

Board Meeting Handout
Distinguishing Liabilities from Equity (Including Convertible Debt)
February 13, 2019

Meeting Purpose

1. At the September 20, 2017 meeting, the Board added a project to its agenda to improve the understandability and operability of the guidance and reduce the complexity (without loss information for users) of the liabilities and equity guidance. The project's scope includes guidance on indexation and settlement (in the context of the derivative scope exception), convertible instruments, disclosures, and earnings per share (EPS).
2. The February 13, 2019 Board meeting is a decision-making meeting to deliberate the following topics (which were previously discussed in a non-decision-making educational Board meeting on January 30, 2019):
 - a. Disclosures for convertible instruments
 - b. Improvements to the derivatives scope exception
 - c. Disclosures for contracts in an entity's own equity that meet the derivatives scope exception
 - d. EPS.

Questions for the Board

Convertible Instruments Disclosures

1. Does the Board want to make the following disclosure improvements, as recommended by the staff to (a) add a disclosure objective, (b) amend guidance related to certain terms and features (events or changes in conditions that significantly affect conversion conditions, which party controls the conversion option, and alignment in disclosure guidance between contingently convertible instruments and other convertible instruments), (c) amend the fair value disclosure guidance under Subtopic 825-10, Financial Instruments—Overall, for convertible instruments by requiring information be disclosed at the individual instrument level, and (d) centralize the guidance?

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2. Does the Board want to improve the format of certain disclosures related to convertible instruments: (a) basic information, such as principal amount, coupon rate, unamortized issuance cost and discount, net carrying amount, fair value amount, and maturity date at the instrument level, (b) interest expense and amortization of the discount and issuance cost, and (c) long-term debt (including convertible debt) maturities and sinking fund requirements? If yes, would the Board like to explicitly require tabular format (Alternative A) or only include a tabular format disclosure as an illustrative example in the implementation guidance (Alternative B)?

Derivatives Scope Exception

3. Which package of improvements do Board members prefer for improvements to the indexation and settlement criteria (Alternative A or Alternative B)?

4. When would the Board like an entity to reassess whether a contract meets the derivative scope exception—at set time intervals (Alternative A) or upon trigger events (Alternative B)? If the Board prefers Alternative A, should the reassessment be required at each reporting date or at annual reporting dates?

5. Does the Board want to make the following disclosure improvements in Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity, as recommended by the staff in Board Memo 18: (a) add a disclosure objective, (b) clarify scope, and (c) require disclosure about terms and features that could trigger reclassification?

6. Would Board members like to require disclosures about the fair value of instruments classified in equity? If so, what should be the scope of the disclosures? What information would Board members like to require (that is, amount, technique, inputs, and so on)?

EPS

7. Does the Board want to require the if-converted method (as suggested to be amended in Memo 19) be applied to all convertible instruments and does the Board want to make a technical correction to paragraph 260-10-55-34 (regarding year-to-date share calculations)?

8. For a contract that may be settled in either cash or shares, would the Board like to remove an entity's ability to overcome the presumption about share settlement?

9. Would the Board like to add a project to the research agenda about including antidilutive instruments in EPS calculations, which was discussed at the November

2018 IAC meeting? If yes, would the Board like to defer disclosure amendments to the research project or address disclosure improvements as part of this project (Alternative A: amend existing disclosures in Topic 815, Derivatives and Hedging, and Topic 505, Equity, or Alternative B: add new disclosure requirement to Topic 260, Earnings Per Share)?

Disclosures for Convertible Instruments

3. The current disclosure guidance on convertible instruments (including convertible debt and convertible preferred shares) is contained in several Codification Subtopics. The staff reviewed the disclosure guidance on convertible instruments in those Subtopics and noted that the required disclosures could be analyzed in three main categories: terms and features, fair value, and accounting impact.
4. On the basis of the staff's research and stakeholders' feedback, the staff identified the following potential improvements for the Board's consideration.
 - a. **Disclosure Objective**—Add disclosure objective for convertible debt and convertible preferred shares.
 - b. **Terms and Features:**
 - i. Add a disclosure about events or changes in conditions/circumstances that occur during the reporting period and significantly affect the conversion conditions.
 - ii. Include a disclosure identifying who controls the conversion option in the list of examples that should be disclosed for pertinent rights and privileges of the various securities outstanding under paragraph 505-10-50-3.
 - iii. Align the disclosure requirements for contingently convertible instruments and other convertible instruments with certain disclosures specifically for contingently convertible instruments.
 - c. **Fair Value**—Amend the guidance in Subtopic 825-10 (which applies to public business entities) to require that the information about fair value and leveling of convertible instruments be disclosed at the individual instrument level together with the related carrying amount.
 - d. **Guidance Organization**—Centralize guidance on convertible debt in Subtopic 470-20, Debt—Debt with Conversion and Other Options, and guidance on convertible preferred shares in Topic 505.

- e. **Accounting Impact**—Improve the format of disclosing certain quantitative information about convertible instruments, including (i) a table for basic information, such as principal amount, coupon rate, unamortized issuance cost and discount, net carrying amount, fair value amount, and maturity date at instrument level; (ii) a table for interest expense recognized for the period relating to both the contractual interest coupon and amortization of the discount and issuance cost; and (iii) a table for long-term debt (including convertible debt) maturities and sinking fund requirements for each of the five years following the date of the latest balance sheet presented. Improvements could be made by explicitly requiring a tabular format (Alternative A) or by including a tabular format disclosure as an illustrative example in the implementation guidance (Alternative B).

Improvements to the Derivatives Scope Exception

- 5. Under Section 815-40-15, Derivatives and Hedging—Contracts in Entity’s Own Equity—Scope and Scope Exceptions, an entity must determine whether a contract meets a scope exception from derivative accounting. The guidance must be applied to:
 - a. Freestanding financial instruments or embedded features that have all the characteristics of a derivative instrument
 - b. Freestanding financial instruments that potentially are settled in an entity’s own stock, regardless of whether the instrument has all the characteristics of a derivative instrument.
- 6. The analysis to determine whether a contract meets this scope exception within Subtopic 815-40 includes two criteria, which often are referred to in practice by their pre-Codification standards, as follows:
 - a. The contract is indexed to the entity’s own stock (EITF Issue No. 07-5, “Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity’s Own Stock,” or the “indexation criterion”)
 - b. The contract is equity classified (EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” or the equity classification or “settlement criterion”).
- 7. If both above criteria are not met, the contract must be accounted for as a derivative asset or liability. For hybrid instruments, this means that the embedded feature (which is referred to as an embedded derivative) must be bifurcated and accounted for separately from its host instrument under Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives. If the above criteria are both met for a freestanding instrument, it is equity classified and is not

accounted for as a derivative instrument and if the above criteria are both met for an embedded feature, it would not be separated from the host contract.

8. The staff has received feedback that stakeholders have difficulty applying the guidance for the exception to derivative accounting because of its sheer volume and lack of organization, as well as that the guidance is rules-based, internally inconsistent, and often results in form-over-substance accounting.

Indexation and Settlement Criteria

9. The staff has identified two alternative packages of improvements for the Board's consideration based on views expressed at that meeting, as follows:

Alternative A

Indexation—Path 1: Layer a Probability Threshold to Existing Guidance—Retain all existing guidance but remove the requirement that an entity evaluate a potential adjustment that is remote in occurring (or similar likelihood threshold). Under this path, an entity would be able to screen out any settlement adjustments that are considered remote of occurring (or similar probability threshold) and not evaluate those adjustments under the guidance in Section 815-40-15.

Settlement—Package of Four Improvements (1) introduce a likelihood threshold, (2) remove the condition regarding settlement in unregistered shares (paragraph 815-40-25-10(a)), (3) remove collateral condition (paragraph 815-40-25-10(g)), and (4) remove shareholder rights condition (paragraph 815-40-25-10(f)).

Alternative B

Indexation—Path 2: Standard Antidilution—A contract that an entity must or may settle by issuing a fixed number of its equity shares at a fixed price would be considered indexed to an entity's own stock (for example, a share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price would be considered indexed to the entity's stock). If the number of shares or the contract's strike price used to calculate the monetary value (that is, the settlement amount) is not fixed, the contract would still be considered indexed to an entity's own stock if the settlement amount is variable because of standard antidilution provisions (as defined by the Codification).

Settlement—Remove the condition regarding settlement in unregistered shares (paragraph 815-40-25-10(a)).

Reassessment of the Derivatives Scope Exception

10. Under paragraphs 815-40-35-8 through 35-13, the classification of a contract in an entity's own equity should be reassessed at each balance sheet date or at the date of an event that caused the reclassification. That is, an entity must continually reassess whether the derivatives scope exception (indexation and settlement criteria) is met. This reassessment can result in reclassifications between asset/liability and equity. Currently, there is no limit on the number of times a contract may be reclassified.
11. The staff has identified the following alternatives for the Board's consideration for reassessments under Subtopic 815-40:

Alternative A—Reassess at Set Time Intervals:

- a. Reassess at each reporting date (Current guidance)
- b. Reassess at annual reporting dates.

Alternative B—Reassess Only on the Occurrence of a Triggering Event.

Disclosures for Contracts in an Entity's Own Equity That Meet the Derivatives Scope Exception

12. Depending on the Board's decisions on indexation and settlement, there will be a population of contracts (mostly contracts that were accounted for as derivatives because of their form and not because of their substance) that were previously accounted for as derivatives (marked to market through net income each period) but would now be accounted for as equity (not remeasured).
13. Improvements to disclosures can be categorized into two areas: (a) improvements to existing disclosures in Subtopic 815-40 and (b) fair value disclosures requirement for equity-classified instruments.
14. On the basis of the staff's research and stakeholders' feedback, the staff identified the following potential improvements to the existing disclosures in Subtopic 815-40, for the Board's consideration:
 - a. Consider adding a disclosure objective for instruments that are within the scope of Subtopic 815-40.
 - b. Clarify the scope of the disclosures in Subtopic 815-40.
 - c. Consider requiring disclosure under Section 815-40-50, Derivatives and Hedging—Contracts in Entity's Own Equity—Disclosure, of triggering events that could cause a reclassification.

15. In addition to research performed on the improvements above, the staff also performed research about fair value disclosures for equity-classified instruments.

EPS

16. The staff focused its analysis on Topic 260, Earnings per Share, on improvements related to the areas included in the overall project scope of (a) convertible instruments and (b) instruments that qualify for the derivatives scope exception for contracts in an entity's own equity in Subtopic 815-40.
17. The Board will discuss the following issues related to EPS:
 - a. Convertible Instruments: Diluted EPS for Instrument C (and Instrument X when an entity controls the settlement and has past experience or a stated policy of settling in cash) is currently calculated using the treasury stock method while diluted EPS for other convertible instruments is calculated using the if-converted method. Because the Board has decided to align the recognition and measurement guidance for convertible instruments, the Board will consider whether to align the diluted EPS calculation for convertible instruments.
 - b. Cash versus Share Settlement: Current GAAP includes a rebuttable presumption about share settlement when calculating diluted EPS when an entity controls the method of settlement. The Board will consider whether to remove an entity's ability to overcome that presumption.
 - c. Potential Research Project: At the November 2018 Investor Advisory Committee (IAC) meeting, some IAC members suggested that the Board add a project to its agenda to amend the EPS calculation. Oftentimes, entities have a strategy of issuing multiple instruments at or near the same time to manage the potential effects for dilution. For example, an entity may issue convertible debt with a purchased call option or other derivative transactions. In calculating diluted EPS, an entity includes the potential dilution from exercise of the conversion option but does not include the potential offset from the related hedge transactions because they are antidilutive. The request was for Board members to consider including in the diluted EPS calculation the antidilutive impact of call options and convertible note hedges that offset the dilution from convertible instruments. Some IAC members also suggested that if the Board is open to considering this topic for convertible instruments, then it would suggest looking at the impact of all antidilutive instruments and whether to amend the diluted EPS calculation.
 - d. Disclosures: Board members will discuss whether improvements should be made to disclosures, related to the transactions described in (c) above. If the Board decides to address disclosures as part of this project, the following alternatives will be discussed.

- i. Alternative A: Amend Topic 505 and Topic 815 disclosure requirements.
- ii. Alternative B: Amend Topic 260 disclosure requirements.

Board Meeting Handout
Segment Reporting
February 13, 2019

Meeting Purpose

1. The purpose of this meeting is to ask the Board if it wants to explore changes to how the management approach applies to the segment disclosure requirements in the 2019 segment disclosure study materials.
2. The Board has expressed a view that segment disclosures should be improved. One potential solution is to modify how the management approach applies to the segment disclosure requirements. This handout discusses three options for doing so.

Questions for the Board

1. Does the Board want to include Alternative 1 in the 2019 Disclosure Study?
2. Does the Board want to include Alternative 2 or Alternative 2* in the 2019 Disclosure Study?
3. Does the Board want to include Alternative 3 in the 2019 Disclosure Study?

Explanation of the Management Approach

3. In developing FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (now codified into Topic 280, Segment Reporting), the Board settled on the management approach as the methodology for determining what segment information to report. The management approach requires an entity to report segment information in the way that management internally organizes its segments to make operating decisions and assess performance. The principles underlying the management approach are applied the same way for segment identification, measurement, and disclosures.
4. This handout focuses on options that would modify how the management approach applies to *segment disclosures*. It does not consider changes to how the management approach relates to segment identification. Similarly, segment measurement is not discussed further in this handout.

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The Specific Aspects Underpinning the Management Approach

5. The literature identifies the following four principles underpinning the management approach:
 - a. **Chief operating decision maker (CODM)**—within the management hierarchy, segments are identified from the CODM perspective, segment amounts are measured on the amounts used by the CODM, and segment disclosures are reported if the CODM reviews those items.
 - b. **Regularly reviewed information**—segment information needs to be “regularly” reviewed or regularly provided to the CODM for the information to be part of the analysis for segment identification or disclosure by reportable segment. If information is reviewed on an irregular basis, it does not contribute to the analysis of the segment disclosure requirements.
 - c. **Allocates resources and assesses performance**—to meet the definition of an operating segment, management must both allocate resources and assess performance of that activity. That is, management must review a measure of segment profit or loss. In practice, this generally means a profitability measure such as gross margin, operating margin, or net income by segment. Revenue only or expense only information would not meet the definition of an operating segment.
 - d. **Segment manager**—a segment manager is accountable for the activities and results of a segment and maintains regular contact and discusses the results of the segment with the CODM.
6. This handout focuses on whether these four aspects of the management approach should be applied differently for segment disclosures than for segment identification.

Background

Current GAAP

7. Under current GAAP, the following pieces of information are required to be disclosed by reportable segment:

280-10-50-22 A public entity shall report a measure of profit or loss and total assets for each reportable segment. A public entity also shall disclose all of the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in that measure of segment profit or loss:

- a. Revenues from external customers
- b. Revenues from transactions with other operating segments of the same public entity
- c. Interest revenue
- d. Interest expense

- e. Depreciation, depletion, and amortization expense
- f. Unusual items as described in paragraph 220-20-45-1
- g. Equity in the net income of investees accounted for by the equity method
- h. Income tax expense or benefit
- i. Subparagraph superseded by Accounting Standards Update No. 2015-01
- j. Significant noncash items other than depreciation, depletion, and amortization expense.

280-10-50-25 A public entity shall disclose both of the following about each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the determination of segment assets:

- a. The amount of investment in equity method investees
- b. Total expenditures for additions to long-lived assets other than any of the following:
 - 1. Financial instruments
 - 2. Long-term customer relationships of a financial institution
 - 3. Mortgage and other servicing rights
 - 4. Deferred policy acquisition costs
 - 5. Deferred tax assets.

280-10-50-26 If no asset information is provided for a reportable segment, that fact and the reason therefore shall be disclosed.

- 8. To be clear, the items in paragraphs 280-10-50-22 and 280-10-50-25 (hereafter “the List”) will be disclosed only if either (a) the item is allocated segmentally and the CODM is regularly provided with those items or (b) those items are included within the measure of segment profit or loss or total assets reviewed by the CODM. This means that if an entity defines its segment profit as earnings before interest, income tax, depreciation, amortization, and nonrecurring items, then most of the items on the List would not be reported unless the CODM reviews them specifically.

Alternatives to Modify How the Management Approach Applies to the Segment Disclosure Requirements

- 9. As noted above, entities are required to provide certain disclosures by reportable segment if that selected information is regularly provided to the CODM or otherwise forms part of the measure of segment profit or loss or segment assets. This disclosure method causes frustration for investors who often comment that “someone in the organization must review this information.” In this section, three options are identified that could change or clarify the way the management approach applies to the segment disclosure requirements.

Alternative 1—Clarify the Meaning of “Regularly Reviewed Information”

- 10. Topic 280 permits judgment about what a public entity considers to be “regularly reviewed” or regular provided information to the CODM. Entities are often asked to explain which set

of information the CODM reviews and the frequency that information is provided. The staff believes that there are two distinct aspects to this issue—technology changes and occasional reporting.

Technology Changes—Report Format and Level of Detail

11. When the standard was issued in 1997, accounting systems were largely set up to provide hard copy reports for month or quarter end reporting. Since the standard's issuance, technological improvements mean that senior management can access a variety of segment information both in hard and soft copy formats.
12. The Board could clarify that regularly reviewed information should consider all forms of hard copy or soft copy reports regularly provided to the CODM, including information pulled or continuously accessed by the CODM. The staff doubts that clarifying the format of the reports as hard copy or soft copy would change behavior. The format of the internal reports is not an area of practice concern.
13. Technology changes have enabled reporting of performance at very low levels of detail. In the staff's view, the different levels of reports indicate a concern more with segment identification, which is outside the project's scope, and less so with the segment disclosure requirements. GAAP already includes a variety of factors to consider when determining which set of reports should be used as the basis for segment identification.

Occasional Reporting

14. In the 2018 aggregation study, the staff learned of several instances of public entities asserting that the CODM reviews certain segment information only on an irregular basis. Because that information is not "regularly" provided to the CODM, it is not required to be disclosed.
15. Under Alternative 1, the Board could clarify what is meant by regularly provided information as it relates to disclosing items on the List along the following lines:

For the purposes of evaluating the segment disclosure requirements in paragraph 280-10-50-22 and 50-25 and whether segment information is regularly provided to the CODM, the specified amounts are considered regularly reviewed by the CODM if:

- a. the segment information is used for resource allocation including periodic budgeting or planning decisions which may occur on an annual, quarterly or monthly basis; or
- b. the segment information is used for performance assessment including compensation and remuneration decisions which may occur on an annual, quarterly or monthly basis.

The information sets identified in (a) or (b) may be in addition to set monthly or quarterly reporting packages presented to the Board of Directors.

16. This clarification is intended to apply only to the segment disclosure requirements. It is not intended to apply to segment identification.

Alternative 2—Change the Perspective When Applying the Segment Disclosure Requirements

Segment Manager Perspective or Overseer of the Segment

17. Under this alternative, the Board could lower the perspective to the segment manager level when applying the disclosures in Topic 280, rather than the CODM level. That is, require the disclosures in paragraphs 280-10-50-22 and 280-10-50-25 to be reported if the specified amounts are included in the measure of segment profit or loss reviewed by the segment manager or are otherwise regularly provided to the segment manager, even if not included in that measure of segment profit or loss.
18. The staff learned during the 2018 aggregation study of circumstances in which entities do not have segment managers. Topic 280 does not require a segment manager to be present to justify the segment identification process. Therefore, under Alternative 2, if an operating segment does not have a segment manager, the perspective is applied from the management level that has responsibility for implementing the decisions or plans for the segment established by the CODM (segment overseer).
19. There are several operability challenges and follow-on issues with Alternative 2, including:
 - (a) Between the segment manager and the segment overseer, whose perspective applies when some of an entity's segments have managers and other segments do not? In other words, would a hybrid of perspectives involving the segment managers and segment overseers apply?
 - (b) Between the segment manager and the segment overseer, whose perspective of the items on the List applies when a segment manager is promoted or otherwise vacates his or her position during the year or at the reporting date and the new manager or overseer reviews a different set of information? Would restatement of prior period segment information be necessary?
 - (c) When a new segment manager or segment overseer replaces an existing segment manager or segment overseer during the reporting period, which perspective of the items on the List applies? Again, would a restatement of prior period segment information be necessary?

Alternative 2 *(Prime) —Persons That Directly Report to the CODM

20. A modification on Alternative 2 could lower the perspective to the persons that directly report to the CODM on segment matters when applying the disclosures in Topic 280 if no segment manager or segment overseer is identified.
21. Said differently, if there is no segment manager or overseer, the disclosures on the List are required to be reported if the specified amounts are included in the measure of segment profit or loss reviewed by the persons that directly report to the CODM on segment matters, such as the chief operating officer or chief financial officer.
22. Again, there are several operability challenges with this approach, including:
 - (a) Between the direct reports, which perspective applies when different direct reports discuss different segment matters with the CODM?
 - (b) Between a segment manager or direct report, whose perspective of the items on the List applies when a segment manager vacates his or her position during the year or at the reporting date?
 - (c) When a new direct report, such as a chief financial officer, replaces an existing direct report during the reporting period, which perspective of the items on the List applies?
 - (d) Which perspective applies when an entity reorganizes or restructures its operations?

Alternative 3—Pierce the Management Approach and Require the Disclosures to Be Reported by Segment

23. As noted previously, the standard requires disclosure of the items on the List if those specified amounts are regularly provided to the CODM or otherwise form part of the measure of segment profit or loss or segment assets. This disclosure method requires both (a) the item to be allocated segmentally and (b) regularly provided to the CODM or otherwise part of the profit and loss measure.
24. Under Alternative 3, the Board would pierce the management approach and (a) require all public entities to allocate the items in the List segmentally and (b) require that information to be reported segmentally regardless of whether the CODM reviews that information. The items on the List would not be required to be included within the measure of segment profit or loss; however, the items would be allocated segmentally.
25. This idea would be a very significant change to practice. Entities often do not allocate interest revenue, interest expense, or income taxes segmentally. Alternative 3 would require entities to do so. Again, entities would not be required to include interest revenue or expense or income tax expense within their measure of segment profit or loss.

Board Meeting Handout
Codification Improvements—Leases (Topic 842)
February 13, 2019

Memo Purpose

1. The February 13, 2019 meeting is a decision-making meeting. The purpose of the meeting is to discuss comments received from stakeholders and redeliberate key issues raised on the proposed Accounting Standards Update, *Leases (Topic 842): Codification Improvements*. The staff has provided the Board with a summary of the comments received on the proposed Update.

Questions for the Board

1. Does the Board want to affirm its decisions reached in the proposed Update for (a) determining the fair value of the underlying asset by lessors that are not manufacturers or dealers and (b) presentation on the statement of cash flows—sales-type and direct financing leases and finalize the amendments for those items? If not, what does the Board recommend?
2. Does the Board want to affirm its decisions about effective date and transition for the amendments? If not, what does the Board recommend?
3. Does the Board agree that no further action is required on the issues related to (a) lessor collectibility criteria, and (b) sublessor application of Update 2018-20? If not, what does the Board recommend?
4. Does the Board want to include a Codification improvement in the final Update to provide entities with an exception from the disclosure requirements in paragraph 250-10-50-3? If not, what does the Board recommend?
5. Has the Board received sufficient information and analysis to make an informed decision on the perceived costs of the changes? If not, what other information or analysis is needed?
6. Does the Board think that the benefits of the changes justify the perceived costs of the changes? If not, is there additional information that the Board needs to make that determination?

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7. Does the Board give the staff permission to draft a final Update for vote by written ballot?

Project Background

2. On February 25, 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases (Topic 842)*, to improve the financial reporting of leasing transactions. Since its issuance, the staff has been working with stakeholders to discuss various aspects of the standard for which questions have arisen.
3. The proposed Update provided Codification improvements to the lessor accounting guidance in Topic 842 for the following three issues:
 - (a) Issue 1: Determining the Fair Value of the Underlying Asset by Lessors That Are Not Manufacturers or Dealers
 - (b) Issue 2: Presentation on the Statement of Cash Flows—Sales-Type and Direct Financing Leases.
4. The proposed Update was issued for public comment on December 19, 2018, with the comment period ending on January 15, 2019. Eighteen comment letters were received on the proposed Update. Most respondents addressed all of the questions in the proposed Update. The following table provides information on the composition of the comment letter respondents by respondent type:

Type of Respondent	Number of Respondents
Preparers (Mainly Financial Institutions)	4
Practitioners	7
Preparer Groups	3
CPA Societies	2
Individuals	2
Total Respondents	18

5. All respondents supported reinstating the exception in Topic 842 for lessors that are not manufacturers or dealers to use their cost, reflecting any volume or trade discounts that may apply, as the fair value of the underlying asset (Issue 1). All respondents also supported the clarification that lessors that are depository and lending institutions within the scope of Topic 942, *Financial Services—Depository and Lending*, will classify all “principal payments received under leases” within investing activities (Issue 2).

Summary of Responses

Issue 1: Determining the Fair Value of the Underlying Asset by Lessors That Are Not Manufacturers or Dealers

Background

6. Topic 840, Leases, provides an explicit exception for lessors who are not manufacturers or dealers (generally financial institutions and captive finance companies) for determining fair value of the leased property (underlying asset under Topic 842). For those entities, fair value is ordinarily the underlying asset's cost, reflecting any volume or trade discounts that may apply, instead of fair value as defined in Topic 820, Fair Value Measurement. Topic 842 did not carry forward this exception. Therefore, lessors previously qualifying for the exception in Topic 840 would be required to apply the definition of fair value in Topic 820, which is defined as the price that would be received to sell the underlying asset in an orderly transaction between market participants at the measurement date (exit price). Those lessors are concerned that this change in determining fair value will not provide decision-useful financial information because, unlike current practice, acquisition costs (for example, sales taxes and delivery charges) would be expensed at lease commencement and subsequently "recovered" through increased interest income for sales-type and direct financing leases.
7. The amendments in the proposed Update reinstated the exception in Topic 842 for lessors that are not manufacturers or dealers. Specifically, those lessors would use their cost, reflecting any volume or trade discounts that may apply, as the fair value of the underlying asset. However, if a significant lapse of time occurs between the acquisition of the underlying asset and lease commencement, those lessors would be required to apply the definition of fair value (exit price) in Topic 820.
8. The proposed amendments added paragraph 842-30-55-17A, as follows:

842-30-55-17A Notwithstanding the definition of **{add glossary link to 2nd definition}fair value{add glossary link to 2nd definition}**, if a lessor is not a manufacturer or a dealer, **the fair value of the underlying asset at lease commencement is its cost, reflecting any volume or trade discounts that may apply. However, if there has been a significant lapse of time between the acquisition of the underlying asset and lease commencement, the definition of fair value shall be applied.**

Question 1: Should a lessor that is not a manufacturer or dealer establish fair value of the underlying asset as its cost, subject to any trade or volume discounts that apply (acknowledging that if a significant lapse of time occurs between the acquisition of the underlying asset and lease commencement, the definition of fair value must be used)? If not, please explain why.

9. All respondents answered this question and agreed with the proposed amendment to reinstate the exception in Topic 842 for lessors that are not manufacturers or dealers to use

their cost, reflecting any volume or trade discounts that may apply, as the fair value of the underlying asset.

Question 2: Are the amendments in this proposed Update operable? If not, please explain why.

10. The 17 respondents who answered this question agreed that the proposed amendment was operable as drafted.

Question 3: Would the proposed amendments result in a reduction of decision-useful information to users of financial statements? If so, please explain why.

11. The 16 respondents who answered this question stated their belief that they expected that application of the proposed amendment would not result in a reduction of decision-useful information.

Issue 2: Presentation on the Statement of Cash Flows—Sales-Type and Direct Financing Leases

Background

12. Topic 840 does not provide guidance on how cash received from leases by lessors from sales-type and direct financing leases should be presented in the cash flow statement. The Board was informed that lessors within the scope of Topic 942 have been presenting “principal payments received under leases” within investing activities on the basis of an illustrative example in Topic 942. Those lessors expressed a preference for continuing this presentation, which is consistent with the presentation of principal payments received on loans more generally. Topic 842 introduced guidance that requires all lessors to present all cash receipts from leases within operating activities. The illustrative example in Topic 942 was not eliminated when Topic 842 was issued. Consequently, conflicting guidance exists on the presentation of “principal payments received from leases” under sales-type and direct financing leases.
13. The amendments in this proposed Update addressed the concerns of lessors within the scope of Topic 942 about where “principal payments received under leases” should be presented. Specifically, lessors that are depository and lending institutions within the scope of Topic 942 would present all “principal payments received under leases” within investing activities.
14. The proposed amendment to paragraph 842-30-45-5 and the addition of paragraph 942-230-45-4 are as follows:

842-30-45-5 In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities. However, if the lessor is within the scope of Topic 942 on financial services—depository and lending, it shall follow the guidance in paragraph 942-230-45-4 for the presentation of principal payments received from leases.

942-230-45-4 Entities within the scope of this Subtopic shall classify principal payments received under sales-type and direct financing leases within investing activities.

Question 4: Should lessors that are depository and lending institutions present “principal payments received under sales-type leases and direct financing leases” in investing activities? If not, please explain why.

15. All respondents answered this question and agreed with the amendments in the proposed Update that would require lessors that are depository and lending institutions within the scope of Topic 942 to classify all “principal payments received under leases” within investing activities. One practitioner suggested that the Board consider a broader classification requirement based on the underlying nature of the transaction rather than based on the type of entities. That practitioner noted that there may be entities outside the scope of Topic 942 that acquire and subsequently lease assets for investment purposes and, as a result, would be required to classify cash receipts within operating activities.

Question 5: Are the proposed amendments operable? If not, please explain why.

16. The 17 respondents who answered this question agreed that the proposed amendment was operable as drafted.

Question 6: Would the proposed amendments result in a reduction of decision-useful information to users of financial statements? If so, please explain why.

17. The 16 respondents who answered this question stated their belief that they expected that application of the proposed amendment would not result in a reduction of decision-useful information.

Transition and Effective Date

Background

18. The amendments in this proposed Update would amend Topic 842. That Topic has different effective dates for public business entities and entities other than public business entities. The effective date of a final Update of these proposed amendments would be for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years for any of the following (entities within the scope of paragraph 842-10-65-1(a)):
- (a) A public business entity
 - (b) A 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

- (c) An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

- 19. For all other entities, the effective date would be for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.
- 20. Early application would be permitted. The proposed amendments would be applied at the date that an entity first applied Topic 842, using the same transition methodology in accordance with paragraph 842-10-65-1(c).

Question 7: Should the effective date for all lessors within the scope of the proposed amendments be for fiscal years beginning after December 15, 2019, with early application permitted? If no, what effective date should be established and why?

- 21. Sixteen of the 17 respondents who addressed this question agreed with the effective date requirements in the proposed Update. The respondent who disagreed with the proposal stated that the effective date should be the same as the standard itself to ensure consistent presentation for public companies for fiscal years 2019 and 2020.

Question 8: Should the proposed amendments be applied at the date that an entity first applied Topic 842 using the same transition methodology in accordance with paragraph 842-10-65-1(c)? If not, please explain why.

- 22. The 16 respondents who answered this question agreed with the transition requirements in the proposed Update.

Additional Issues Unrelated to the Proposed Update

- 23. The following three issues were raised in certain comment letters and are unrelated to the amendments in the proposed Update. The staff will analyze these issues in a separate paper and provide recommendations on how to address the issues.

Issue 1

- 24. A preparer group requested that the Board add to its agenda a project to amend the conditions in paragraph 842-30-25-3 to permit a lessor to recognize payments received from the lessee as revenue when the lessor has delivered the asset and is not required to deliver any further products or services to the lessee and the payments received are nonrefundable. This respondent believes that Topic 842 is not aligned with Topic 606, Revenue from Contracts with Customers, on this issue and states that “we see no reason why the two Topics should not be aligned as it relates to the recognition of payments received as revenue when the seller/lessor is unable to conclude that collectibility of the consideration expected to be received/lease payments is probable.”

Issue 2

25. A practitioner requested that the Board clarify whether the guidance in Accounting Standards Update No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, applies broadly to all variable payments related to lessor costs paid by lessees to third parties. This respondent stated that:

We believe the FASB should clarify whether or not it intended this guidance to be applied broadly (i.e., beyond variable payments related to insurance and taxes on the leased property). For example, questions have arisen in practice about whether a sublessor could apply the amendments in Update 2018-20 when, under the terms of a separately negotiated sublease contract, the sublessee makes variable payments based on its operations (e.g., variable payments based on a percentage of the sublessee's retail sales) directly to the head lessor. That is, it is unclear whether the FASB intended the exception to apply to the sublessor's lease accounting as a lessee.

Issue 3

26. In the Topic 842 transition requirements, paragraph 842-10-65-1(i) requires an entity to provide transition disclosures under Topic 250, Accounting Changes and Error Corrections, upon adoption of Topic 842, with the exception of the requirements in paragraph 250-10-50-1(b)(2). This paragraph otherwise would have required an entity to disclose in the fiscal period in which a change in accounting principle is made the effect of a change in accounting principle on income from continuing operations, net income, and other affected amounts for the current period. The fiscal period for the above disclosures is being considered the annual period.
27. Six practitioners and a preparer group noted that although paragraph 842-10-65-1(i) explicitly exempts entities from these disclosure requirements for annual periods, it does not explicitly exempt entities from the interim period transition disclosure requirements in paragraph 250-10-50-3, which are identical to those required by paragraph 250-10-50-1(b)(2). Those respondents expressed concern that entities could be required to provide these disclosures for the interim periods after adoption (for example, the first quarter of the adoption year) that they are not required to provide for the first full annual period after the date of adoption. Consequently, they requested that the Board clarify, preferably through a Codification amendment, whether its intent was to require these interim disclosures.