituents that the Board's intention was not clear that all lease classification reassessments, whether because of a lessee reassessment or a lease modification, be based on current facts and circumstances (e.g. then-current fair value of the underlying asset).

For more information on lessee reassessments, lessee lease modifications and lessor lease modifications, see Section 6.6, Section 6.7 and Section 7.6 of KPMG's Handbook, Leases.

Lessor reassessment of lease term and purchase options

The proposed ASU would clarify that the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset should be accounted for as a lease modification only if the option was not already factored into the lessor's accounting. For example, modification accounting would only be required when the period covered by the lessee renewal option was not already included in the lessor's determination of 'lease term' or the lessee's expected exercise of a purchase option was not already factored into the lease classification and measurement of the lessor's net investment in the lease.

The FASB did not intend for a lessor to account for the exercise of a lessee extension, termination or purchase option that was already factored into the lessor's accounting as a lease modification. For more information on lessor accounting for lease modifications, see Section 7.6 of KPMG's Handbook, Leases.

Other amendments in the proposed ASU	
Residual value guarantees	Would correct a reference about guarantees by a seller-lessee of the underlying asset's residual value in a sale and leaseback transaction.[11]
Investment tax credits	Investment tax credits would reduce the fair value of the underlying asset when determining lease classification.
Lease term and lessor termination option	A period covered by a lessor-controlled option to terminate a lease would be an input to the determination of the lease term and does not affect the noncancellable period of the lease.
Amounts previously recognized in business combinations	The transition guidance provided to lessors for assets or liabilities recognized under accounting guidance for business combinations would apply to leases classified as sales-type and direct-financing leases under the new standard rather than those classified as sales-type or direct-financing leases under current US GAAP.[12]
Transition guidance for leases previously classified as capital leases	Would correct a reference in transition guidance about subsequent measurement of the lease that occurs before the effective date of the new standard.[13]

[11] ASC 460-10-60-32

[12] ASC 842-10-65-1(h)(3) for assets or liabilities recognized under ASC 805, Business Combinations

[13] ASC 842-10-65-1(r)(4)

Other amendments in the proposed ASU	
Transition guidance for modifications to leases previously classified as direct financing or sales-type leases	The transition guidance would be applied based on how the lease was classified before it was modified.[14]
Transition guidance for sale and leaseback transactions	The transition guidance on sale and leaseback transactions would apply to all transactions occurring before the effective date of the new standard and would correct references.[15]
Unguaranteed residual asset	Consistent with current US GAAP, a lessor should cease accretion of an unguaranteed residual asset to the extent that it sells at least substantially all of the lease receivable associated with a sales-type or direct-financing lease.
Effect of initial direct costs on the rate implicit in the lease	Would more clearly align the illustration in Example 1 of the lessor accounting implementation guidance with the guidance describing how initial direct costs factor into the determination of the rate implicit in the lease for the lessor's classification of the lease[16]
Failed sale and leaseback transaction	Would specify that a seller-lessee in a failed sale and leaseback transaction should adjust the interest rate on its financial liability to ensure that the interest on the financial liability does not exceed the *total* payments on the financial liability (rather than solely the *principal* payments).

Effective dates and transition

Both proposed ASUs have the same effective date and transition guidance. Because the new lease standard is not yet effective, the proposed ASUs would coincide with the effective dates and transition when the company adopts the new standard. The guidance would be effective for companies that **have early adopted** the new standard on the final ASUs' issuance, and would follow the new standard's transition guidance.

Next steps

Comments on the proposed ASU on land easements are due October 25, 2017. Comments on the proposed technical corrections ASU are due November 13, 2017.

[14] ASC 842-10-65-1(x)(4)

[15] ASC 842-10-65-1(aa) through (ee)

[16] ASC 842-30-55-31 – 55-39 and ASC 842-10-25-4

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KPMG's Financial Reporting View

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