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December 15, 2010

Financial Accounting Standards Board
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File Reference No. 1850-100 Exposure Draft:
Leases (Topic 840)

Dear FASB:

I appreciate the references in the questions to the relevant parts of the proposed standard as well as the basis for conclusions. That was very helpful for developing useful comments. I did extensive exploration of the examples provided in the exposure draft (ED). Unfortunately, there weren't nearly enough examples so I created others comparable to the more extensive examples in the 2009 preliminary views document. Through many hours of effort devoted to developing an understanding of the ED, I have identified several substantive flaws summarized here. I have also answered the specific questions posed to respondents. Additional summary lists are included at the end of the letter.

The first major flaw I see in the proposed standard is the failure to discuss what one should do with a lease that has a title transfer or a bargain purchase option. These leases are outside the scope of the standard and yet face similar measurement problems with respect to interest rates, what payments to include in computing the financial obligation, etc. I presume the Boards were thinking that everyone already knows the current process for capitalizing a lease but that is a short-sighted approach. (I am, of course, assuming there is no intent to leave in all the current GAAP for leases just so folks will know what to do with a lease that has a title transfer or bargain purchase option or one of the long list of features in paragraph B31.) A decade or two from now, the standards will not be very useful without clearer guidance for these types of leases that are still (apparently) to be considered as the "actual" acquisition of long-term physical assets. Personally, I think the title transfer and bargain purchase option situations could be

covered by the derecognition method for lessors and an equivalent method "**acquisition method**" for lessees (discussed later in my comments under Question 4b and thoroughly described and illustrated in my Appendix 1.

The second problem I've identified is with the treatment of the lessor's residual values under the derecognition method. There is a built-in perverse incentive to always estimate the shortest possible lease term to maximize reported gross profit on a lease – yes, the profit actually changes and becomes different from what would have been recorded had we originally selected the actual lease term. One possible solution is to return to existing GAAP which estimates the fair value of the leased asset at its return date and includes this amount as though it were one of the cash flows for the computation of the lease payments receivable (which should be equal to the fair value of the asset being derecognized). This method works well if the treatment of guaranteed residual values is modified and lessors with a lease that has nontrivial unguaranteed residual values is required to use the performance obligation method. However, I've proposed another "allocation" method that is at least a bit more sensible than the one illustrated in ED Examples 4 & 5 (see my alternative "corrected" examples in Appendix A for an overview but the best explanation for my preferred approach is in Appendix 1). See the discussion primarily under Question 2b.

The third problem I've identified has to do with initial direct costs. I recommend a modest change to paragraph 33 so that the amortization method for initial direct costs of lessees and lessors using the performance obligation method would be the same. In other words, paragraph 33 should specify that the initial direct costs should be added to the **lease liability** which is amortized straight-line over the expected lease term. This would be equivalent to paragraph 12 where the initial direct costs are added to the lessee's right-to-use asset which is also amortized over the expected lease term (presumably straight-line or some other method available for the depreciation of buildings and equipment). This avoids the complication of having to determine a new implicit rate so that initial direct costs for the lessor can be amortized using the effective interest method (see my examples in Appendix B). For the derecognition method (paragraph 49), however, initial direct costs would have to be added to the lease payments receivable unless the Boards determine that immediate expensing (similar to current treatment of sales-type leases) would be acceptable. See the first paragraph under Question 2b.

My fourth major concern is about the usefulness of the elaborate accounting systems that will be needed to handle individually insignificant leases on the books of lessees. Lessors have an easier situation since they probably use standardized lease agreements and could come up with a composite method of some sort to handle groups of similar small leases. In contrast, the lessee might have contracts with hundreds of different lessors, so each individual contract would need to be evaluated separately. My suggestion is to have an official materiality threshold linked to an entity's policy for capitalizing other long-lived assets – whether that is $500 or $5,000. Please see discussion primarily under Question 4 but also under Question 1a and Question 3.

For purposes of classifying comment letters, my title is professor of accounting and I am employed at the University of Idaho. I have held my CPA license since 1977. Prior to beginning my 28-year academic career, I held a variety of positions including staff accountant in a small public accounting firm, controller for several small to medium-size business entities, and as

director of finance for a large not-for-profit entity. As an active donor and small investor, I have occasion to read the financial information of charities and publicly-traded companies.

## Response by Question Number

### The accounting model

**Question 1a: Lessees**
(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

I'm generally supportive of the change. I believe the Boards are determined to change existing GAAP and are justified in that decision since there has been so much "cooking of the books" related to leases. It has been way too easy to avoid capital/finance leases and that means we end up with economically equivalent situations accounted for in a very different manner. An "out" for less-than-one-year leases (more like the one for lessors than the one for lessees) would be a helpful compromise and should be sufficient for the lessor-side of the contract. However, I think the Boards need to **clearly state** that the lessee need not capitalize right-to-use lease contracts if the present value of the expected lease payments is less than the entity's threshold for the capitalization of fixed assets. Alternatively, an entity's policy might be to expense rather than capitalize unless the present value (or total value) of the expected payments exceeds the threshold for approval by top management. See discussion under Question 4.

It would also help if small businesses and charities could continue to record lease payments as debits to cash and credits to lease expense. At year end, the auditor could easily reclassify the "principal" portion of the payments to reduce the balance forward in the lease liability account, book any new leases at present value, and recognize depreciation equal to the reduction in principal owed on the lease (using the decelerated or interest method of depreciation). For many small entities, it is useful to have total lease expense equal the cash outflow. The best way to do this is to use one of the decelerated depreciation methods. These methods used to be described in intermediate accounting texts but since the method was mostly used by utilities and other regulated industries, I haven't seen an example in the textbooks in many years. I prepared an example (see Appendix H) that I believe would not violate the concerns expressed in BC8-BC11. After completing it, I'm not sure that making this adjustment is all that much easier than adjusting to straight-line. There is also the problem that having the auditor do the work would put them in the position of auditing their own work. However, the point is that avoiding unnecessary and relatively meaningless differences between expense and cash outflow is useful and may facilitate internal decision making while reducing preparation costs.

**Question 1b: Lessees**
(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Since right-to-use assets are presented within plant, property and equipment, I think the process of using up the quasi-tangible asset should follow ASC 360 rather than 350. Otherwise, I strongly recommend that an example be added to ASC 350-55 to illustrate amortization methods suitable for right-to-use assets. I believe they should be equivalent to common depreciation

methods including straight-line, sum-of-the-years-digits, activity method, declining balance, and the interest method (see Question 1a).

More importantly, I would like to see a "recognition" or "acquisition" method described for the lessee that parallels a slightly-revised derecognition method for lessors. This method would be suitable for leases with title transfer or bargain purchase option. It would fix the problem of "no guidance" for these currently scoped out transactions. I have developed a set of modest and partial changes to the language of the ED that would be needed as well as a set of illustrations. See Appendix 1 (which comes before Appendix A) since I did it last but felt it to be the most important.

**Question 2a: Lessors**
(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

The two methods have some surface validity. However, the guidance on when to use each is not altogether clear (B22-B27). I really think that ***a*** derecognition method should be reserved for title transfers, bargain purchase options, residual values deemed insignificant upon return to lessor because the lease term is for substantially all the asset's remaining useful life, etc. We should also have a recognition method for the lessee side of these transactions. However, ***the*** derecognition method described in the ED has some serious flaws as explained below (Question 2b).

**Question 2b: Lessors**
(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

The measurement of lease receivable is fine for both performance obligation and derecognition approaches. The straight-line amortization of the "liability to let others use assets" seems a bit strange but it is easy enough to do. My only recommendation for the **performance obligation method** is to change paragraph 35 so that any initial direct costs incurred by the lessor is added to the lease performance obligation (liability) rather than the right to receive lease payments (asset). That will simplify the accounting process because one won't need to find a new interest rate to make the amortization table "come out right."

A much bigger issue is related to the **derecognition method** and its arbitrary allocation of fair value between the portion derecognized and the portion retained. Specifically, I am concerned about the perverse incentive the measurement and "allocation" of changes in the lease receivable as described in Paragraph 56 and illustrated in B30 (Examples 4 and 5). I believe this is a BAD approach because it gives the lessor an incentive to increase profits by always underestimating the lease term at inception. In other words the gross profit on the lease is higher if you start with the 8 year assumption in both Example 4 and 5 (see table below). I believe the problem is the allocation to the residual value of the underlying asset. The method illustrated gives a number that is too low when the lease term turns out to be longer and too high when the lease term is shortened. Specifically, the remaining PVELP at the end of Year 1 in Example 4 is $5,206 as compared to a given fair value of $6,250. This implies the residual value should be 83% of

$4,500 (depreciated book value) or $751. However, the adjustment in Example 4 only raises the residual value to $241. In Example 5, the computation seems even more bizarre and the PVELP to fair value doesn't work at all. The residual value, after adjustment, is $746. Does it not seem strange that the same fact pattern produces such very different residual values? This might be "okay" under IFRS where they can write long-lived assets up as well as down, but we are only allowed to write assets down under US GAAP.

| Using the ED Derecognition Method for Lessor | | | | | |
|---|---|---|---|---|---|
| Original lease term as compared to Revised lease term | | Length in years | Actual Cash Received | Profit over lease term | Advantage of shorter term |
| Example 4 | Longer | 10 changed to 8 | 8,000 | 3,241.56 | |
| | Same | 8 unchanged | 8,000 | 3,895.26 | 653.70 |
| | My recommended method #1 | | 8,000 | 3,895.26 | none |
| | My method #2 - no change in term | | 8,000 | 3,895.00 | |
| | My recommended method #2 | | 8,000 | 3,895.00 | none |
| Example 5 | Shorter | 8 changed to 10 | 10,000 | 5,746.21 | 539.13 |
| | Same | 10 unchanged | 10,000 | 5,207.08 | |
| | My recommended method #1 | | 10,000 | 5,207.08 | none |
| | My method - no change in term | | 10,000 | 5,207.00 | |
| | My recommended method #2 | | 10,000 | 5,207.00 | none |

I think the "allocation" method to establish the initial amount assigned to the residual value was intended to be a laudable simplification. I also believe that the Boards intended the derecognition method to be used only when unguaranteed residual values are trivial in amount – but that is not entirely clear in the standard. After thinking about it, however, I see no advantage for this particular change to existing lessor accounting. Preparers and users of both IFRS and the US GAAP are already comfortable with "finance lease" accounting. The derecognition approach is basically a finance lease. I've come up with two solutions that would remove the perverse incentive. My first attempt at a solution is one I call the "if we had only known" approach to the adjustment (I think this was called the "catch-up method" in the preliminary views document). The second method may be better because it is comparable to current GAAP for financing leases: the expected residual value is included in the present value of expected lease payments (PVELP) computation (for lessor only). After all, auditors are already used to evaluating residual values of leases and preparers are already familiar with "traditional" accounting for finance leases. Please see Appendix A for a comparison of the ED approach to these two other approaches that remove the incentive to underestimate the lease term. {Note that this issue is also related to what I believe is a problem with the ED's treatment of guaranteed residual values – as discussed under Question 9 (part 1).}

Please note that my original replication of Examples 1 and 2 led me to the conclusion that under the performance obligation method, lessor would always just "break-even" with no profit on a lease. That didn't make sense and I "corrected" the book value of the leased asset to make the leases profitable. I suggest that the final version of these examples be changed as follows:

Example 1 & 2: Carrying value of leased asset at inception = CU 7,500 instead of CU 15,000 so that depreciation expense will drop from CU 1,000 to CU 500. This will make the lease in

Example 1 show a profit of CU 1,500 instead of zero. It will make the lease in Example 2 show a profit of CU 2,500 instead of zero.

**Question 2c: Lessors**

(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

If it is no longer possible to avoid "capitalizing" leases, perhaps the incentives for creating leveraged leases will be reduced. Just how big of a problem have leveraged leases been? I have no idea how prevalent they are and that makes it very hard to have an opinion one way or the other.

**Question 3: Short-term leases**

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

<u>The materiality issue.</u>

First of all, the reasoning in BC43 is fallacious when one considers the multitude of physical assets that are already expensed by public and private entities because they are simply not worth keeping track of. For example, I am still using the stapler I was issued in 1986 when I was hired (and it wasn't new then). Clearly the useful life is way longer than 12 months. However, the purchase price of this stapler was expensed long ago. If you think about the thousands of staplers (and wastebaskets and office chairs, etc.) in use on my campus, the amount is surely "material" in aggregate and "the assets and liabilities in the statement of financial position [are] incomplete and [are] not a faithful representation" [BC43] of our physical plant.

Isn't the purpose of this standard to make leasing roughly equivalent to buying assets outright? Are the Boards not setting a very costly precedent if it were applied to similar assets currently being purchased and expensed? There are sound business reasons for setting materiality thresholds for the recognition of fixed assets – the cost of keeping track of the items is higher than any occasional loss. Since no one, that I know of, seems to be worried because major corporations use a $1,000 threshold (or even more) to decide whether a long-lived asset should be capitalized, why should we capitalize individually insignificant leases – regardless of length? For example, a two-year $100 per month lease (at 10%) would have a present value of less than the $1,000 threshold.

The reason that the Boards need to officially address this issue is the problem preparers have with their auditors – who want you to prove that something is not material – so you have to analyze all transactions anyway. If you don't provide materiality guidance in the lease standard, auditors are going to question an entity because the <u>cumulative</u> effect of 300 small leases is large even though each individual lease would have a negligible impact on financial position and the results of operation.

**Question 3a: Short-term leases (continued)**

(a) At the date of inception of a lease, a **lessee** that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

I believe this standard places a much higher burden on lessees than the equivalent treatment for lessors – the lessee has to book an asset and liability, the lessor does not! The lessee just gets to choose to avoid the hassles of discounting current liabilities but still has to amortize an asset recognized only to make the debits equal the credits. We definitely need a better materiality threshold than this as well as a more reasonable treatment for short-term leases! Since you don't provide an example – here is mine:

| Eight month lease for $100 per month: | Debit | Credit |
|---|---|---|
| Right-to-use asset | 800 | |
| Liability to make lease payments | | 800 |
| | | |
| First payment: | | |
| Liability to make lease payments | 100 | |
| Cash | | 100 |
| Amortization expense | 100 | |
| Right-to-use asset | | 100 |

On the surface, this seems like a lot of wasted time doing insignificant and meaningless journal entries. We inflate both assets and liabilities (no effect on net assets) and we are changing NOTHING on the income statement that we wouldn't have by the traditional approach with a separate line item on the income statement or a disclosure in the notes:

| Each payment: | Debit | Credit |
|---|---|---|
| Rent expense – short-term leases | 100 | |
| Cash | | 100 |

| Footnote disclosure – short-term leases | Year ended 2012 | Year ended 2011 |
|---|---|---|
| Total payments on leases with a term of less than 12 months | 800 | 750 |

However, after thinking some more about the ED, I presume the intention is to discourage lessees and lessors from making most leases for one year without renewal options but with some sort of unwritten agreement that the price won't change for the next year. Given the games that have been played in the past, I can see this is a risk. It would also be fraudulent behavior since the leases would be regularly renewed – but it might not be treated as such even if noticed by auditors.

**Question 3b: Short-term leases (continued)**
(b) At the date of inception of a lease, a **lessor** that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65). (See also paragraphs BC41−BC46.) Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

This approach for lessors is reasonable – and seems to be much simpler than what is proposed for lessees! There was no numeric example for short term leases in the implementation guidance. However, I presume that the lessor who collects rent payments in advance would recognize deferred rent revenue in a similar fashion to current practice for operating leases. There would be no other lease liability. If the lease payments are not prepaid, there would be no accrual of a receivable unless the payments were not made when due. Thus, there would generally be no lease payments receivable among assets (for short-term leases) and no lease performance obligation (for short-term leases) among current liabilities.

However, I believe there should be an additional disclosure by the lessor worded something like this: "***On the face of the income statement or in the notes, the lessor shall separately disclose the total payments received under leases with initial terms of less than twelve months***."

The chances for game-playing are at least as likely for lessors as lessees. Accordingly, the user of financial statements needs to be aware of the proportion of leases that are for initial terms of less than 12 months. This will facilitate analysis over time to see if this segment of the business is growing or declining. For a lessor with one or two leases, the amounts might be immaterial and not worth "front page" status but it wouldn't hurt to have the total in the notes.

## Definition of a lease

**Question 4a – Definition of a lease**
(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

<u>With regard to paragraphs B1 to B4:</u>
I believe the "specific asset" guidance in B2 is good. It makes all or almost all real estate leases fit the definition of a right-to-use asset since it would be rare for the lessor to have the right to force a tenant to move into a different apartment, house, factory or office. Assets customized to suit the lessee are also appropriately included in the definition of a specific asset. Paragraph B3 is not as clear since it says that lessor's right to substitute another asset when the original asset is broken does not preclude calling the arrangement a lease. Paragraph B4 on control of the leased asset is reasonable. However, I STRONGLY recommend that paragraph B1 be moved from "application guidance" to the "official" guidance section – perhaps an expansion of the short definition in the glossary (page 38). I have a hunch that some respondents may be over-reacting because they did not read as far as page 41.

**Question 4b – Definition of a lease**

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

I don't have a problem with counting only leases with a bargain purchase option or title transfer as a sale. However, I think that merely being able to distinguish a purchase from a right-to-use lease contract is not sufficient guidance to account for these "transfer of assets" arrangements. A lease with a title transfer or a bargain purchase option would still have similar measurement problems to a lease that is not equivalent to a purchase. For example, lessors are going to also be applying paragraph B31 to decide whether something is a sale in a sale-leaseback. So why aren't these guidelines included for the "scope out" of leases that are sales of assets? Wouldn't it be more efficient and convenient to have all the guidance for what to include as a lease payment (to compute a present value) in one place rather than spreading it all around? For example, if the guarantee of lessor's debt by the lessee extends past the end of the lease term, do we include renewal period payments (current US GAAP)? Another example, the bargain purchase option is at the end of one or more optional renewal periods – should the payments during the renewal periods be included (as under current US GAAP)? To totally exclude leases with title transfer or bargain purchase options from the scope of the "lease topic" would, in the long run, make the accounting harder to understand because it would presumably require additional guidance for what to do with a lease that is equivalent to a purchase. Some issues are very basic like: what discount rate should be applied when there is a title transfer? Please see my proposed alternative "acquisition model" for lessees that parallels a slightly modified "derecognition method" for lessors in Appendix 1.

**Question 4c – Definition of a lease**

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

I strongly recommend change to paragraph B5 because the default treatment for a commingled contract is to call the entire contract a lease if the services are not distinct from the underlying asset. We should be able to use revenue/expense recognition critiera if a contract is primarily or predominantly for services and the inclusion of tangible assets is a small part of the contract. I suggest the following REPLACEMENT wording for Paragraph B5, sections b and c.

(b) If the service component is not distinct, a **lessee** shall evaluate the predominant purpose of the contract. If the contract is predominantly for acquisition of services, the lessee shall account for the payments as expense and not recognize a right-to-use asset or liability to make lease payments. If the use and control of the asset is the predominant purpose of the contract, the lessee shall apply lease accounting provisions to the entire contract.

(c) If the service component is not distinct, a **lessor** shall evaluate the predominant purpose of the contract. If the contract is predominantly for the provision of services to the customer, the lessor shall apply the revenue recognition criteria and recognize a service performance obligation but no lease performance obligation. If the use and control of the asset is the predominant purpose of the contract, the lessor shall apply the performance obligation method to account for the entire contract.

**Question 5: Scope exclusions**
This exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33−BC46). Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

These scope exceptions based on the nature of the underlying asset are okay with me. However, I do NOT believe we should omit leases with title transfers and bargain purchase options. Lessors should treat these with something similar to the proposed guidance for the "derecognition method." Lessees should record the asset as land, building or equipment rather than a "right to use" asset. Otherwise, the accounting should be identical to other leases. This means there does need to be a bit of additional guidance regarding the including of bargain purchase options in the lease payments for the "recognition method" for lessees (as opposed to the "right-to-use" method). Please see my recommended model in Appendix 1.

**Question 6: Contracts that contain service components and lease components**
This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, *Revenue Recognition* (Topic 605): *Revenue from Contracts with Customers,* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5 −B8 and BC47−BC54). If the service component in a contract that contains service components and lease components is not distinct:
(a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
(b) The IASB proposes that:
(i) A lessee should apply the lease accounting requirements to the combined contract.
(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.
Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

I don't think I like either suggestion and propose a different policy: A lease contract that contains a service component shall be analyzed to determine whether the contract is predominately for the service or predominantly equivalent to the acquisition of the physical asset. Lessees and lessors would be allowed to bifurcate contracts instead, but should have the option of choosing one type over the other (see also Question 4 recommended wording change for paragraph B5). I'm thinking about small contracts where it is hard to distinguish the service from the equipment. For example, think about leasing cell phones. Individually, each cell phone is a hundred dollars or so but the only reason to have the cell phone is for the services component – regardless of how many cell phones are being leased under a single contract. Another example: I have a colleague who reports payments on over 300 different leases of photocopies within her institution of higher education. These leases do not require top management approval – they are more like a consumable: the colleges and departments want to have a worry-free way to make copies. The lease is mechanism whereby the user doesn't have to worry about anything but the supplies (paper and toner) – if the machine breaks, it will be repaired or replaced. As a donor, I would not like to see a not-for-profit organization have to put on additional administrative staff to merely deal with keeping track of individually insignificant lease payments, particularly given the relatively "steady-state" nature of the recurring operating expense. Disclosure of the annual amount of expenditures with perhaps a projection of "commitments" over the next five year would be ample disclosure. Let me reiterate the need for

a materiality threshold for capitalization of right-to-use lease contracts. Yes, lease terms of less than twelve months should be excluded from the scope of this standard. On the lessee-side, however, there needs to be an additional practical standard. As I've suggested under Questions 1a and 3, a convenient and entity-specific criterion would be based on the capitalization threshold or the threshold that triggers higher management approval for capital acquisitions.

It may be hard to draw the line – perhaps leases of real estate should be excluded from consideration as a pure service. I definitely think the materiality issue is different for entities in the business of leasing equipment or real estate (as compared to lessees). For example, the lessor should be able to aggregate leases by type for analysis and reporting because they use standard agreements. In addition, it would be important to inform the financial statement users about the aggregate magnitude of expected cash inflows under new and existing lease contracts.

**Question 7: Purchase options**

This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).
Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

For making the decision on what to exclude from lease accounting, current GAAP seems to have better guidance than what is in the ED. What if the bargain purchase option is at the end of one or more renewal periods? What if the rents during the renewal period are at a bargain rate such that the lessee will probably have control over the asset's entire useful life? A real lease agreement that I remember from years ago was for a fleet of passenger vans. The charity used them for transporting senior citizens, sick people to hospital for cancer treatments, etc. The lease specified a fixed amount per month for 36 months after which the charity could buy the vans for $4 each or continue to rent them for $4 per month. So which $4 payment counts? Under existing US GAAP, we would know because a bargain purchase option "trumps" a bargain renewal period: a lease always ends at the date of a bargain purchase option. Are we giving up too much "tried and true" guidance for lease arrangements? In addition, why do we have additional guidance what constitutes a sale only when it is a sale-leaseback (paragraph B31)?

For the question I am supposed to be answering: a purchase option at the expected fair value of the underlying asset is an uncertain event. Therefore, recognition of the acquisition only when the option is actually exercised makes some sense. For consistency, however, should the "sale" happen once it becomes **probable** that the option will be exercised? Presumably, this would be for the lessee only. However, a similar situation exists when the lessor has the option to force the lessee to buy the asset. When the lessor decides it is probable that the option to force purchase will be made, shouldn't the lessor book the sale – particularly under the performance obligation approach?

## Measurement

**Question 8: Lease term**
Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

I'm pretty sure that the current definition of an asset would not cover anything improbable and probable has long been used as a higher standard that "more-likely-than-not." So I looked to the "working definition" on the FASB website: "**An *asset* of an entity is a present economic resource to which the entity has a right or other access that others do not have,**" and **"A *liability* of an entity is a present economic obligation for which the entity is the obligor**."

Perhaps the FASB and IASB are changing the conceptual framework to fit what they want to do? However, it really isn't clear that a fifty-one to forty-nine percent chance of renewal is a real obligation. Of course, deferred income tax liability is not all that real, either, since one must assume future profits for there to be a chance that the taxes will ever be paid. However, if there is no *present* reason to anticipate renewal of a lease (i.e., no nonrenewal penalty, no bargain rents during the renewal period, etc.), then I'm not sure there is an asset or a liability for the extended lease term.

Being well aware of the games that people have played with lease terms to avoid having to book a liability, I can understand the reason behind the criterion for the lease term. However, a lease that CAN be terminated earlier by the unilateral decision of the lessee is not the same as an obligation to make payments on other liabilities. There is generally no "out" for a liability other than declaring bankruptcy or some sort of troubled debt restructuring. We can't just decide we don't want to make further payments! Isn't this an important difference? I'm leaning toward accounting for the noncancellable term but including any ***probable*** payments related to nonrewal penalties, bargain renewal periods, etc. However, I believe that it will be extremely useful to have entities lay out the optional period payments in a schedule like the one I've illustrated below for Question 15.

At a minimum, the Boards should consider guidance similar to that in the recent revenue recognition exposure draft that calls for historical experience with similar transactions or general industry level evidence of frequency of renewals and the like. Take a look at paragraphs 38 and 39 in that ED which discuss how to make and justify reasonable estimates.

**Question 9: Lease payments (part 1)**
Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

This question is a mixed bag because contingent rentals are different from penalties for nonrenewal. One knows in advance that either the renewal payments will be made or the penalty will be paid. So there are really only two possible outcomes in most of these arrangements. Contingent rentals are related to unknown future events. I think the use of a fancy expected outcome technique should be optional. These techniques are a way of pretending we can predict

the future with a degree of certainty that rarely exists. But being more elaborate doesn't make them any more accurate. In fact, any symmetrical set of probabilities/amounts devolves into the average or central probability. So if we have no way of estimating with some level of certainty that the probability distribution for contingent rent increase (or residual value payment) is asymmetrical, an expected value computation adds little real value. We might get a sense of satisfaction that we've explored several alternatives, but we are no more likely to have predicted the future than we would be had we used a single best estimate.

The most important flaw I see is the description of what a LESSOR is to do with a **residual value guarantee**. I concur that the lessee need only include the amount expected to be paid (the difference between the amount guaranteed and the value of the asset upon its return to the lessor) in accordance with paragraph 11. However, paragraphs 31 and 47 use exactly the same language. However, the lessor will get the FULL value that is guaranteed – either in the form of cash or in the form of the fair value of the returned asset. In addition, there is confusion over third-party guarantees in the ED. They are not lease payments as far as the lessee is concerned but the third-party guarantee is a receivable that the lessor can count on (again, part of the total value is in the physical asset being returned and the rest in cash). Then in the subsequent measurement sections (paragraphs 39 and 56), the lessor is supposed to reassess the residual value guarantees – with no explanation of why that amount would change. Presumably, the guarantee may no longer be enforce because of its separate time limit (3rd party guarantee) or because the lessee extends the lease and there is no equivalent guarantee at the end of the extended term. Paragraph B19 (a)(iii) says the lessor is to include ONLY the estimate of the CASH to be received under the guarantee. Why? That makes little sense to me! It makes more sense to include the *guaranteed* residual values in the lessor's receivable account (lease payments receivable) as we do under current GAAP. It is only the unguaranteed portion that will not be collectible with certainty and cannot honestly be labeled "lease payments receivable." Please note, however, that I was always okay with including both guaranteed and unguaranteed residual values in the lessor's "lease receivable" under current GAAP because the returned asset **is** a receivable!

After more thought on the topic, it seems to me that the treatment of guaranteed residual values (GRV) should be different for the performance obligation and the derecognition methods.

- For the **performance obligation method** – do not include any portion of a GRV. The underlying asset remains in the lessor's books. The value of the asset upon its return is to be a particular amount. Whether that amount is in cash or in the form of the returned asset, the amount is the same total. Accordingly, the form of the GRV is irrelevant to the lessor. If cash is expected from the lessee due to a decline in value of the underlying, an impairment of the underlying might be booked earlier but presumably that would generally await the return of the asset when the value is more readily ascertained.
- For the **derecognition method** – include the full amount of the GRV. The underlying asset is NOT on the lessor's books. Accordingly, the lessor should include the GRV at its maximum amount in lease payments receivable: the lessor will either receive back an asset with that value or the asset plus cash to equal the GRV. Accordingly, a GRV should be part of the lease payments receivable regardless of whether the guarantee is from the lessee or an unrelated third party.

**Question 9: Lease payments (part 2)**
Do you agree that lessors should **only** include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

What about bargain renewal period payments? Doesn't that make a longer period of payments probable? The list seems rather incomplete. Won't there be lots of ways to structure leases so that a lower liability is recognized? For example, a guarantee of the lessor's debt by the lessee would normally assure renewal through the period of the guarantee (I'm thinking also of the list of items in B31). I think you may be throwing away too much existing guidance. For example, the following implementation guidance lists for lease term and expected lease payments would be helpful:

**THE LEASE TERM:**

Includes renewal periods
- covered by bargain renewal options
- when there is a penalty large enough to assure renewal
- when extension of lease term is at option of lessor
- during which the lessee guarantees the lessor's debt related to the property
- during which there is a loan from lessee to the lessor
- during other renewal periods that are considered to be likely*

*Exercise of renewal options should be considered likely if:

- the cost of relocating of the business using the leased assets is significant
- the lessee has made significant leasehold improvements that would be lost if the lease is not extended
- alternate productive capacity does not currently exist and substantial revenues would be lost if the lease is not extended
- significant costs would be incurred to return the asset to the lessor

**EXPECTED LEASE PAYMENTS:**

Include fixed rentals and most-likely projected amount for contingent rentals during the expected term of the lease

Include all rental payments up to date of a purchase option that is expected to be exercised

Include the amount of any purchase option that is expected to be exercised

Include renewal penalties not large enough to assure continuation of lease but exclude renewal penalties that are large enough to assure continuation of lease

Include rents during renewal periods during which there is/(are):
- renewal options expected to be exercised
- a nonrenewal penalty large enough to assure continuation of lease
- any guarantee by lessee of lessor's debt related to leased property
- an outstanding loan from lessee to the lessor

Lessee – include most-likely amount to be paid under a guarantee of residual value. Lessors using the derecognition method (but not the performance obligation method) should include the full guaranteed amount as part of the lease payments receivable.

Include any other payments (other than those for distinct services) that will be made to lessor under the terms of the lease during the expected lease term

**Question 10: Reassessment**
Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

I don't see a way to avoid reassessments. If we were to stick to the noncancellable lease term plus any *probable* renewal periods instead of the more-likely-than-not lease term, reassessments might be less common (see comments under Question 8). But assessment would be needed if previously unlikely options are exercised. When the most likely scenario of events fails to occur, the lessee and lessor must recognize a different set of payments than originally anticipated. Since it is troublesome to make the adjusting entries, perhaps everyone will do their best to select the most likely lease term (or is that wishful thinking!) However, contingent rentals should rarely trigger a reassessment, based on my own playing-around with examples (see first paragraph under Question 9, part 1 as well as my example in Appendix B.

## Sale and leaseback transactions

**Question 11 – Sale and leaseback**
Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

I'm confident that the people who wrote paragraphs 66 to 69 on sale-leaseback knew what they meant but this section is very confusing. This is an important example of why the FASB and IASB need to provide examples. I think I finally figured out what paragraphs 66 to 69 meant – but that was after at least 5 hours of experimentation with journal entries that didn't make sense or would work for some leases but not others, etc. If the Boards' intent is reflected in my final interpretation (Appendix F), great. If not, I'm still confused. Here is what I believe caused the confusion:

- We are told to look to B9, B10, and B31 to determine if a lease is a sale. Those passages are rather "backwards" to the issue of whether the asset has been transferred to the lessor. In this case, we are considering the sale-leaseback as a single transaction and a lease that has a title transfer or bargain purchase option makes the sale-leaseback "unreal" in an economic sense because the asset is never actually transferred to the "lessor/buyer." Please see my recommended re-wording of this section that follows the numbered questions.
- Separate sections or paragraphs would have helped. I now believe that only paragraphs 67b and 68b should be associated with paragraph 69 because there can't be a sale that doesn't make economic sense. In other words, why would a lessor give more cash to the lessee than the lessor expects to collect in the future through the lease payments (the "no sale" situation in 67b and 68b). It seems to me that the fair values of lease payments and asset would rarely be questionable when it is really just a loan of money from lessor/buyer to the lessee/seller.
- Perhaps there should be clearer LABELS for the parties involved. If there is a bargain purchase option or title transfer in the lease, the lessee/seller is not a "transferor" and the buyer/lessor is not a "transferee" because the underlying asset is not transferred from the

lessee/seller to the lessor/buyer at all. (Can you see how the reader can get confused by the language in the ED?)

- There should be several examples of sale-leaseback in the implementation guidance including:
  - An example of a situation that is not a sale (lease has a bargain purchase option or title transfer) and no problems with fair value of lease payments or initial fair value of the leased asset (similar to my Scenario A in Appendix F).
  - An example of a sale-leaseback that is an actual sale (no bargain purchase option or title transfer) and no problems with fair value of lease payments or initial fair value of the leased asset (similar to Scenario B in Appendix F)
  - An example of a sale-leaseback that is an actual sale (no bargain purchase option or title transfer) and the initial transfer of cash to lessee is greater or smaller than the fair value of the leased asset but the lease payments are at fair value
  - An example of a sale-leaseback that is an actual sale (no bargain purchase option or title transfer) and the lease payments are more or less than the amount that would be paid to lease equivalent property but the initial transfer of cash to lessee is at the fair value of the leased asset
  - Combination of the last two?

After spending so much time on this small portion of the ED, I decided to stick with a single basic example with "honest" fair values. In my earlier attempts to try to correct for non-market lease payments or initial payments not equal to the fair value of the underlying asset, I confronted situations where the interest rates would be negative and other confusions. A picture is worth a thousand words and examples are even better – please provide some!

## Presentation

**Question 12a: Statement of financial position**

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143−BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

The ED approach makes sense for basic leases – the right-to-use assets are reported with similar tangible assets and the liability to make lease payments is reported with other similar liabilities. However, the presentation can get lots more complicated when there are subleases. In the presentation described in paragraph 43, we start to have liabilities being offset against assets and it all looks very strange and confusing if reported at this level of detail on the face of the balance sheet (as shown in ED Example 3). In addition, there could be multiple sets of leases with subleases and other leases without subleases. I recommend that, at most, there should be one line to report all right-to-use assets net of sublease accounts. Details similar to ED Example 3 could then be relegated to the notes. To do otherwise just puts too much detail on the face of the balance sheet. Today, lots of companies just disclose "plant, property and equipment net of

accumulated depreciation" on one line (with the details in the notes). That seems "good enough" to me and I've never, as a user, felt deprived of useful information or misled.

**Question 12b: Statement of financial position**

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

I've "tried out" the presentation described in paragraph 42 and it certainly seems strange to have assets reported in the liability section and vice versa depending on the net debit or credit result. While we do something similar for construction in progress and progress billing accounts under current US GAAP, as far as my book-learning goes, we don't report the details! Here's the presentation that would go with ED Example 2 (performance obligation method) with the slight correction to depreciation described just before Question 2c. It looks pretty strange to me! (See my Appendix D for the full set of illustrations.)

| | | | | | |
|---|---|---|---|---|---|
| | **ED EXAMPLE 2** | | | | |
| **Balance Sheet Presentation per Para. 42 - performance obligation approach** | | | | | |
| | | | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 |
| Underlying assets | | | 7,000 | 6,500 | 6,000 |
| Rights to receive lease payments | | | 1,783 | 2,577 | 1,783 |
| Lease performance liabilities | | | (1,718) | (2,435) | (1,623) |
| Net lease asset or (liability) | | | 7,065 | 6,642 | 6,160 |

In all the playing around I did with the examples, I never managed to end up with a situation where the net of the accounts listed in paragraph 42 was a credit – so I assume it would be rare to have the assets reported among the liabilities. But we certainly are getting the liabilities reported among the assets! I think that would be very confusing to the users of financial statements. For the sophisticated user, disclosure of all the nitty-gritty details in the notes should be enough. For the overall picture provided by the statement of financial position, I vote for presentation of only the "net lease asset." After all, if the Boards continue to specify more and more detail on the face of the financial statements (I'm thinking of the financial instruments ED), our balance sheets are going to take four or five pages. At that point, the usefulness of an overall picture of financial position will be lost.

However, we will also need a disclosure regarding the full amount of plant, property and equipment because the paragraph 42 disclosure puts PART of the PP&E in the net lease asset. Won't that make it unclear as to the total amounts for accumulated depreciation and the values for land, buildings and equipment? It seems like we are going to have a lot more explaining to do, Lucy, if these mixtures of assets and liabilities go forward!

**Question 12c: Statement of financial position**

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

My recommendation is to change the derecognition method so that the lease receivable includes the prospective fair value of the asset upon its return to the lessor (see discussion under Question 2b). I think the real problem is permitting lessors to use this method when an asset is expected to have a material unguaranteed value upon its return. If this is the case, the lessor should be using the performance obligation method instead!

If my preferred recommended improvement (lease receivable at fair value of asset derecognized) is accepted, there would be no separate disclosure of the residual values on the face of the balance sheet. While the same sorts of disclosure we have regarding impairments of residual values in finance leases would be appropriate for the notes to the financial statements, there would be no need for the roll-forward analysis described in paragraph 80(c). Please note, however, that my recommended method would permit the derecognition method only if the unguaranteed residual value of an asset being derecognized was trivial. If the unguaranteed residual value is more than trivial, the lessor should be using the performance obligation method (see Appendix 1).

If my less-preferred recommended improvement or no change is made to the ED version of the derecognition method, I still don't think it would be relevant to emphasize the residual values on the face of the balance sheet. After all, if the unguaranteed residual value is substantial, a lessor is not supposed to use the derecognition method – at least that's how I interpret paragraphs B22 to B27 (admittedly a rather vague set of guidelines). Accordingly, unguaranteed residual values for leases should be relatively immaterial in comparison with plant, property and equipment and would thus not warrant a separate row.

**Question 12d: Statement of financial position**

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a **sublease** in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

There are a lot of questions in my mind about **sublease accounting** and this seems to be the only question about subleases (?). Please refer to my Appendix E for a comparison of the proposed presentation when the lessee chooses the performance obligation method versus the derecognition method for the sublease. The complete example file with journal entries and amortization tables is available on my webpage. Here is a list of questions and concerns:

- What happens if the sublease agreement is for the entire facility and at a higher rental payment than the lessee is paying? This means a negative "right to use" asset which makes little sense. In my sublease example 3, I just zeroed out the asset to avoid negative amortization expense. I don't think this would happen with the use of the performance obligation method.
- Also, should the interest expense and interest revenue be netted in the income statement when both exist for the same leased asset?
- What about the statement of cash flows – should/could the payments be netted to show the net cash outflow for each lease and sublease set?

- What if there are multiple sets of leases with sublease income? Can they be combined or should the combination be only between those in a net asset position or those in a net liability position?
- Why is there no parallel to Paragraph 43 for the derecognition method? Shouldn't the description of how to handle a sublease really be in the lessee section anyway?
- Could Paragraph 26 be the place to say whether one can net interest expense on the lease obligation with interest revenue from a sublease?
- Should the maturity analysis described in paragraph 86 include a column for sublease payments, similar to current US GAAP?
- Examples would be helpful, of course, in clarifying the Boards' intentions.

Consider requiring a single method for subleases (similar to the requirement in paragraph 68 that lessors in certain sale-leaseback transactions should use the performance obligation method). The presentation is more straight-forward when the lessor uses the derecognition method versus the performance obligation method for a sublease as I've shown in my Appendix E, but as long as only the NET amount appears on the face of the balance sheet, either method would be okay with me. Leave the all the myriad details for the intensely interested user of the financial statements. That person will seek out and read the notes. I don't have a problem with putting all the details on the face of the financial statements if the transactions are really important. I just don't think the Boards should require the details as long as all the equivalent facts get reported in a reasonably accessible place.

**Question 13: Income statement**

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

The answer to this question really depends on the materiality. If lease income is only a percent or two of total revenues, I see no need for a separate line on the face of the income statement. The same would be true if a lessee has only a few leases.

<u>Lessee disclosure</u>: Since some users might like to gain a better understanding of what is being "amortized" – particularly since that term is more generally associated with patents and other intangibles with limited lives. Likewise, knowing what "caused" the interest expense could be relevant to users. It certainly doesn't hurt to disclose a breakdown for total interest expense and for total amortization or depreciation expense in the notes. Therefore, I conclude that the information specified in paragraph 26 should be provided but the location of the information should be left to the judgment of the lessee.

<u>Lessor disclosure (performance obligation method).</u>
Paragraph 44 is interesting but would add a good bit of length to the income statement if the separate disclosures of all lease-related revenues and expenses are netted but still displayed in complete detail. If this provision in the ED is finalized, I would like to ask that total depreciation, amortization, etc. still be disclosed somewhere else. Don't make us add up multiple numbers – depreciation on fixed assets plus amortization on right-to-use leased assets (but not on intangibles, etc.) However, the better solution might be to put the detailed presentation in the notes as a sort of summary of the impact of the entity's leasing operations. Here is the parallel disclosures for the example under Question 12b.

**ED EXAMPLE 2**

**Income Statement Presentation per Para. 44 - performance obligation approach**

| For year ending: | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 |
|---|---|---|---|
| Lease income | 859.03 | 811.73 | 811.73 |
| Interest income | 206.17 | 264.97 | 206.17 |
| Depreciation expense | (500.00) | (500.00) | (500.00) |
| Net lease income or (expense) | 565.20 | 576.70 | 517.90 |

If lease transaction are actually equivalent to the purchase of the underlying asset (albeit for a limited period of time), then there is good reason for the knowing the total depreciation/amortization expense and the total interest revenue included in the computation of net income. The paragraph 44 disclosure is interesting and could, optionally, be placed on the face of the income statement. But I think it would be just as good to report "net lease income" on the face of the statement with the details in the notes. In that case, however, I think we still need to be able to find "total interest income" and "total depreciation expense" somewhere. So maybe there is no good solution.

Lessor disclosure (derecognition method).

I may have slightly misinterpreted Paragraph 61 – apparently we are supposed to show two types of sales – regular sales versus sales by means of lease. {Does that suggest we should also show separately "cash sales" versus "on account" sales?} In the following snippet which is related to my Appendix A, part 1 (variations on ED Example 4), I was intending to just put the "sales-type lease" revenues in with the other sales as we would do for a sales-type lease under current US GAAP:

| | | | | | |
|---|---|---|---|---|---|
| | **DERECOGNITION METHOD - EXAMPLE 4** | | | | |
| **Presentation on income statement per Para. 61 & 62** | | | | *This version uses the "histori* | |
| | | For year ending | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 |
| Interest income (separate from other interest income) | | | 537 | 417 | 370 |
| | | | | | |
| Possibility (a) - sales-type | | | | | |
| Sales (at PVELP) | | | 6,710 | (1,041) | - |
| Cost of sales | | | (4,793) | 688 | - |
| | | | 1,917 | (352) | - |
| Possibilty (b) - direct financing type | | | | | |
| Net lease income (expense) | | | 1,917 | (352) | - |
| | Total impact on net income | | 2,454 | 64 | 370 |

Note that this example had a change in the lease term in the second year of the lease – otherwise, there would be nothing but interest income after the first year. If the company's business plan is to provide financing primarily to facilitate sales of its products, then I don't see a real need for disclosing sales disaggregated based on "how the customer paid." Not that the detail wouldn't be interesting, but I can't think of a particular need for separate disclosure given other information already available. In particular, note that the "new leases" in the roll-forward

accounts required per paragraph 80 would be same amount that would otherwise be reported as "new sales financed by a lease." Note that the difference between the right-to-use asset figure and the equivalent figure under liability is initial direct costs incurred by the lessee. [The following excerpt is from my Appendix G.]

| | | Liability for Lease Payments | Right-to-use Assets |
|---|---|---|---|
| 1/1/2011 | Balance forward | (1,584) | 1,536 |
| 2011 | New leases | (892) | 900 |
| 2011 | Payments made | 605 | |
| 2011 | Interest expense | (155) | |
| 2011 | Amortization expense | | (471) |
| 2011 | Sublease income | | |
| 12/31/2011 | Ending balance | (2,026) | 1,964 |

**Question 14: Statement of cash flows**

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Separate disclosure is fine, particularly when leases play a substantial role in the entity's business plan as either lessor or lessee.

Lessees.

From paragraph 27, I gather that 100% of the lease payments will be reported as a financing activity – in contrast to current US GAAP that places only the principal in financing because interest expense is reported only as an operating activity. Accordingly, this would be a simplification for lessees. However, we are now going to have many more leases to account for. Many of these leases are small and routine and clearly associated with operations. The leases are often merely for convenience – we avoid buying new laptops every other year by leasing them. Part of the reason for the lease is to always have the latest model. Perhaps it is a lease for or tax purposes and the company would otherwise buy the assets. In other words, a lease is not always a mechanism for financing. I imagine lots of companies that currently report "no debt" have many of these operating leases. Shouldn't the business plan enter into "where" the lease payments are reported?

However, I will concede that financing activities is as good a place as any if it is the easiest place. No one will have to try to assign lease payments as being either operating or financing. So "easy" and "arbitrary" do have advantages! Confusion may arise, however, because "interest paid" will become just part of the interest paid and that will make the financial statements harder to understand unless there is a disclosure someplace that compiles all the interest expense reported in various spots on the income statement and shows how it is related to the amount reported as interest paid on the statement of cash flows.

Lessors (performance obligation method).
Paragraphs 45 and 63 correctly identify lease income as an operating activity. Again, if leases are important, separate disclosure is warranted. I certainly hope we get rid of the indirect method soon – see how confusing it looks in my Appendix D as compared to the direct method display. On the other hand, there is a cash flow (maturity) disclosure for lessors in paragraph 86 that somewhat ameliorates the confusing line in the reconciliation schedule.

| **Presentation on statement of cash flows per Para. 63** | | | | |
|---|---|---|---|---|
| Direct method: | For year ending | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 |
| Lease payments received | | 1,000.00 | 1,000.00 | 1,000.00 |
| Indirect method: | | | | |
| Change in right to receive lease payments (on separate row) | | 6,453.97 | (935.84) | (630.17) |

**Question 15 – Disclosure**
Do you agree that lessees and lessors should disclose quantitative and qualitative information that:
(a) identifies and explains the amounts recognized in the financial statements arising from leases; and
(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?
(paragraphs 70−86 and BC168−BC183)? Why or why not? If not, how would you amend the objectives and why?

Paragraphs 70 through 86 detail a lot of disclosures. Some of these disclosures will be no more useful than existing vague disclosures regarding the provisions of capital leases. Take paragraph 73, for example. We have similar current disclosure requirements in US GAAP but once a company is talking about 20, or 500, ot 3,000 different leases, the paragraph is going to be very short and very vague! Who would really count up the fact that 500 out of 3,000 leases have residual value guarantees and another 200 leases have purchase options? Even if they did, I don't think I would find the information all that useful as a reader/user of the financial statements! What is useful is a concise disclosure of cash flows under lease contracts during current and future periods. There is a lot of useful information, for example, in the disclosure I recommended in my 2009 comment letter on the preliminary views document (I've made a few modification to suit the ED). I think preparers will not be enthusiastic but as a user I think this disclosure would add a lot of transparency and be much more useful than some vague discussion of the terms of the leases. For example, the user could add the present value of the "optional" payments during renewal periods if he or she believes the entity has a practice of underestimating the length of contracts.

| | Projected payments under leases | Minimum fixed rentals under existing contracts | Planned payments under unexercised renewal options or nonrenewal penalties | Estimated contingent rentals and residual value guarantees | Additional cash flows under existing leases extended to maximum length |
|---|---|---|---|---|---|
| 2012 | 655 | 625 | - | 30 | 30 |
| 2013 | 655 | 625 | - | 30 | 30 |
| 2014 | 675 | 625 | 20 | 30 | 30 |
| 2015 | 575 | 525 | 20 | 30 | - |
| 2016 | 575 | 525 | 20 | 30 | - |
| 2017-2021 | 2,875 | 125 | 2,600 | 150 | 100 |
| Thereafter | 1,510 | - | 1,500 | 10 | 60 |
| | 7,520 | 3,050 | 4,160 | 310 | 250 |
| Less interest | 3,245 | | | | |
| Lease obligation | 4,275 | | | | |

The weighted average incremental borrowing rate is 10% and the current incremental borrowing rate is 9%. If existing leases were extended through the maximum possible period, the liability would be 4,411 with a fair value estimated at 4,633.

Another issue that a table like this could address: Some would argue that the definition of a liability cannot be stretched to include "optional" renewal periods since they are not a present obligation of the entity. If the Boards were to agree with this assessment, then the above table could be a place to force entities to reveal what payments "might" need to be made when/if renewal becomes probable. As shown, the total column includes all but the final column but other variations are possible so that the projected payments column shows only the probable payments.

I'm also concerned that the roll-forward disclosures in paragraphs 77 and 80 are unnecessary if we continue to provide the cash flows disclosures in paragraphs 86 and 86. However, it will be challenging to develop the information for either disclosure since many companies will be going from dozens and hundreds of reported leases to hundreds and thousands of lease contracts to analyze. Do we really need both? Please refer to my Appendix G that demonstrates that the user has the necessary information to do a roll-forward analysis if it is desired – for both the right-to-use asst and the liability to make lease payments. I did "cheat" a bit and use the interest method to amortize the right-of-use assets as discussed in the comments included with the example in Appendix G.

**Question 16a – Transition**

(a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186−BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

A strictly prospective transition might be warranted, at least for nonpublic entities: all new leases would be evaluated under the new standards but existing capitalized leases (regardless of the reason for capitalization) would merely have account titles changed to be consistent with the new standard (as explained in paragraph 92) and existing operating leases would be ignored (eliminate paragraphs 90 & 91). This simplified approach would make an earlier effective date feasible. If entities have to gather voluminous information to do the present values for all existing operating leases, I anticipate a later effective date would be required.

**Question 16b – Transition**
(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

I have no problem with full retrospective application but I wonder why any company would want to do that. Consistency and comparability would be better, however, if all public companies made the transition in the same way. That would argue against permitting full retrospective application at the option of the individual entity.

**Question 17 – Benefits and costs**
Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

I have raised some important points regarding the costliness and limited benefits of some of the provisions of the ED. Please refer particularly to Question 1a, Question 4, and Appendix G (unnecessary disclosures). The most important issue is using a different standard for "right to use assets" than we use for plant, property and equipment acquired through purchase instead of lease. There really needs to be a materiality threshold or the auditors will be the only big beneficiaries for the more complex accounting process and expanded disclosures associated with the many small and routine leases for things like photocopiers and laptop computers.

**Question 18 – Other comments**
Do you have any other comments on the proposals?

I've provided bullet points about other problems identified including hard to understand passages and flawed examples. In some cases, I have provided alternate "improved" wording for selected paragraphs. These points follow my comments by question number.

**Question 19 -Non-public entities**
Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

If my materiality threshold ideas are not acceptable (comments primarily under Questions 1a & 4), I would like to see small business and not-for-profit **lessees** be excluded from some of the provisions of the ED. In particular, there needs to be some way to avoid the expense of tracking small leases – even if initially for more than 12 months. You might also let nonpublic entities out of the roll-forward disclosures in paragraph 77.

## Possible typos and other passages lacking clarity

- Paragraph 39 (b) (III). When I read about the adjustment, it first sounded like one could have a lease obligation of less than zero. I think this is supposed to mean that one would NOT go below zero. Perhaps word it as follows: "However, the lessor shall recognize in net income any changes that would otherwise reduce the liability below zero." Or perhaps. "The liability shall not be reduced below zero. Any additional adjustment shall be made to net income."
- Recommended titles would be helpful to distinguish between performance obligations related to leases and the obligation to make cash payments – since both can appear on the same set

of books in relation to a single lease (if there is a sublease) or anytime a party is both a lessee and a lessor – see Appendix E example disclosure. Terminology is vague, at this point, because there are lessor examples but no lessee examples. Perhaps the following would work as *suggestions* (not required):

- Lease payments receivable (lessor's expected cash inflows)
- Liability to make lease payments (lessee's expected cash outflows)
- Lease performance liability (for lessor's performance obligation)

- Para. 20. Since the ED specifies that right-to-use assets be reported among other capital assets like land, buildings and equipment, I think it would be better to use the term "depreciation" rather than "amortization" for the process of "using up" the tangible asset. This means that the reference in paragraph 20 should be to Topic 360 instead of Topic 350. I don't see any strong reason to forbid the use of depreciation methods like double declining balance, sum-of-the-year's-digits, composite methods, or the interest method. For many not-for-profits and small businesses, there is a lot to be said for minimizing unnecessary differences between expenses and cash outflows. Use of the decelerated interest method facilitates the preparation of cash budgets, the statement of cash flows, and may make contract negotiations easier. With the interest method (as illustrated in my Appendix H) the differences between total expense under straight-line and the decelerated interest approach are minimal yet expense always equals the cash outflow. All allocation methods are arbitrary – neither right or wrong. Any rational, systematic method that spreads the expense over the life of the asset should be acceptable.

- As discussed in the introduction and under Question 2b, please reword paragraph 33 (but not the equivalent paragraph 49 for the derecognition method) as follows:

  **Initial measurement (performance obligation method)**

  33. At the date of inception of the lease, a lessor shall measure:

  (a) the right to receive lease payments at the sum of the present value of the lease payments (see paragraphs 34- 36), discounted using the rate the lessor charges the lessee (see paragraph B12).

  (b) the lease liability at the present value of the lease payments, discounted using the rate the lessor charges the lessee **plus any initial direct costs** incurred by the lessor (see paragraphs B14 and B15).

- As discussed under Question 3b, consider adding the following statement to paragraph 65 or to the section which lists required disclosures:
  On the face of the income statement or in the notes, the lessor shall separately disclose the total payments received under leases with initial terms of less than twelve months.

- As discussed under Question 11, please clarify the accounting for sale-leaseback transactions. Here is my suggestion for re-wording of paragraphs 67 and 68:

  67. If a transaction meets the criteria in paragraph 66 and the lease portion of the arrangement meets the conditions for a sale (B9, B10, and B31), the

seller/lessee retains economic control and there no transfer to the buyer/lessor is recognized.

(a) The seller/lessee shall account for the contract as a loan. The seller/lessee shall not derecognize the transferred asset and shall recognize any amounts received as a financial liability in accordance with applicable US GAAP. The seller/lessee will not report a right to use asset or obligation to make lease payments for the sale-leaseback in the financial statements.

(b) The buyer/lessor shall not recognize the transferred asset. The buyer/lessor shall recognize the amount paid as a receivable in accordance with applicable US GAAP. The buyer/lessor shall not report a receivable for the lease payments or a performance obligation liability related to the sale-leaseback in the financial statements.

(c) Disclosures in accordance with Topics related to financial assets and liabilities shall be provided.

68. If a transaction meets the criteria in paragraph 66 and the lease portion of the arrangement does not meet the conditions for a sale (B9, B10, and B31), the transfer of economic control from seller/lessee to the buyer/lessor is recognized in accordance with applicable Topics.

(a) The seller/lessee (transferor) shall account for the lease in accordance with paragraphs 10-27.

(b) The buyer/lessor (transferee) shall account for the lease using the performance obligation method in accordance with paragraphs 30-45.

- **Guaranteed residual values** – an important omission from lease payments receivable? The lessee is only supposed to include the expected amount that would have to be paid as part of the guarantee and that's fine. The lessor provisions are not. See discussion under Question 9 (part 1). It seems to me that the lessor (using the derecognition method) needs to include the full amount of the guarantee in its lease payments receivable since it will get that combined value at the end of the lease. However, the lessor using the performance obligation method should not include any portion of the GRV because the asset is already carried on its books. These changes would affect a lot of lessor paragraphs including 31, 35 (about 3rd party guarantees not being lease payments when they really would be part of the lessor's receivable under the derecognition method), 39 & 52 & 56 (why the "reliably measure" when guarantees are for specific amount), B19, etc.
  - Also note that paragraph 46 totally ignores residual value guarantees – I would presume they are lease payments in 46 (a) but it says elsewhere that third-party lease guarantees are not lease payments so people are bound to get confused as to what to do with them! This might be a good place to put in the fact that ***the right-to-receive lease payments shall include any amounts guaranteed by the lessee or unrelated third parties***.
  - For the performance obligation method, the asset is still "on the books" of the lessor. Even if the lessee eventually pays some cash because the value is lower than the

guarantee, the lessor would be no better off. Therefore, the lease payments receivable should not include ANY guarantees of residual value – even ones from the lessee. Paragraph 30 might be a good place to make this clarification? It would help, though, to tell us what to do with a third party guarantee – is it a contingent asset or carried at cost? Or maybe the intention is that only the expected cash should be booked. But that isn't sensible if the asset is still on the books. Maybe this wording for paragraph 30: "At the date of commencement of a lease, a lessor shall recognize in the statement of financial position a right to receive lease payments and a lease liability. The lessor shall not derecognize the underlying asset. ***The right to receive lease payments and the lease liability computation excludes all guarantees of residual value whether by the lessee or by a third party guarantor."***

- Paragraph 31(c) is very confusing because it sounds like that the lessor satisfies the residual value guarantees??? Maybe it should say "…residual value guarantees at the end of the lease term."
- Missing glossary terms? The lessor's receivable should be defined since it is complicated and possibly different in amount from the lessee's liability to make lease payments. This would be a good place to introduce recommended wording for account titles (listed in an earlier bullet point). I'd certainly like to see expanded definitions of lease term and lease payments more like the ones in the FASB ASC glossary – the lease term definition is especially helpful.
- The standard needs MORE examples! An example would have saved hours of time I spent trying to provide you with good comments. Here are some suggestions:
    - Examples of lessee accounting under the ASU as well as what to do when there is a title transfer or a bargain purchase option.
    - An example disclosure for leases with a sublease (similar perhaps to my Appendix E)
    - Example(s) showing revisions related to contingent rentals that differ from the original expectations. One might show the catch-up method for major changes in comparison to the annual adjustments to net income method for minor changes in contingent rents. You might find my example (loosely based on the 2009 preliminary views document helpful: Contingent Rentals Examples (xlsx) – it is not included as an appendix but is available on my website.
    - Example showing impact of Initial Direct Costs on amortization of lessee's "right-to-use asset" or "liability to make lease payments" and lessor's "lease payments receivable" or "lease performance obligation." My recommendation (see Question 2b and rewording of paragraph 33 above) is to make the lessee method match the lessor performance obligation method – initial direct costs would increase the "right to use asset" and the "lease performance obligation." This would simplify the accounting since one would not need to find a new interest rate. For the derecognition method, I'm recommending recognizing the receivable at the fair value of the derecognized asset plus initial direct costs – which would generally require computation of a new implicit rate. See also my Appendix C which compares for initial direct costs split between lessor and lessee in the manner specified in the ED.

- Most commonly, a lease is an annuity due (first payment is made immediately). It would help if at least some examples illustrated this "more likely" scenario rather than the ordinary annuity payments in all the lease illustrations in the ED. With current technology, it is no harder to do it "right" than wrong. I have to believe that the choice of ordinary annuity illustrations is grounded in the old fashion use of time-value-of-money tables. For those computations, yes, one had to make a simple adjustment to the ordinary annuity table (multiply by 1 plus the interest rate). Now we just enter a "1" instead of a "0" in Excel or hit the "begin" instead of "end" key on our financial calculators. Accordingly, the simplification is well-intended but could actually cause confusion.
- There is no reason to provide overly simplified examples for complex real-world situations. In particular, all the illustrations assume an option to get out of a lease. Aren't options to renew just as common? To be more interesting, a bargain renewal option might be illustrated as well since it creates more interesting numbers for the initial lease receivable and lease liability for the performance obligation approach. How about an illustration with a penalty for nonrenewal? Such a penalty certainly helps make a renewal become "more likely than not." Of course, the penalty might be paid or the lease might be renewed but in either case, one would have to deal with including the penalty OR the payments during the renewal period.
- Sale-leaseback examples, see suggestions listed under Question 11.

## Comments based on working with examples in the ED

### Example 1 & 2 – a simple fix

After working through the first two examples, I was afraid that the Board's intent was to have NO PROFIT from leases under the performance obligation method. However, I think that is an artifact of the particular facts provided. With or without the change in lease term, the examples (as written) are unreasonable because they are unprofitable. For Example 1, the CU118 profit in year one is entirely reversed in Year 2 (loss of CU25) and Year 3 (loss of CU93). In Example 2, the CU160 profit in the first 3 years is entirely reversed in the last two years. To fix, change the useful life of the leased asset to 30 years or reduce the carrying value to $7,500 so that depreciation drops to something like CU500. Then there would be a 500 per year profit. In other words, it is a very strange situation when the lease payment exactly equals the depreciation expense! The underlying file that supports my Appendix C is on my website and has all the journal entries for ED Examples 1 and 2 with the recommended correction.

### Example 3 – a typo?

Why is cash being included with plant property and equipment in this example of a sublease? Is that a typo? Since right-to-use assets are to be included in PP&E (but separately) per paragraph 25, I assume that the "net sublease asset" could be one of many different subleases and not all leases would have subleases. That is just too much detail on the face of the balance sheet. Today, lots of companies just disclose "plant, property and equipment net of accumulated depreciation" on one line (with the details in the notes).

### Examples 4 & 5 – a serious problem with method that needs correction

In addition to the problem with the way the illustrations allocate residual value to the accounts, I also felt that all the examples were a bit unreasonable in that the decision that the lease term would differ from original expectations was made only one year after the lease began. For Example 1, it is not an obvious problem but I suggest that this early decision is far less likely for Examples 4 and 5. I assume the examples are written that way because it looks less complicated.

However, as discussed in Question 2b, the BIG problem with Examples 4 & 5 is the way that the adjustment to the residual value is being made. As requested, I have provided alternative proposed methods. The first is a different allocation method. The second (preferred) method would be to recognize the projected fair value of the leased asset as part of the lessor's receivable. The method is basically current GAAP because the lessor's receivable, at the inception of the lease, is always equal to the fair value of the asset being derecognized. However, it works best when the use of the derecognition method is limited to situations in which the unguaranteed residual value of the asset to be returned is trivial. The Boards should also consider whether adding initial direct costs to the fair value is reasonable for both sales-type leases and those that are primarily a financing activity (see paragraph 61). I think it has worked fine to expense initial direct costs as a type of selling expense for business models described in 61a and to capitalize initial direct costs as part of the receivable for business models described in 61b. Why change a standard that has functioned adequately since the 1970s? Now that there are fewer ways to avoid finance leases, this existing and well honed technique need not be abandoned. I think we'd call it throwing out the baby with the bathwater.

## Summary and Conclusions

It is time to change how we account for leases. While I'm generally supportive of the exposure draft, it does have flaws that need fixing before it is ready for implementation. In particular, I'm recommending parallel treatment for lessees and lessors using an acquisition/derecognition method that would include leases with title transfer or bargain purchase option features. This has the advantage of helping preparers refer to a single place to decide whether a lease is equivalent to a purchase/sale of an asset or whether it is merely the right to use the asset for a limited period of time. My recommended method also fixes the identified flaw in the existing derecognition method for lessors. I believe we should avoid allocation when possible. In this case, it is always better to record the lease receivable and the transferred asset at its fair value – consistent with existing GAAP. I have also identified certain other passages that need fixing, the most important of which are:

- Consistent treatment of initial direct costs by lessee and lessor (add to the amount that is being amortized straight-line (or similar method) so one can avoid finding a new interest rate to set the payments equal to carrying value. This applies just to the method I label the right to use approach for lessees and the performance obligation approach for lessors. For the recognition/derecognition methods, one is forced to deal with changes in the interest rate implicit in the lease.
- Clarification of the very confusing section on sale-leaseback transactions
- The need for a materiality threshold that parallels accounting for other fixed assets.

I apologize for remaining typos, errors and inconsistencies. I simply had to switch to grading student assignments and final exams! The appendices are not in any particular order – I added them as I felt I had 'mastered' the particular topic. I hope you find the comments and suggestions useful. Please do not hesitate to contact me if something I've said lacks clarity.

Sincerely,

*Teresa P Gordon*

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Attachments:

Appendix 1 – Recommended Alternative: An acquisition approach for lessees to match the derecognition method for lessors and a right-to-use approach for lessees to match the performance obligation method for lessors.

Other Appendices (denoted with letters):

Appendix A – Recommended Changes to Derecognition Method for Lessors (Examples 4 and 5 with comparison to Exposure Draft approach).

Appendix B - Contingent Rent Example (significant difference from forecast)

Appendix C – Comparative Lessee & Lessor Examples with initial direct costs and nonrenewal penalty

Appendix D – Presentation the leases in ED Examples 1 & 2 on the financial statements

Appendix E – Sublease Presentation

Appendix F – Sale-leaseback Example

Appendix G – A comparison of the information content of roll-forward versus cash-flow schedules related to leases

Appendix H – Decelerated Depreciation Approach compared to Straight-line Depreciation

See also Excel files posted at my webpage: www.cbe.uidaho.edu/tgordon/presentations n comltrs.htm

# Appendix 1
# Teresa Gordon's Recommended Alternative to Accounting for Leases

## Key features:

- Leases with title transfer and bargain purchase options would not be excluded from the scope.
- Leases with title transfer or bargain purchase option would be handled by the acquisition method by the lessee and the derecognition method by the lessor.
- Leases that do not meet the criteria for acquisition/derecognition treatment would be accounted for by the right-to-use method (lessee) or performance obligation method (lessor).
- Four combinations of the methods are illustrated for a set of transactions with equivalent economic value following this very rough and partial "re-write" of the ED.

## Required changes to the ED as written:

Paragraph 8 could be removed from the scope section and modified to distinguish when the acquisition/derecognition method versus right-to-use/performance obligation approach is appropriate.

**Lessee**

**When to apply the right to use or acquisition approach**

8. An entity shall use the acquisition approach (lessee) and the derecognition approach (lessor) to contracts which represent a purchase by the lessee and a sale by the lessor of an *underlying asset*:

   (a) a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity (see paragraphs B9 and B10); and

   (b) All other leases shall be accounted for by the right-to-use method (paragraphs 10-27).

   (c) For leases initially accounted for using the right-to-use method (lessee) or the performance obligation method (lessor), exercise of a purchase option specified in the lease ends the lease contract. The leased asset is recognized by the acquirer (former lessee) in accordance with Topic 360 and the seller (former lessor) recognizes any gain or loss from derecognition of the underlying asset.

**Recognition – acquisition approach**

8a. At the date of commencement of a lease, a lessee shall recognize in the statement of financial position a tangible asset measured at lower of (i) the present value of expected lease payments using the lessee's incremental borrowing rate or (ii) the fair value of the asset acquired.

8b. A lessee shall recognize the following items in the income statement, except to the extent that another Topic requires or permits its inclusion in the cost of an asset:

   (a) interest expense on the liability to make lease payments (see paragraph 16(a)).

   (b) depreciation of the asset acquired in accordance with Topic 360.

   (c) any changes in the liability to make lease payments resulting from reassessment of the expected amount of *contingent rentals* or expected payments under term option penalties and *residual value guarantees* relating to current or prior periods (see paragraph 18(a)).

   (e) any impairment losses on the acquired asset in accordance with Topic 360.

Appendix 1 (continued)

**Measurement**
**Initial measurement: acquisition approach**

8c. At the date of inception of the lease, a lessee shall measure:

(a) the liability to make lease payments at the present value of the lease payments (see paragraphs 13-15), discounted using the *lessee's incremental borrowing rate* or, if it can be readily determined, the *rate the lessor charges the lessee* (see paragraph B11).

(b) the tangible asset in accordance with Topic 360 at lower of fair value or the liability to make lease payments plus any *initial direct costs* incurred by the lessee (see paragraphs B14-B15). If the fair value is less than the present value of the liability to make lease payments, initial dir ect costs incurred by the lessee shall be expensed immediately.

Subsequent measurement: acquisition approach

8d. After the date of commencement of the lease, a lessee shall measure:

(a) the liability to make lease payments at amortized cost using the *interest method*, subject to the requirements in paragraphs 17−19.

(b) the tangible asset at cost less accumulated depreciation in accordance with Topic 360 including analysis of impairment if warranted.

Paragraph 33: For the performance obligation method, initial direct costs would be added to the lease performance obligation (rather than the right to receive lease payments). Some additional modification would be needed to paragraph 29 as well.

## Lessor

**When to apply the performance obligation or derecognition approach**

28. At the date of inception of the lease, a lessor shall assess whether a lease is accounted for in accordance with the performance obligation approach or the derecognition approach on the basis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset either:

(a) during the expected term of the lease; or

(b) after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or selling the underlying asset.

(see paragraphs B9-B10, B22-B27, B31)

29. If a lessor retains exposure to significant risks or benefits associated with an underlying asset, the lessor shall apply the performance obligation approach to the lease. If a lessor does not retain exposure to significant risks because (i) the asset is transferred to the lessee because of a title transfer or bargain purchase option or because of other provisions in the lease indicate minimal or trivial retained risk, the lessor shall apply the derecognition approach to the lease. A lessor shall not change the lessor accounting approach after the date of inception of the lease.

**Initial measurement (performance obligation method)**

33. At the date of inception of the lease, a lessor shall measure:

(a) the right to receive lease payments at the sum of the present value of the lease payments (see paragraphs 34- 36), discounted using the rate the lessor charges the lessee (see paragraph B12). Any guaranteed residual value is excluded since the underlying asset is being carried by the lessor.

(b) the lease liability at the present value of the lease payments, discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor (see paragraphs B14 and B15).

Appendix 1 (continued)

Paragraph 49, 56, 57: Derecognition method would be modified to avoid the use of an allocation to residual value in place of accounting for any (rare) residual value at the fair value of the asset when it is returned to the lessor.

**Revised wording for initial measurement (derecognition method)**

49. At the date of inception of the lease, a lessor shall measure:
    (a) the right to receive lease payments at the fair value of the asset being derecognized.
    (b) If paragraph 61(a) describes the business model, the sum of the present value of the lease payments will be recognized as revenue using the rate the lessor charges the lessee (see paragraph B12) and any the initial direct costs (see paragraphs B14 and B14) will be expensed during the period when the asset is derecognized. The lease payments receivable includes the full amount of any lessee or unrelated third-party guaranteed residual value because the underlying asset is not otherwise recognized on the financial statements of the lessor.
    (c) if paragraph 61(b) describes the business model, initial direct costs incurred by the lessor (see paragraphs B14-B15) shall be added to fair value and the discount rate will be adjusted to set the fair value of the asset plus any initial direct costs equal to the expected lease payments.

**Revised wording for subsequent measurement (derecognition method)**

56. After the date of commencement of the lease, the lessor shall reassess the carrying amount of the right to receive lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the right to receive lease payments since the previous reporting period and any expected residual value of the asset. When such indications exist, a lessor shall:
    (a) reassess the length of the lease term in accordance with paragraph 51..
    (b) reassess the expected amount of any contingent rentals and any expected payments under residual value guarantees that the lessor can reliably measure and any expected payments under term option penalties in accordance with paragraph 52. A lessor shall recognize any resulting changes in the expected amount of the right to receive lease payments in net income.

57. A lessor shall not change the rate used to discount the lease payments except to reflect changes in reference interest rates when contingent rentals are based on those reference interest rates or when the expected residual value of the underlying asset declines. When contingent rentals are based on reference interest rates, a lessor shall recognize any changes to the right to receive lease payments arising from changes in the discount rate in net income.

Appendix 1 (continued)

## FACTS FOR FOUR ILLUSTRATIONS

There are four economically equivalent lease arrangements that would use a combination of the two lessee and the two lessor approaches to accounting for leases.

- The underlying asset is initially carried on the lessor's books for CU 35,000 (historical cost of CU 60,000 less accumulated depreciation of CU 25,000).
- The fair value of the asset at inception is CU 43,000. It is expected to be worth CU 25,000 at the end of five years and the lessor expects it to be worth CU 18,000 at the end of ten years.
- Unless otherwise noted, there are no initial direct costs.
- The lessee and lessor use straight-line depreciation (no salvage value) for buildings and equipment.
- The lessee amortized right-to-use assets over the lease term using the straight-line method.
- The lessor determines lease income (performance obligation method) by dividing the initial amount of the lease performance obligation by the expected lease term.
- The lessor would charge the lessee 9% which is the lessee's incremental borrowing rate.

**Scenario A: Lessee uses acquisition approach and lessor uses derecognition approach.**
**Key feature: bargain purchase option at end of 5 years**

- The initial lease term is for a 5 year period.
- Payments are CU 10,000 per year, with the first payment due upon signing.
- There is a bargain purchase option at the end of the 5$^{th}$ year for CU 925.

**Scenario B: Lessee uses right-of-use approach and lessor uses performance obligation approach**
**Key feature: nonrenewal penalty expected to be paid**

- The initial lease term is for a 5 year period
- Payments are CU 6,000 per year, with the first payment due upon signing.
- There is a penalty for nonrenewal at the end of the 5$^{th}$ year for CU 2,100. If renewed, the same payment would be made for five additional years.
- Both parties expect the lessee to pay the penalty instead of renewing the lease.

**Scenario C: Lessee uses right-of-use approach and lessor uses derecognition approach**
**Key feature: third party guarantee of residual value**

- The initial lease term is for a 5 year period
- Payments are CU 6,310 per year, with the first payment due upon signing.
- The lessor obtains a third party guarantee of the CU 25,000 expected value for a fee of CU 500 (an initial direct cost).
- Note: The situation would be similar if the lessee were the guarantor but did not expect that the underlying asset would decline in value below the guaranteed amount.

- Appendix 1 (continued)

**Scenario D: Lessee uses acquisition approach and lessor uses performance obligation approach**
**Key feature: purchase option which is evaluated differently by the two parties**

- The initial lease term is for a 5 year period
- Payments are CU 5,000 per year, with the first payment due upon signing.
- There is a penalty for nonrenewal at the end of the 5th year for CU 2,100. If renewed, the same payment would be made for five additional years (as with Scenario B).
- There is a purchase option at the end of the 10th year in the amount of CU 19,000
- The lessee believes the purchase option is a bargain and accordingly uses the acquisition method.
- The lessor expects the asset will be worth less than the option price (the book value at the end of ten years is CU 17,500).
- The lessor expects the lessee will pay the penalty rather than renew and accordingly believes the most likely lease term is 5 years.
- During the fifth year, the lessor reassess the lease term when the sixth annual payment is received from the lessee. The lessor continues to use the performance obligation method under the assumption that the lessee will not exercise the purchase option.

The complete journal entries with amortization tables are posted on my website at http://www.cbe.uidaho.edu/tgordon/presentations n comltrs.htm.

Appendix 1 (continued)

**Scenario A - Bargain Purchase Option**

| | | Acquisition Method (Lessee) | | Derecognition Method (Lessor) | |
|---|---|---|---|---|---|
| | | debit | credit | debit | credit |
| Jan 1, Yr 1 | Cash | | 10,000 | 10,000 | |
| | Equipment | 43,000 | | | 60,000 |
| | Accumulated depreciation | | | 25,000 | |
| | Lease payments receivable | | | 33,000 | |
| | Obligation to make lease payments | | 33,000 | | |
| | Gain/loss on sale | | | | 8,000 |
| | | 43,000 | 43,000 | 68,000 | 68,000 |
| | | debit | credit | debit | credit |
| Dec 31, Yr 1 | Depreciation expense | 2,150 | | | |
| | Accumulated depreciation | | 2,150 | | |
| | Interest expense | 7,031 | | | |
| | Accrued interest payable | | 7,031 | | |
| | Accrued interest receivable | | | 7,031 | |
| | Interest revenue | | | | 7,031 |
| | | 9,181 | 9,181 | 7,031 | 7,031 |
| | | debit | credit | debit | credit |
| Jan 1, Yr 2 | Cash | | 10,000 | 10,000 | |
| | Obligation to make lease payments | 2,969 | | | |
| | Accrued interest payable | 7,031 | | | |
| | Lease payments receivable | | | | 2,969 |
| | Accrued interest receivable | | | | 7,031 |
| | | 10,000 | 10,000 | 10,000 | 10,000 |

Observations: This is a typical combination of methods and would commonly be found in practice. The equipment is reported only on the lessee's books. Only the lessee reports depreciation expense. The lessor reports a gain (or loss) on the transfer of the equipment to the lessee at the inception of the lease and thereafter the only effect on the income statement is interest revenue.

Appendix 1 (continued)

| | | Scenario B - nonrenewal penalty paid | | | |
|---|---|---|---|---|---|
| | | Right-of-use Method (Lessee) | | Performance Obligation Method (Lessor) | |
| | | debit | credit | debit | credit |
| Jan 1, Yr 1 | Cash | | 6,000 | 6,000 | |
| | Right-of-use asset | 26,803 | | | |
| | Obligation to make lease payments | | 20,803 | | |
| | Lease receivable | | | 20,803 | |
| | Lease performance obligation | | | | 26,803 |
| | | 26,803 | 26,803 | 26,803 | 26,803 |
| | | debit | credit | debit | credit |
| Dec 31, Yr 1 | Depreciation expense | | | 1,750 | |
| | Accumulated depreciation | | | | 1,750 |
| | Amortization expense | 5,361 | | | |
| | Acc'd amortization (right-to-use asset) | | 5,361 | | |
| | | | | | |
| | Lease performance obligation | | | 5,361 | |
| | Lease income | | | | 5,361 |
| | | | | | |
| | Interest expense | 1,872 | | | |
| | Accrued interest payable | | 1,872 | | |
| | | | | | |
| | Accrued interest receivable | | | 1,872 | |
| | Interest revenue | | | | 1,872 |
| | | 7,233 | 7,233 | 8,983 | 8,983 |
| | | debit | credit | debit | credit |
| Jan 1, Yr 2 | Cash | | 6,000 | 6,000 | |
| | Obligation to make lease payments | 4,128 | | | |
| | Accrued interest payable | 1,872 | | | |
| | Lease payments receivable | | | | 4,128 |
| | Accrued interest receivable | | | | 1,872 |
| | | 6,000 | 6,000 | 6,000 | 6,000 |
| and so on | | | | | |

Observations: This is a typical combination of methods and would commonly be found in practice. The underlying asset stays on the lessor's books and only the lessor recognizes depreciation expense. The lessee has a right-to-use asset and the lessor has a lease performance obligation which match because both parties are using the same assumptions about lease term, payments, interest rates and both are using straight-line amortization.

Appendix 1 (continued)

**Scenario C - Guaranteed Residual Value**

| | | Right to use Method (Lessee) | | Derecognition Method (Lessor) | |
|---|---|---|---|---|---|
| | | debit | credit | debit | credit |
| Jan 1, Yr 1 | Cash | | 6,310 | 6,310 | 500 |
| | Right-to-use asset | 26,753 | | | |
| | Liability to make lease payments | | 20,443 | | |
| | Equipment | | | | 60,000 |
| | Accumulated depreciation | | | 25,000 | |
| | Lease payments receivable | | | 37,190 | |
| | Obligation to make lease payments | | | | |
| | Gain/loss on sale | | | | 8,000 |
| | | 26,753 | 26,753 | 68,500 | 68,500 |

**Scenario C - Guaranteed Residual Value**

| | | Right to use Method (Lessee) | | Derecognition Method (Lessor) | |
|---|---|---|---|---|---|
| | | debit | credit | debit | credit |
| Dec 31, Yr 1 | Depreciation expense | *neither party records depreciation because the* | | | |
| | Accumulated depreciation | *physical asset is on neither set of books* | | | |
| | Interest expense | 1,840 | | | |
| | Accrued interest payable | | 1,840 | | |
| | Accrued interest receivable | | | 3,193 | |
| | Interest revenue | | | | 3,193 |
| | | 1,840 | 1,840 | 3,193 | 3,193 |
| | | debit | credit | debit | credit |
| Jan 1, Yr 2 | Cash | | 6,310 | 6,310 | |
| | Obligation to make lease payments | 4,470 | | | |
| | Accrued interest payable | 1,840 | | | |
| | Lease payments receivable | | | | 3,117 |
| | Accrued interest receivable | | | | 3,193 |
| | | 6,310 | 6,310 | 6,310 | 6,310 |

Observations: This combination of methods is not unlikely given the availability of third party guarantors. Neither party reports the equipment on their balance sheet. The lessee has no obligation to make sure the equipment is worth CU 25,000 at the end of the fifth year. The lessor is assured of getting back CU 25,000 in either cash from the third party, the equipment returned by the lessee, or a combination of these two sources. Accordingly, the guaranteed residual value is part of the lessor's receivable.

Appendix 1 (continued)

**Scenario D - Renewal & Purchase Options**

| | | Acquisition Method (Lessee) | | Performance Obligation Method (Lessor) | |
|---|---|---|---|---|---|
| | | debit | credit | debit | credit |
| Jan 1, Yr 1 | Cash | | 5,000 | 5,000 | |
| | Liability to make lease payments | | 38,000 | | |
| | Equipment | 43,000 | | | |
| | Right to receive lease payments | | | 17,563 | |
| | Lease performance obligation | | | | 22,563 |
| | Lease payments receivable | | | | |
| | | 43,000 | 43,000 | 22,563 | 22,563 |
| | | debit | credit | debit | credit |
| Dec 31, Yr 1 | Depreciation expense | 2,150 | | 1,750 | |
| | Accumulated depreciation | | 2,150 | | 1,750 |
| | Interest expense | 3,420 | | | |
| | Accrued interest payable | | 3,420 | | |
| | Accrued interest receivable | | | 1,581 | |
| | Interest revenue | | | | 1,581 |
| | Lease performance obligation | | | 4,513 | |
| | Lease income | | | | 4,513 |
| | | 5,570 | 5,570 | 3,331 | 3,331 |

*Note that the physical asset is initially on both sets of books*

| | | debit | credit | debit | credit |
|---|---|---|---|---|---|
| Jan 1, Yr 2 | Cash | | 5,000 | 5,000 | |
| | Obligation to make lease payments | 1,580 | | | |
| | Accrued interest payable | 3,420 | | | |
| | Lease payments receivable | | | | 3,419 |
| | Accrued interest receivable | | | | 1,581 |
| | | 5,000 | 5,000 | 5,000 | 5,000 |

and so on until the 5th year when the lessee opts to renew the lease and pays no penalty. The lessor may still assume that the purchase option is not a bargain.

| | Beg of Yr 5 | Should be | Adjustment |
|---|---|---|---|
| Bal fwd in lease receivable | 1,927 | 19,448 | 17,522 |
| Bal fwd in lease performance obligation = | 4,513 | add adjustment and divide by 6 more years | |

Appendix 1 (continued)

**Scenario D - Renewal & Purchase Options**

| | | Acquisition Method (Lessee) | | Performance Obligation Method (Lessor) | |
|---|---|---|---|---|---|
| | | debit | credit | debit | credit |
| Dec 31, Yr 5 | Lease payments receivable | | | 17,522 | |
| | Lease performance obligation | | | | 17,522 |
| | | | | | |
| | Depreciation expense | 2,150 | | 1,750 | |
| | Accumulated depreciation | | 2,150 | | 1,750 |
| | Interest expense | 2,770 | | | |
| | Accrued interest payable | | 2,770 | | |
| | Accrued interest receivable | | | 1,751 | |
| | Interest revenue | | | | 1,751 |
| | Lease performance obligation | | | 3,672 | |
| | Lease income | | | | 3,672 |
| | | 4,920 | 4,920 | 24,695 | 24,695 |

And so on until the lessee exercises the purchase option at the end of Year 10:

**Scenario D - Renewal & Purchase Options**

| | | Acquisition Method (Lessee) | | Performance Obligation Method (Lessor) | |
|---|---|---|---|---|---|
| Dec. 31, Yr 10 | | debit | credit | debit | credit |
| | Cash | | 19,000 | 19,000 | |
| | Obligation to make lease payments | 17,431 | | | |
| | interest expense | 1,569 | | | |
| | | | | | |
| | Depreciation expense | 2,150 | | 1,750 | |
| | Accumulated depreciation | | 2,150 | | 1,750 |
| | | | | | |
| | Equipment | | | | 60,000 |
| | Accumulated depreciation | | | 42,500 | |
| | Gain on sale of asset | | | | 1,500 |
| | | | | | |
| | Lease performance obligation | | | 3,672 | |
| | Lease income | | | | 3,672 |
| | | 21,150 | 21,150 | 66,922 | 66,922 |

Observations: I expected that this combination of methods would be relatively rare. It results from different perceptions about lease term as well as what constitute a bargain so it is possible. In this case both the lessor and the lessee are carrying the equipment on their balance sheet. Both parties are recording depreciation expense on the same asset. The interest revenue reported by the lessor is not equal to the interest expense reported by the lessee even though both are using the same discount rate. The lessee ends up with an asset with a carrying value of CU 21,500 at the end of the tenth year. The lessor recognized a gain on disposition in the tenth year.

## Appendix A, Part 1 (Example 4)
## Proposed alternatives to the "allocation" of fair value between cost of goods sold and the residual value under the proposed Derecognition Method

The assumptions in these recommended changes include the "original" amounts allocated to the residual value in Examples 4 and 5 – that is, the residual value of the underlying derecognized asset is $207 if the lease is for 10 years and $895 if the lease is for 8 years. I did not change these assumptions because I wanted the suggested alternatives to be exactly parallel. As with Examples 4 and 5, I have used ordinary annuities. For clarity, I've made the adjustment to expected lease term early in year 2, rather than in year 1. Note that under current GAAP for a sales-type lease, cost of goods sold is reduced by the present value of any anticipated residual value. Amortization tables follow the explanations for change in cost of goods sold (after the journal entries).

Present values for Examples 4 and 5

| Additional Present Values | Undiscounted Residual Value | Remaining term | PV of RV | PVELP Without Residual Value | PVELP Including Residual Value |
|---|---|---|---|---|---|
| Beg of Year 1 (10 yr lease) | 207 | 10 | 95.88 | 6,710.08 | 6,805.96 |
| Beg of Year 1 (8 year lease) | 895 | 8 | 483.54 | 5,746.64 | 6,230.18 |
| End of Year 1 (10 yr lease) | 207 | 9 | 103.55 | 6,246.89 | 6,350.44 |
| End of Year 1 (8y yr lease) | 895 | 7 | 522.22 | 5,206.37 | 5,728.59 |

| | | | Variations on Example 4 | | | | | |
|---|---|---|---|---|---|---|---|---|
| Example 4 | | | | | If we had only known | | Equivalent to Existing GAAP | |
| | | | ED Method | | Recommended Method #1 | | Recommended Method #2 | |
| At inception (Year 1) | | | Debit | Credit | Debit | Credit | Debit | Credit |
| | Lease receivable | | 6,710.08 | | 6,710.08 | - | 6,805.96 | - |
| | Sales | | | 6,710.08 | - | 6,710.08 | - | 6,710.08 |
| | Cost of goods sold | | 4,793.00 | | 4,793.00 | - | 4,904.12 | - |
| | Inventory (or underlying asset) | | | 5,000.00 | - | 5,000.00 | - | 5,000.00 |
| | PP&E - residual value | | 207.00 | | 207.00 | - | | - |
| | | | 11,710.08 | 11,710.08 | 11,710.08 | 11,710.08 | 11,710.08 | 11,710.08 |
| End of Year 1 - payment is received | | | | | | | | |
| | Cash | | 1,000.00 | | 1,000.00 | - | 1,000.00 | - |
| | Lease receivable | | | 463.19 | - | 463.19 | - | 455.52 |
| | Interest revenue | | | 536.81 | - | 536.81 | - | 544.48 |
| | | | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 |

Appendix A (continued)

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | Variations on Example 4 | | | |
| | | | | | If we had only known | | Equivalent to Existing GAAP | |
| Adjustment because lease is now expected to | | | ED Method | | Recommended Method #1 | | Recommended Method #2 | |
| be for | 8 | years | | | - | - | - | - |
| Sales | | | 1,040.52 | | 1,040.52 | - | 1,040.52 | - |
| Lease receivable | | | | 1,040.52 | - | 1,040.52 | - | 621.85 |
| Leased asset (residual value) | | | 34.46 | | 688.26 | - | | - |
| Cost of Goods Sold | | | | 34.46 | - | 688.26 | | 418.67 |
| | | | 1,074.98 | 1,074.98 | 1,728.78 | 1,728.78 | 1,040.52 | 1,040.52 |
| | | | | | - | - | - | - |
| Year 2 payment | | | From Table 4-1-2 | | From Table 4-1-2 | | From Table 4-2-2 | |
| | Cash | | 1,000.00 | | 1,000.00 | | 1,000.00 | - |
| | Lease receivable | | | 583.49 | - | 583.49 | - | 541.71 |
| | Interest revenue | | | 416.51 | - | 416.51 | - | 458.29 |
| | | | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 |
| | | | | | - | - | - | - |
| | Lease receivable at end of Year | | 6,246.89 | | 6,246.89 | | 6,350.44 | |
| | Correct amount at end of Year | | 5,206.37 | | 5,206.37 | | 5,728.59 | |
| | Adjustment to lease receivable | | 1,040.52 | | 1,040.52 | | 621.85 | |

| | | | |
|---|---|---|---|
| Adjustment needed to cost of goods sold: | | | |
| ED method: | | | |
| decrease in receivable | 1,041 | = | |
| Fair value at end of yr 1 (given) | 6,250.00 | | 0.17 |
| Original amount allocated to residual value | | | 207.00 |
| | Increase needed = | | 34.46 |

| Method #2 (equivalent to current GAAP) | |
|---|---|
| PVELP without RV (end of Yr 1) | 6,246.89 |
| Should be = | 5,206.37 |
| Adjustment to Sales = | 1,040.52 |
| | |
| PV of RV at end of Yr 1 | 103.55 |
| Should be | 522.22 |
| Adjustment to COGS = | 418.67 |

| Method #1 change (if we had only known approach) | | | |
|---|---|---|---|
| Present value | 5,747 | PV should have been (n=8) | |
| Fair value | 7,000 | at inception | |
| Percentage SOLD = | | 0.82 | |
| Book value (Yr0 | 5,000 | 4,104.74 | portion sold |
| RV should have been = | | 895.26 | residual value |
| Originally recorded = | | 207.00 | residual value |
| | Change = | 688.26 | adj needed |

Appendix A (continued)

| | Table 4-1-1 | Method #1 | | | Table 4-1-2 | Method #1 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Original amortization schedule | | | | MODIFIED AMORTIZATION SCHEDULE | | | | |
| Period | Payment | Interest | Redution | Balance | Payment | Interest | Redution | Adjustment | Balance |
| 0 | | 8% | | $6,710.08 | | 8% | | | $6,710.08 |
| 1 | 1,000 | 536.81 | 463.19 | 6,246.89 | 1,000 | 536.81 | 463.19 | 1,040.52 | 5,206.37 |
| 2 | 1,000 | 499.75 | 500.25 | 5,746.64 | 1,000 | 416.51 | 583.49 | | 4,622.88 |
| 3 | 1,000 | 459.73 | 540.27 | 5,206.37 | 1,000 | 369.83 | 630.17 | | 3,992.71 |
| 4 | 1,000 | 416.51 | 583.49 | 4,622.88 | 1,000 | 319.42 | 680.58 | | 3,312.13 |
| 5 | 1,000 | 369.83 | 630.17 | 3,992.71 | 1,000 | 264.97 | 735.03 | | 2,577.10 |
| 6 | 1,000 | 319.42 | 680.58 | 3,312.13 | 1,000 | 206.17 | 793.83 | | 1,783.26 |
| 7 | 1,000 | 264.97 | 735.03 | 2,577.10 | 1,000 | 142.66 | 857.34 | | 925.93 |
| 8 | 1,000 | 206.17 | 793.83 | 1,783.26 | 1,000 | 74.07 | 925.93 | | 0.00 |
| 9 | 1,000 | 142.66 | 857.34 | 925.93 | | | | | 0.00 |
| 10 | 1,000 | 74.07 | 925.93 | 0.00 | | | | | 0.00 |
| | 10,000.00 | 3,289.92 | 6,710.08 | | 8,000.00 | 2,330.44 | 5,669.56 | | |

| | Table 4-2-1 | Method #2 | | | Table 4-2-2 | Method #2 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Original amortization schedule | | | | MODIFIED AMORTIZATION SCHEDULE | | | | |
| Period | Payment | Interest | Redution | Balance | Payment | Interest | Redution | Adjustment | Balance |
| 0 | | 8% | | $6,805.96 | | 8% | | | $6,805.96 |
| 1 | 1,000 | 544.48 | 455.52 | 6,350.44 | 1,000 | 544.48 | 455.52 | 621.85 | 5,728.59 |
| 2 | 1,000 | 508.04 | 491.96 | 5,858.47 | 1,000 | 458.29 | 541.71 | | 5,186.88 |
| 3 | 1,000 | 468.68 | 531.32 | 5,327.15 | 1,000 | 414.95 | 585.05 | | 4,601.83 |
| 4 | 1,000 | 426.17 | 573.83 | 4,753.32 | 1,000 | 368.15 | 631.85 | | 3,969.98 |
| 5 | 1,000 | 380.27 | 619.73 | 4,133.59 | 1,000 | 317.60 | 682.40 | | 3,287.58 |
| 6 | 1,000 | 330.69 | 669.31 | 3,464.28 | 1,000 | 263.01 | 736.99 | | 2,550.58 |
| 7 | 1,000 | 277.14 | 722.86 | 2,741.42 | 1,000 | 204.05 | 795.95 | | 1,754.63 |
| 8 | 1,000 | 219.31 | 780.69 | 1,960.73 | 1,000 | 140.37 | 859.63 | | 895.00 |
| 9 | 1,000 | 156.86 | 843.14 | 1,117.59 | | | | | 895.00 |
| 10 | 1,000 | 89.41 | 910.59 | 207.00 | | | | | 895.00 |
| | 10,000.00 | 3,401.04 | 6,598.96 | | 8,000.00 | 2,710.88 | 5,289.12 | | |

## Appendix A, part 2 (Example 5)

**Proposed alternatives to the "allocation" of fair value between cost of goods sold and the residual value under the proposed Derecognition Method**

The assumptions in these recommended changes include the "original" amounts allocated to the residual value in Examples 4 and 5 – that is, the residual value of the underlying derecognized asset is $207 if the lease is for 10 years and $895 if the lease is for 8 years. I did not change these assumptions because I wanted the suggested alternatives to be exactly parallel. As with Examples 4 and 5, I have used ordinary annuities. For clarity, I've made the adjustment to expected lease term early in year 2, rather than in year 1. Note that under current GAAP for a sales-type lease, cost of goods sold is reduced by the present value of any anticipated residual value. Amortization tables follow the explanations for change in cost of goods sold (after the journal entries).

Note that Method 2 ends up with the predicted residual value in the Lease Receivable account. An entry would be made to record the noncash amount received, presumably at the fair value of the returned asset. At that point a small gain or loss might need to be recognized. This method is also suitable to use when there are changes in the predicted residual value of the asset removed from the books at the inception of the lease.

Present values for Examples 4 and 5

| Additional Present Values | Undiscounted Residual Value | Remaining term | PV of RV | PVELP Without Residual Value | PVELP Including Residual Value |
|---|---|---|---|---|---|
| Beg of Year 1 (10 yr lease) | 207 | 10 | 95.88 | 6,710.08 | 6,805.96 |
| Beg of Year 1 (8 year lease) | 895 | 8 | 483.54 | 5,746.64 | 6,230.18 |
| End of Year 1 (10 yr lease) | 207 | 9 | 103.55 | 6,246.89 | 6,350.44 |
| End of Year 1 (8y yr lease) | 895 | 7 | 522.22 | 5,206.37 | 5,728.59 |

| | | | | Variations on Example 5 | | | |
|---|---|---|---|---|---|---|---|
| Example 5 | | | | If we had only known | | Equivalent to Existing GAAP | |
| | | ED Method | | Recommended Method #1 | | Recommended Method #2 | |
| At inception (Year 1) | | Debit | Credit | Debit | Credit | Debit | Credit |
| | Lease receivable | 5,746.64 | | 5,746.64 | - | 6,230.18 | - |
| | Sales | | 5,746.64 | - | 5,746.64 | - | 5,746.64 |
| | Cost of goods sold | 4,105.00 | | 4,105.00 | - | 4,516.46 | - |
| | Inventory (or underlying asset) | | 5,000.00 | - | 5,000.00 | - | 5,000.00 |
| | PP&E - residual value | 895.00 | | 895.00 | - | | - |
| | | 10,746.64 | 10,746.64 | 10,746.64 | 10,746.64 | 10,746.64 | 10,746.64 |
| End of Year 1 - payment is received | | | | | | | |
| | Cash | 1,000.00 | | 1,000.00 | - | 1,000.00 | - |
| | Lease receivable | | 501.59 | - | 501.59 | - | 501.59 |
| | Interest revenue | | 498.41 | - | 498.41 | - | 498.41 |
| | | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 |

Appendix A (continued)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | Variations on Example 5 | | | |
| | | | | | If we had only known | | Equivalent to Existing GAAP |
| Adjustment because lease is now expected to | | | ED Method | | Recommended Method #1 | | Recommended Method #2 |
| be for | 10 | years | | | - | - | - | - |
| | Sales | | | 1,040.52 | - | 1,040.52 | | 1,040.52 |
| | Lease receivable | | 1,040.52 | | 1,040.52 | - | 621.85 | - |
| | Leased asset (residual value) | | | 149.00 | | 687.92 | | |
| | Cost of Goods Sold | | 149.00 | - | 687.92 | - | 418.67 | |
| | | | 1,189.52 | 1,189.52 | 1,728.43 | 1,728.43 | 1,040.52 | 1,040.52 |
| | | | | | - | - | - | - |
| Year 2 payment | | | From Table 5-1-2 | | From Table 5-1-2 | | From Table 5-2-2 | |
| | Cash | | 1,000.00 | | 1,000.00 | | 1,000.00 | - |
| | Lease receivable | | | 500.25 | - | 500.25 | - | 491.96 |
| | Interest revenue | | | 499.75 | - | 499.75 | - | 508.04 |
| | | | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 |
| | | | | | - | - | - | - |
| | Lease receivable at end of Year | | 5,206.37 | | 5,206.37 | | 5,728.59 | |
| | Correct amount at end of Year | | 6,246.89 | | 6,246.89 | | 6,350.44 | |
| | Adjustment to lease receivable | | (1,040.52) | | (1,040.52) | | (621.85) | |

| **Adjustment needed to cost of goods sold:** | | |
|---|---|---|
| ED method: | | |
| decrease in receivable | 1,041 | = |
| Fair value at end of yr 1 (given) | 6,250.00 | 0.17 |
| Original amount allocated to residual value | | 895.00 |
| Reduction needed = | | 149.00 |

| **Method #2 (equivalent to current GAAP)** | |
|---|---|
| PVELP without RV (end of Yr 1) | 6,246.89 |
| Should be = | 5,206.37 |
| Adjustment to Sales = | 1,040.52 |
| | |
| PV of RV at end of Yr 1 | $522.22 |
| For 10 yr ese, should be | $103.55 |
| Adjustment to COGS = | (418.67) |

| **Method #1 change (if we had only known approach)** | | | |
|---|---|---|---|
| Present value | 6,710 | PV should have been (n=10) | |
| Fair value | 7,000 | at inception | |
| Percentage SOLD = | | 0.96 | |
| Book value (Yr0 | 5,000 | 4,792.92 | portion sold |
| RV should have been = | | 207.08 | residual value |
| Originally recorded = | | 895.00 | residual value |
| Change = | | (687.92) | adj needed |

Appendix A (continued)

| | Table 5-1-1 | Method #1 | | | Table 5-1-2 | Method #1 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Original amortization schedule | | | | MODIFIED AMORTIZATION SCHEDULE | | | | |
| Period | Payment | Interest | Reduction | Balance | Payment | Interest | Reduction | Adjustment | Balance |
| 0 | | 8% | | 5,746.64 | | 8% | | | $5,746.64 |
| 1 | 1,000 | 459.73 | 540.27 | 5,206.37 | 1,000 | 459.73 | 540.27 | (1,040.52) | 6,246.89 |
| 2 | 1,000 | 416.51 | 583.49 | 4,622.88 | 1,000 | 499.75 | 500.25 | | 5,746.64 |
| 3 | 1,000 | 369.83 | 630.17 | 3,992.71 | 1,000 | 459.73 | 540.27 | | 5,206.37 |
| 4 | 1,000 | 319.42 | 680.58 | 3,312.13 | 1,000 | 416.51 | 583.49 | | 4,622.88 |
| 5 | 1,000 | 264.97 | 735.03 | 2,577.10 | 1,000 | 369.83 | 630.17 | | 3,992.71 |
| 6 | 1,000 | 206.17 | 793.83 | 1,783.26 | 1,000 | 319.42 | 680.58 | | 3,312.13 |
| 7 | 1,000 | 142.66 | 857.34 | 925.93 | 1,000 | 264.97 | 735.03 | | 2,577.10 |
| 8 | 1,000 | 74.07 | 925.93 | 0.00 | 1,000 | 206.17 | 793.83 | | 1,783.26 |
| 9 | - | 0.00 | (0.00) | 0.00 | 1,000 | 142.66 | 857.34 | | 925.93 |
| 10 | - | 0.00 | (0.00) | 0.00 | 1,000 | 74.07 | 925.93 | | 0.00 |
| | 8,000.00 | 2,253.36 | 5,746.64 | | 10,000.00 | 3,212.84 | 6,787.16 | | |

| | Table 5-2-1 | Method #2 | | | Table 5-2-2 | Method #2 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Original amortization schedule | | | | MODIFIED AMORTIZATION SCHEDULE | | | | |
| Period | Payment | Interest | Reduction | Balance | Payment | Interest | Reduction | Adjustment | Balance |
| 0 | | 8% | | 6,230.18 | | 8% | | | 6,230.18 |
| 1 | 1,000 | 498.41 | 501.59 | 5,728.59 | 1,000 | 498.41 | 501.59 | (621.85) | 6,350.44 |
| 2 | 1,000 | 458.29 | 541.71 | 5,186.88 | 1,000 | 508.04 | 491.96 | | 5,858.47 |
| 3 | 1,000 | 414.95 | 585.05 | 4,601.83 | 1,000 | 468.68 | 531.32 | | 5,327.15 |
| 4 | 1,000 | 368.15 | 631.85 | 3,969.98 | 1,000 | 426.17 | 573.83 | | 4,753.32 |
| 5 | 1,000 | 317.60 | 682.40 | 3,287.58 | 1,000 | 380.27 | 619.73 | | 4,133.59 |
| 6 | 1,000 | 263.01 | 736.99 | 2,550.58 | 1,000 | 330.69 | 669.31 | | 3,464.28 |
| 7 | 1,000 | 204.05 | 795.95 | 1,754.63 | 1,000 | 277.14 | 722.86 | | 2,741.42 |
| 8 | 1,000 | 140.37 | 859.63 | 895.00 | 1,000 | 219.31 | 780.69 | | 1,960.73 |
| 9 | - | | | | 1,000 | 156.86 | 843.14 | | 1,117.59 |
| 10 | - | | | | 1,000 | 89.41 | 910.59 | | 207.00 |
| | 8,000.00 | 2,664.82 | 5,335.18 | | 10,000.00 | 3,354.97 | 6,645.03 | | |

## Appendix B – Contingent Rent Example (significant difference from forecast)

This is one example from a set I prepared. The methodology assumes that the contingent rent from the most recent period is used to forecast the remaining payments. I call it the "continuously adjusted" approach. I believe this illustrates the intent of ED Paragraph 18 as it recognizes past errors in net income and only the anticipated future changes affect the right-to-use asset. Obviously, total expenses are always equal to the cash flow for lease payments (see bottom of next page)

**Roughtly based on Example 9 in the 2009 Preliminary Views document**

A lessee enters into a five-year lease of a retail store. The lease is non-cancellable and the lessee has no option to extend the lease. The lessee is required to make fixed annual payments of CU500. In addition, the lessee is required to make payments equal to 1 percent of sales from the leased store. The lessee forecasts the following sales for the store and assigns each outcome a probability:

| | Sales Level | | | |
|---|---|---|---|---|
| Total forecast sales years 1 — 5 (CU) | 10,000.00 | 20,000.00 | 35,000.00 | Expected Value |
| Probability that forecast sales will occur | 10% | 60% | 30% | |
| Probability weighted expected sales | 1,000.00 | 12,000.00 | 10,500.00 | 23,500.00 |
| Total contingent rentals 1% of forecast sales (CU) | | | | 235.00 |
| Total fixed rentals years 1 — 5 (CU) - at CU 500 per year | | | | 500.00 |
| Total estimated rentals years 1 — 5 (CU) | | | | 735.00 |

**Assume actual sales are as follows:**

| Year | sales | cont rent @ 1% |
|---|---|---|
| 1 | 50,000.00 | 500.00 |
| 2 | 55,000.00 | 550.00 |
| 3 | 65,000.00 | 650.00 |
| 4 | 70,000.00 | 700.00 |
| 5 | 75,000.00 | 750.00 |
| | 315,000.00 | 3,150.00 |

Present value of expected lease payments

| | |
|---|---|
| n= | 5.00 |
| i= | 10% |
| pmt= | 735.00 |
| fv= | 0.00 |
| Ord annuity | 0.00 |
| PVELP= | 2,786.23 |

See excel file at my website for variations with smaller differences between actual and forecast contingent rentals as well as a more realistic version with annuity due payments for the base rent and one adjustment at end of Year 3. The annuity due version also has both "small" and "large" prediction error versions. In all cases, the original estimate (even flawed) produces an answer that doesn't seem to cause material differences in the timing of expense recognition for the lessee.

**Scenario 4 - significant changes in contingent rents, ordinary annutiy**

**Continually revised table** type= 0.00

r= 10% LT= 5.00 fv= 0.00

| Period | Fixed Payment | Contingent payment | Total payment | Interest | Principal Reduction | Adjustment | Balance | Remaining payments | Revised Payment | Balance should be | Prior balance | Actual contingent rent | Difference to NI |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 0 | | | | | | | 2,786.23 | | | | | | |
| 1 | 500.00 | 235.00 | 735.00 | 278.62 | 456.38 | -840.02 | 3,169.87 | 4 | 1,000.00 | 3,169.87 | 2,329.85 | 500.00 | -265.00 |
| 2 | 500.00 | 500.00 | 1,000.00 | 316.99 | 683.01 | -124.34 | 2,611.20 | 3 | 1,050.00 | 2,611.19 | 2,486.85 | 550.00 | -50.00 |
| 3 | 500.00 | 550.00 | 1,050.00 | 261.12 | 788.88 | -173.55 | 1,995.87 | 2 | 1,150.00 | 1,995.87 | 1,822.32 | 650.00 | -100.00 |
| 4 | 500.00 | 650.00 | 1,150.00 | 199.59 | 950.41 | -45.46 | 1,090.91 | 1 | 1,200.00 | 1,090.91 | 1,045.45 | 700.00 | -50.00 |
| 5 | 500.00 | 700.00 | 1,200.00 | 109.09 | 1,090.91 | | 0.00 | 0 | | 0.00 | | 750.00 | -50.00 |
| TRUE | 2,500.00 | 2,635.00 | 5,135.00 | 1,165.41 | 3,969.59 | | | | | | | 3,150.00 | -515.00 |

**Scenario 4 - significant changes in contingent rents, ordinary annutiy**

**Continually revised table**

| | Beginning of Year 1 | | Beginning of Year 2 | | Beginning of Year 3 | | Beginning of Year 4 | | Beginning of Year 5 | |
|---|---|---|---|---|---|---|---|---|---|---|
| At inception of lease: | debit | credit | debit | credit | debit | credit | debit | credit | debit | credit |
| Right-of-use asset | 2,786.23 | | 840.02 | | 124.34 | | 173.55 | | 45.46 | |
| Liability for lease payments | | 2,786.23 | | 840.02 | | 124.34 | | 173.55 | | 45.46 |
| | 2,786.23 | 2,786.23 | 840.02 | 840.02 | 124.34 | 124.34 | 173.55 | 173.55 | 45.46 | 45.46 |
| Carrying value for right-to-use asset after adjustment | 2,786.23 | | 3,069.00 | | 2,426.09 | | 1,790.94 | | 940.93 | |
| | | | divided by 4 | | divided by 3 | | divided by 2 | | divided by 1 | |

Adjustments always assume that future contingent rentals will be the same as contingent rent just paid

| | End of Year 1 | | End of Year 2 | | End of Year 3 | | End of Year 4 | | End of Year 5 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | debit | credit | debit | credit | debit | credit | debit | credit | debit | credit |
| Amortization expense | 557.25 | | 767.25 | | 808.70 | | 895.47 | | 940.93 | |
| Acc'd amortization | | 557.25 | | 767.25 | | 808.70 | | 895.47 | | 940.93 |
| | | | | | | | | | | |
| Gain (loss) on contingent rental* | 265.00 | | 50.00 | | 100.00 | | 50.00 | | 50.00 | |
| Liability for lease payments | 456.38 | | 683.01 | | 788.88 | | 950.41 | | 1,090.91 | |
| Interest expense | 278.62 | | 316.99 | | 261.12 | | 199.59 | | 109.09 | |
| Cash | | 1,000.00 | | 1,050.00 | | 1,150.00 | | 1,200.00 | | 1,250.00 |
| | 1,557.25 | 1,557.25 | 1,817.25 | 1,817.25 | 1,958.70 | 1,958.70 | 2,095.47 | 2,095.47 | 2,190.93 | 2,190.93 |

*difference between predicted and actual contingent rentals

| | Total | End of Year 1 | End of Year 2 | End of Year 3 | End of Year 4 | End of Year 5 |
|---|---|---|---|---|---|---|
| Impact on net income | -5,650.00 | -1,100.87 | -1,134.24 | -1,169.82 | -1,145.06 | -1,100.02 |
| Difference between "no adjustment" and "continuous adjustment" | | 0.00 | -29.01 | -14.79 | 4.75 | 39.04 |
| Difference between "continuous adjustment" and "perfect forecast" | | 170.12 | 79.12 | -24.86 | -85.33 | -139.06 |
| Difference between "no adjustment" and "perfect forecast" | | 170.12 | 108.13 | -10.07 | -90.08 | -178.10 |

## Appendix C – Comparative Lessee & Lessor Examples with initial direct costs and nonrenewal penalty

These examples are loosely based on Example 8 in the 2009 Preliminary Views document. I have added initial direct costs to demonstrate a problem I see with the exposure draft. There are two variations – one in which the initial lease term is shortened and the other where the initial lease term is lengthened.

Assumptions:

- Primary non-cancellable lease period — five years
- Secondary optional period — three years at same rate per year
- The lessee is neither required nor permitted to exercise the renewal option until the end of the five-year period. However, there is a CU 500 penalty for nonrenewal.
- Annual rentals — CU 1,000, paid in arrears
- The most likely lease term is reassessed at start of year 4.
- Lessee's incremental borrowing rate over the entire lease period — 10 percent
- Rate the lessor charges the lessee over the entire lease period -- 10 percent
- Lessor and lessee split the fee paid to an attorney to draw up the lease agreement (CU 200 each)
- For the **Lessee's** initial measurement, (a) the lease obligation is measured at the present value of the lease payments over the expected lease term using the lessee's incremental borrowing rate and (b) the right-of-use asset is equal to the obligation plus initial direct costs (as per ED paragraph 12).
- For the **Lessor's** initial measurement, (a) the right to receive lease payments (lease receivable) is measured at initial direct costs plus the present value of the lease payments over the expected lease term using the rate at which the lessor would lend money to the lessee (which is equal to the lessee's incremental borrowing rate) as per ED paragraphs 33 and 49. For the performance obligation method, the lease liability is measured the same way but does not include initial direct costs. For the derecognition method, the residual asset is carried at an allocated amount (see below).
- For subsequent measurement, (a) the **lessee's** obligation is amortised using the effective interest method over the expected lease term and (b) the right-of-use asset is depreciated on a straight-line basis over the expected lease term.
- For subsequent measurement, the **lessor's** right to receive lease payments is amortized using the effective interest rate (adjusted as necessary for the impact of the initial direct costs). For the performance obligation method, the lease liability is amortised straight-line over the expected lease term and the leased asset is depreciated straight-line over its remaining useful life.
- Lessor's book value at inception is CU 4,000.00 and the useful life is 10 years

| Most likely lease term at inception | | |
|---|---|---|
| Variation A | 5 | years |
| Variation B | 8 | years |

For derecognition method, residual value is
Allocated at 50/50 if lease ends in 5 years or CU 2,000 initially.
Allocated at 75/25 if lease ends in 8 years or CU 1,000 initially

Present values for examples (payments in arrears - ordinary annuity)

| Lease Term in Years | Interest rate | Annual Payment | Future Value (penalty for nonrenewal) | Present Value (Before Initial Direct Costs) |
|---|---|---|---|---|
| 5 | 10% | 1,000 | 500 | 4,101 |
| 8 | 10% | 1,000 | 0 | 5,335 |

Initial amortization tables are on the next page followed by journal entries for each variation.

Appendix C, continued
Initial amortization tables

| Lessee Table for 5 yr term | | | Variation A | |
|---|---|---|---|---|
| Period | Payment | Interest | Principal | Balance |
| 0 | | 10% | | 4,101.25 |
| 1 | 1,000.00 | 410.12 | 589.88 | 3,511.37 |
| 2 | 1,000.00 | 351.14 | 648.86 | 2,862.51 |
| 3 | 1,000.00 | 286.25 | 713.75 | 2,148.76 |
| 4 | 1,000.00 | 214.88 | 785.12 | 1,363.64 |
| 5 | 1,500.00 | 136.36 | 1,363.64 | 0.00 |
| Totals | 5,500.00 | 1,398.75 | 4,101.25 | |

| Lessor Table for 5 yr term | | | Initial direct costs | 200 |
|---|---|---|---|---|
| Period | Payment | Interest | Principal | Balance |
| 0 | (4,301) | 8.26% | | 4,301.25 |
| 1 | 1,000.00 | 355.45 | 644.55 | 3,656.70 |
| 2 | 1,000.00 | 302.19 | 697.81 | 2,958.89 |
| 3 | 1,000.00 | 244.52 | 755.48 | 2,203.41 |
| 4 | 1,000.00 | 182.09 | 817.91 | 1,385.50 |
| 5 | 1,500.00 | 114.50 | 1,385.50 | (0.00) |
| Totals | 5,500.00 | 1,198.75 | 4,301.25 | |

| Lessee Table for 8 yr term | | | Variation B | |
|---|---|---|---|---|
| Period | Payment | Interest | Principal | Balance |
| 0 | | 10% | | 5,334.93 |
| 1 | 1,000.00 | 533.49 | 466.51 | 4,868.42 |
| 2 | 1,000.00 | 486.84 | 513.16 | 4,355.26 |
| 3 | 1,000.00 | 435.53 | 564.47 | 3,790.79 |
| 4 | 1,000.00 | 379.08 | 620.92 | 3,169.87 |
| 5 | 1,000.00 | 316.99 | 683.01 | 2,486.85 |
| 6 | 1,000.00 | 248.69 | 751.31 | 1,735.54 |
| 7 | 1,000.00 | 173.55 | 826.45 | 909.09 |
| 8 | 1,000.00 | 90.91 | 909.09 | 0.00 |
| Totals | 8,000.00 | 2,665.07 | 5,334.93 | |

| Lessor Table for 8 yr term | | | Initial direct costs | 200 |
|---|---|---|---|---|
| Period | Payment | Interest | Principal | Balance |
| 0 | (5,535) | 9.00% | | 5,534.93 |
| 1 | 1,000.00 | 498.11 | 501.89 | 5,033.04 |
| 2 | 1,000.00 | 452.95 | 547.05 | 4,485.99 |
| 3 | 1,000.00 | 403.72 | 596.28 | 3,889.70 |
| 4 | 1,000.00 | 350.05 | 649.95 | 3,239.76 |
| 5 | 1,000.00 | 291.56 | 708.44 | 2,531.32 |
| 6 | 1,000.00 | 227.81 | 772.19 | 1,759.12 |
| 7 | 1,000.00 | 158.31 | 841.69 | 917.44 |
| 8 | 1,000.00 | 82.56 | 917.44 | (0.00) |
| Totals | 8,000.00 | 2,465.07 | 5,534.93 | |

## Appendix C – Variation A (Initial lease term of 5 years is changed to 8 years)

| Comparative Example PV8a | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|
| | Lessee | | Lessor | | Lessor | |
| | debit | credit | debit | credit | debit | credit |
| At inception of lease: | | | | | | |
| Right of use asset | 4,301.25 | | | | | |
| Liability/Receivable for Lease Payments | | 4,101.25 | 4,301.25 | | 4,301.25 | |
| Lease liability (lessor) | | | | 4,101.25 | | |
| Cash (initial direct cost) | | 200.00 | | 200.00 | | 200.00 |
| Plant, property & equipment | | | | | | 4,000.00 |
| Cost of goods sold | | | | | 2,000.00 | |
| Equipment held for lease (residual value) | | | | | 2,000.00 | |
| Lease revenue (PVELP) | | | | | | 4,101.25 |
| | 4,301.25 | 4,301.25 | 4,301.25 | 4,301.25 | 8,301.25 | 8,301.25 |

| Comparative Example PV8a | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|
| | Lessee | | Lessor | | Lessor | |
| End of Year 1 - payment is made: | debit | credit | debit | credit | debit | credit |
| Cash | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | 589.88 | | | 644.55 | | 644.55 |
| Interest expense/revenue | 410.12 | | | 355.45 | | 355.45 |
| | | | | | | |
| Lease liability (SL method) | | | 820.25 | | | |
| Lease revenue | | | | 820.25 | | |
| | | | | | | |
| Amort/Depreciation expense | 860.25 | | 400.00 | | | |
| Accumulated amort/depreciation | | 860.25 | | 400.00 | | |
| (SL method) | 1,860.25 | 1,860.25 | 2,220.25 | 2,220.25 | 1,000.00 | 1,000.00 |

Note: The residual value is arguably too large to justify use of the derecognition method for this situation. Please refer to Appendix 1 which was created later.

Appendix C – Variation A (Initial lease term of 5 years is changed to 8 years)

| Comparative Example PV8a | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| **End of Year 2 - payment is made:** | | debit | credit | debit | credit | debit | credit |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 648.86 | | | 697.81 | | 697.81 |
| Interest expense/revenue | | 351.14 | | | 302.19 | | 302.19 |
| | | | | | | | |
| Lease liability | (SL method) | | | 820.25 | | | |
| Lease revenue | | | | | 820.25 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 860.25 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 860.25 | | 400.00 | | |
| | | 1,860.25 | 1,860.25 | 2,220.25 | 2,220.25 | 1,000.00 | 1,000.00 |

| Comparative Example PV8a | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 3 - payment is made:** | | | | | | | |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 713.75 | | | 755.48 | | 755.48 |
| Interest expense/revenue | | 286.25 | | | 244.52 | | 244.52 |
| | | | | | | | |
| Lease liability | (SL method) | | | 820.25 | | | |
| Lease revenue | | | | | 820.25 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 860.25 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 860.25 | | 400.00 | | |
| | | 1,860.25 | 1,860.25 | 2,220.25 | 2,220.25 | 1,000.00 | 1,000.00 |

Appendix C – Variation A (Initial lease term of 5 years is changed to 8 years)

Beginning of Year 4 - lease term is re-evaluated and renewal is the most likely outcome.

**Revised Amortization Table for Lessee** Initial direct costs = 200

| Period | Payment | Interest | Principal | Adj for Renewal | Balance | | Should now be | Before Adjustment |
|---|---|---|---|---|---|---|---|---|
| 0 | | 10% | | | 4,101.25 | | | |
| 1 | 1,000.00 | 410.12 | 589.88 | | 3,511.37 | | | |
| 2 | 1,000.00 | 351.14 | 648.86 | | 2,862.51 | | | |
| 3 | 1,000.00 | 286.25 | 713.75 | (1,642.03) | 3,790.79 | | 3,790.79 | 2,148.76 |
| 4 | 1,000.00 | 379.08 | 620.92 | | 3,169.87 | | | |
| 5 | 1,000.00 | 316.99 | 683.01 | | 2,486.85 | | | |
| 6 | 1,000.00 | 248.69 | 751.31 | | 1,735.54 | | | |
| 7 | 1,000.00 | 173.55 | 826.45 | | 909.09 | | | |
| 8 | 1,000.00 | 90.91 | 909.09 | | 0.00 | | | |
| Totals | 8,000.00 | 2,256.73 | 5,743.27 | | | | | |

**Revised Amortization Table for Lessor** Initial direct costs = 200

| Period | Payment | Interest | Principal | Adj for Renewal | Balance | Rate | Should now be | Before Adjustment |
|---|---|---|---|---|---|---|---|---|
| 0 | | various | | | 4,301.25 | 8.26% | | |
| 1 | 1,000.00 | 355.45 | 644.55 | | 3,656.70 | 8.26% | | |
| 2 | 1,000.00 | 302.19 | 697.81 | | 2,958.89 | 8.26% | | |
| 3 | 1,000.00 | 244.52 | 755.48 | (1,686.29) | 3,889.70 | 8.26% | 3,889.70 | 2,203.41 |
| 4 | 1,000.00 | 350.05 | 649.95 | | 3,239.76 | 9.00% | | |
| 5 | 1,000.00 | 291.56 | 708.44 | | 2,531.32 | 9.00% | | |
| 6 | 1,000.00 | 227.81 | 772.19 | | 1,759.12 | 9.00% | | |
| 7 | 1,000.00 | 158.31 | 841.69 | | 917.44 | 9.00% | | |
| 8 | 1,000.00 | 82.56 | 917.44 | | (0.00) | 9.00% | | |
| Totals | 8,000.00 | 1,543.78 | 3,456.22 | | | | | |

Note that 8.26% no longer sets present value equal to cash flows.

After the change to 8 years, the implicit rate is 9%

Appendix C – Variation A (Initial lease term of 5 years is changed to 8 years)

| Comparative Example PV8a | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **Beginning of Year 4 - revising of most likely lease term:** | | | | | | | |
| Right-to-use asset | | 1,642.03 | | | | | |
| Lease obligation/receivable | | | 1,642.03 | 1,047.73 | | 1,047.73 | |
| Lease liability (lessor) | | | | | 1,047.73 | | |
| Lease revenue | | | | | | | 523.86 |
| Equipment held for lease (residual value) | | | | | | | 523.86 |
| | | 1,642.03 | 1,642.03 | 1,047.73 | 1,047.73 | 1,047.73 | 1,047.73 |
| New balance in right to use/lease liability | | 3,362.53 | | | 2,688.23 | 1,476.14 | held for lease |
| Remaining years to amortize | | 5 | | | 5 | | |
| | | | | | | | |
| Comparative Example PV8a | | | | Performance obligation method | | Derecognition method | |
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 4 - payment is made:** | | | | | | | |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 620.92 | | | 469.91 | | 469.91 |
| Interest expense/revenue | | 379.08 | | | 530.09 | | 530.09 |
| | | | | | | | |
| Lease liability | (SL method) | | | 537.65 | | | |
| Lease revenue | | | | | 537.65 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 672.51 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 672.51 | | 400.00 | | |
| | | 1,672.51 | 1,672.51 | 1,937.65 | 1,937.65 | 1,000.00 | 1,000.00 |
| | | | | | | | |

Appendix C – Variation A (Initial lease term of 5 years is changed to 8 years)

| Comparative Example PV8a | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 5 - payment is made:** | | | | | | | |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 683.01 | | | 708.44 | | 708.44 |
| Interest expense/revenue | | 316.99 | | | 291.56 | | 291.56 |
| | | | | | | | |
| Lease liability | (SL method) | | | 665.36 | | | |
| Lease revenue | | | | | 665.36 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 672.51 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 672.51 | | 400.00 | | |
| | | 1,672.51 | 1,672.51 | 2,065.36 | 2,065.36 | 1,000.00 | 1,000.00 |

| | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 6 - payment is made:** | | | | | | | |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 751.31 | | | 772.19 | | 772.19 |
| Interest expense/revenue | | 248.69 | | | 227.81 | | 227.81 |
| | | | | | | | |
| Lease liability | (SL method) | | | 665.36 | | | |
| Lease revenue | | | | | 665.36 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 672.51 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 672.51 | | 400.00 | | |
| | | 1,672.51 | 1,672.51 | 2,065.36 | 2,065.36 | 1,000.00 | 1,000.00 |

Appendix C – Variation A (Initial lease term of 5 years is changed to 8 years)

| Comparative Example PV8a | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 7 - payment is made:** | | | | | | | |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 826.45 | | | 841.69 | | 841.69 |
| Interest expense/revenue | | 173.55 | | | 158.31 | | 158.31 |
| | | | | | | | |
| Lease liability | (SL method) | | | 665.36 | | | |
| Lease revenue | | | | | 665.36 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 672.51 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 672.51 | | 400.00 | | |
| | | 1,672.51 | 1,672.51 | 2,065.36 | 2,065.36 | 1,000.00 | 1,000.00 |

| | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 8 - payment is made:** | | | | | | | |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 909.09 | | | 917.44 | | 917.44 |
| Interest expense/revenue | | 90.91 | | | 82.56 | | 82.56 |
| | | | | | | | |
| Lease liability | (SL method) | | | 665.36 | | | |
| Lease revenue | | | | | 665.36 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 672.51 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 672.51 | | 400.00 | | |
| | | | | | | | |
| Equipment held for lease (residual value) | | | | | | | 1,156.85 |
| Plant, property and equipment | | | | | | 1,156.85 | |
| | | 1,672.51 | 1,672.51 | 2,065.36 | 2,065.36 | 2,156.85 | 2,156.85 |

## Appendix C – Variation B (Initial lease term of 8 years is changed to 5 years)

| Comparative Example PV8b | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|
| | Lessee | | Lessor | | Lessor | |
| | debit | credit | debit | credit | debit | credit |
| At inception of lease: | | | | | | |
| Right of use asset | 5,534.93 | | | | | |
| Liability/Receivable for Lease Payments | | 5,334.93 | 5,534.93 | | 5,534.93 | |
| Lease liability (lessor) | | | | 5,334.93 | | |
| Cash | | 200.00 | | 200.00 | | 200.00 |
| Plant, property & equipment | | | | | | 4,000.00 |
| Cost of goods sold | | | | | 3,000.00 | |
| Equipment held for lease (residual value) | | | | | 1,000.00 | |
| Lease revenue (PVELP) | | | | | | 5,334.93 |
| | 5,534.93 | 5,534.93 | 5,534.93 | 5,534.93 | 9,534.93 | 9,534.93 |

| | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|
| | Lessee | | Lessor | | Lessor | |
| End of Year 1 - payment is made: | debit | credit | debit | credit | debit | credit |
| Cash | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | 466.51 | | | 501.89 | | 501.89 |
| Interest expense/revenue | 533.49 | | | 498.11 | | 498.11 |
| | | | | | | |
| Lease liability (SL method) | | | 666.87 | | | |
| Lease revenue | | | | 666.87 | | |
| | | | | | | |
| Amort/Depreciation expense | 691.87 | | 400.00 | | | |
| Accumulated amort/depreciation | | 691.87 | | 400.00 | | |
| (SL method) | 1,691.87 | 1,691.87 | 2,066.87 | 2,066.87 | 1,000.00 | 1,000.00 |

Appendix C – Variation B (Initial lease term of 8 years is changed to 5 years)

| Comparative Example PV8b | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | Lessee | | Lessor | | Lessor | |
| **End of Year 2 - payment is made:** | debit | credit | debit | credit | debit | credit |
| Cash | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | 513.16 | | | 547.05 | | 547.05 |
| Interest expense/revenue | 486.84 | | | 452.95 | | 452.95 |
| | | | | | | |
| Lease liability (SL method) | | | 666.87 | | | |
| Lease revenue | | | | 666.87 | | |
| | | | | | | |
| Amort/Depreciation expense (SL method) | 691.87 | | 400.00 | | | |
| Accumulated amort/depreciation | | 691.87 | | 400.00 | | |
| | 1,691.87 | 1,691.87 | 2,066.87 | 2,066.87 | 1,000.00 | 1,000.00 |

| | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|
| | Lessee | | Lessor | | Lessor | |
| | debit | credit | debit | credit | debit | credit |
| **End of Year 3 - payment is made:** | | | | | | |
| Cash | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | 564.47 | | | 596.28 | | 596.28 |
| Interest expense/revenue | 435.53 | | | 403.72 | | 403.72 |
| | | | | | | |
| Lease liability (SL method) | | | 666.87 | | | |
| Lease revenue | | | | 666.87 | | |
| | | | | | | |
| Amort/Depreciation expense (SL method) | 691.87 | | 400.00 | | | |
| Accumulated amort/depreciation | | 691.87 | | 400.00 | | |
| | 1,691.87 | 1,691.87 | 2,066.87 | 2,066.87 | 1,000.00 | 1,000.00 |

Appendix C – Variation B (Initial lease term of 8 years is changed to 5 years)

Beginning of Year 4 - lease term is re-evaluated and termination at end of 5 years is the most likely outcome

| **Revised Amortization Table for Lessee** | | | Initial direct costs = | | 200 | | Comparative Example PV8b | |
|---|---|---|---|---|---|---|---|---|
| Period | Payment | Interest | Principal | Adj for Renewal | Balance | | Should now be | Before Adjustment |
| 0 | | 10% | | | 5,334.93 | | | |
| 1 | 1,000.00 | 533.49 | 466.51 | | 4,868.42 | | | |
| 2 | 1,000.00 | 486.84 | 513.16 | | 4,355.26 | | | |
| 3 | 1,000.00 | 435.53 | 564.47 | 1,642.03 | 2,148.76 | | 2,148.76 | 3,790.79 |
| 4 | 1,000.00 | 214.88 | 785.12 | | 1,363.64 | | | |
| 5 | 1,500.00 | 136.36 | 1,363.64 | | 0.00 | | | |
| 6 | - | 0.00 | (0.00) | | 0.00 | | | |
| 7 | - | 0.00 | (0.00) | | 0.00 | | | |
| 8 | - | 0.00 | (0.00) | | 0.00 | | | |
| Totals | 5,500.00 | 1,807.10 | 3,692.90 | | | | | |

| **Revised Amortization Table for Lessor** | | | Initial direct costs = | | 200 | | | |
|---|---|---|---|---|---|---|---|---|
| Period | Payment | Interest | Principal | Adj for Renewal | Balance | Rate | Should now be | Before Adjustment |
| 0 | | various | | | 5,534.93 | 9.00% | | |
| 1 | 1,000.00 | 498.11 | 501.89 | | 5,033.04 | 9.00% | | |
| 2 | 1,000.00 | 452.95 | 547.05 | | 4,485.99 | 9.00% | | |
| 3 | 1,000.00 | 403.72 | 596.28 | 1,686.29 | 2,203.41 | 9.00% | 2,203.41 | 3,889.70 |
| 4 | 1,000.00 | 182.09 | 817.91 | | 1,385.50 | 8.26% | | |
| 5 | 1,500.00 | 114.50 | 1,385.50 | | (0.00) | 8.26% | | |
| 6 | - | (0.00) | 0.00 | | (0.00) | 8.26% | | |
| 7 | - | (0.00) | 0.00 | | (0.00) | 8.26% | | |
| 8 | - | (0.00) | 0.00 | | (0.00) | 8.26% | | |
| Totals | 5,500.00 | 1,651.36 | 3,848.64 | | | | | |

Note that 9% no longer sets present value equal to cash flows.

After the change to 5 years, the implicit rate is 8.26%

Appendix C – Variation B (Initial lease term of 8 years is changed to 5 years)

| Comparative Example PV8b | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **Beginning of Year 4 - revising of most likely lease term:** | | | | | | | |
| Right-to-use asset | | | 1,642.03 | | | | |
| Lease obligation/receivable | | 1,642.03 | | | 1,686.29 | | 1,686.29 |
| Lease liability (lessor) | | | | 1,686.29 | | | |
| Lease revenue | | | | | | 1,264.72 | - |
| Equipment held for lease (residual value) | | | | | | 421.57 | - |
| | | 1,642.03 | 1,642.03 | 1,686.29 | 1,686.29 | 1,686.29 | 1,686.29 |
| New balance in right to use/lease liability | | 1,817.30 | | | 1,648.04 | 1,421.57 | held for lease |
| Remaining years to amortize | | 2 | | | 2 | | |
| | | | | | | | |
| | | | | Performance obligation method | | Derecognition method | |
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 4 - payment is made:** | | | | | | | |
| Cash | | | 1,000.00 | 1,000.00 | | 1,000.00 | |
| Lease obligation/receivable | | 785.12 | | | 817.91 | | 817.91 |
| Interest expense/revenue | | 214.88 | | | 182.09 | | 182.09 |
| | | | | | | | |
| Lease liability | (SL method) | | | 824.02 | | | |
| Lease revenue | | | | | 824.02 | | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 908.65 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 908.65 | | 400.00 | | |
| | | 1,908.65 | 1,908.65 | 2,224.02 | 2,224.02 | 1,000.00 | 1,000.00 |

Appendix C – Variation B (Initial lease term of 8 years is changed to 5 years)

| Comparative Example PV8b | | | | Performance obligation method | | Derecognition method | |
|---|---|---|---|---|---|---|---|
| | | Lessee | | Lessor | | Lessor | |
| | | debit | credit | debit | credit | debit | credit |
| **End of Year 5 - payment is made:** | | | | | | | |
| Cash | | | 1,500.00 | 1,500.00 | | 1,500.00 | |
| Lease obligation/receivable | | 1,363.64 | | | 1,385.50 | | 1,385.50 |
| Interest expense/revenue | | 136.36 | | | 114.50 | | 114.50 |
| | | | | | | | |
| Lease liability | (SL method) | | | 824.02 | | | |
| Lease revenue | | | | | 824.02 | | |
| | | | | | | | |
| Equipment held for lease (residual value) | | | | | | | 1,421.57 |
| Plant, property and equipment | | | | | | 1,421.57 | |
| | | | | | | | |
| Amort/Depreciation expense | (SL method) | 908.65 | | 400.00 | | | |
| Accumulated amort/depreciation | | | 908.65 | | 400.00 | | |
| | | 2,408.65 | 2,408.65 | 2,724.02 | 2,724.02 | 2,921.57 | 2,921.57 |

T-accounts for both variations are on the next page. Note that it would be a lot easier to add the initial direct costs to the lease liability under the performance obligation method. With this approach, the initial direct costs would be amortized straight-line (in parallel with the lessee treatment of the right to use asset) rather than by use of the more complicated effective interest method.

For the derecognition method, adding initial direct costs to the lease payments receivable would seem to be the only feasible approach and would work best if the residual value were included in the present value computations at its anticipated fair value at the end of the lease. If this value were changed, additional adjustments to the implicit rate would be included.

# Appendix C – T-accounts for both variations

Comparative Example PV8a

| Lessee T-accounts | | | | Both Lessor Methods | |
|---|---|---|---|---|---|
| Right to Use Asset (net) | | Liability for lease payments | | Lease payments receivable | |
| 4,301 | | | 4,101 | 4,301 | |
| | 860 | 590 | | | 645 |
| | 860 | 649 | | | 698 |
| | 860 | 714 | | | 755 |
| 1,642 | | adjustment | 1,642 | 1,048 | |
| | 673 | 621 | | | 470 |
| | 673 | 683 | | | 547 |
| | 673 | 751 | | | 636 |
| | 673 | 826 | | | 739 |
| | 673 | 909 | | | 860 |
| 5,943 | 5,943 | 5,743 | 5,743 | 5,349 | 5,349 |
| 0 | TRUE | 0 | TRUE | 0 | TRUE |

| Lessor-Performance Obligation Method | | | | | |
|---|---|---|---|---|---|
| Book value of PP&E | | Lease liability | | Variation A | |
| 4,000 | | | 4,101 | Book value of asset using | |
| | 400 | 820 | | performance obligation | |
| | 400 | 820 | | method | 800 |
| | 400 | 820 | | | |
| | | | 1,048 | Residual value under the | |
| | 400 | 538 | | derecogntion method = | |
| | 400 | 538 | | | 1,476 |
| | 400 | 538 | | | |
| | 400 | 538 | | | |
| | 400 | 538 | | | |
| 4,000 | 3,200 | 5,149 | 5,149 | | |
| | 800 | 0 | TRUE | | |

Comparative Example PV8b

| Lessee T-accounts | | | | | Both Lessor Methods | |
|---|---|---|---|---|---|---|
| Right to Use Asset (net) | | | Liability for lease payments | | Lease payments receivable | |
| 5,535 | | | | 5,335 | 5,535 | |
| | 692 | | 467 | | | 502 |
| | 692 | | 513 | | | 547 |
| | 692 | | 564 | | | 596 |
| - | 1,642 | | 1,642 | - | adjustment | 1,686 |
| | 909 | | 785 | | | 818 |
| | 909 | | 1,364 | | | 1,386 |
| 5,535 | 5,535 | | 5,335 | 5,335 | 5,535 | 5,535 |
| 0 | TRUE | | 0 | TRUE | 0 | TRUE |

| Lessor-Performance Obligation Method | | | | | | |
|---|---|---|---|---|---|---|
| Book value of PP&E | | | Lease liability | | Variation B | |
| 4,000 | | | | 5,335 | Book value of asset using | |
| | 400 | | 667 | | performance obligation | |
| | 400 | | 667 | | method = | 2,000 |
| | 400 | | 667 | | | |
| | 400 | | 1,686 | - | Residual value under the | |
| | 400 | | 824 | | derecogntion method = | |
| 4,000 | 2,000 | | 5,335 | 5,335 | | 1,422 |
| - | 2,000 | | 0 | TRUE | | |

## Appendix D – Presentation issues

PERFORMANCE OBLIGATION METHOD **(based on corrected versions of Examples 1 & 2)**

Examples 1 and 2 had depreciation expense exactly equal to depreciation expense which meant that the leases were unprofitable (breakeven). I reduced the carrying value of the leased asset from $15,000 to $7,500 which made the total profit on each lease $500 per year. The complete examples are on my website.

| | | | | | | |
|---|---|---|---|---|---|---|
| | | Presentation for (corrected) Examples 1 and 2 | | | | |
| **EXAMPLE 1** | | | | | | |
| **Balance Sheet Presentation per Para. 42 - performance obligation approach** | | | | | | |
| | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | |
| Underlying assets | 7,000 | 6,500 | 6,000 | - | - | |
| Rights to receive lease payments | 3,312 | 926 | 0 | - | - | |
| Lease liabilities | (3,194) | (833) | - | - | - | |
| Net lease asset or (liability) | 7,118 | 6,593 | 6,000 | - | - | |
| | | | | | | |
| **Income Statement Presentation per Para. 44 - performance obligation approach** | | | | | | |
| For year ending: | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | |
| Lease income | - | 798.54 | 832.65 | 832.65 | - | - |
| Interest income | - | 319.42 | 142.66 | 74.07 | - | - |
| Depreciation expense | - | (500.00) | (500.00) | (500.00) | - | - |
| Net lease income or (expense) | | 617.96 | 475.31 | 406.73 | - | - |
| | | | | | | |
| **Statement of cash flows - operating section on a separate row (Para. 45)** | | 1,000.00 | 1,000.00 | 1,000.00 | | |
| | | | | | | |
| **EXAMPLE 2** | | | | | | |
| **Balance Sheet Presentation per Para. 42 - performance obligation approach** | | | | | | |
| | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | |
| Underlying assets | 7,000 | 6,500 | 6,000 | 5,500 | 5,000 | |
| Rights to receive lease payments | 1,783 | 2,577 | 1,783 | 0 | 0 | |
| Lease liabilities | (1,718) | (2,435) | (1,623) | (812) | - | |
| Net lease asset or (liability) | 7,065 | 6,642 | 6,160 | 4,688 | 5,000 | |
| | | | | | | |
| **Income Statement Presentation per Para. 44 - performance obligation approach** | | | | | | |
| For year ending: | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | |
| Lease income | 859.03 | 811.73 | 811.73 | 811.73 | 811.73 | |
| Interest income | 206.17 | 264.97 | 206.17 | 142.66 | 74.07 | |
| Depreciation expense | (500.00) | (500.00) | (500.00) | (500.00) | (500.00) | |
| Net lease income or (expense) | 565.20 | 576.70 | 517.90 | 454.39 | 385.81 | |
| | | | | | | |
| **Statement of cash flows - operating section on a separate row (Para. 45)** | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | |
| | | | | | | |

Appendix D – Presentation issues (continued)

## DERECOGNITION METHOD **(based on Examples 4 & 5 with proposed improvements/corrections)**

The derecognition examples present a "flawed" approach that allocates (instead of measuring) the residual value of the leased asset. The methodology illustrated results in DIFFERENT residual values depending on whether the lease is shortened or lengthened from the originally expected lease term. In example 4, the residual value starts off at CU 207 and then rises only to CU 242 when the asset is returned at the end of 8 years. In contrast, Example 5 has an initial residual value of CU 895 for the same set of facts and this amount is reduced to CU 746 at the end of 10 years. This makes little sense – it is always better to MEASURE than to allocate. But if we are going to allocate, we certainly need a different allocation method. My first possible solution was to allocate using the original percentage and this does remove the perverse incentive to always underestimate the lease term. However, I believe the best solution is to predict the fair value upon return (as we do under existing GAAP) and include this value in the lease receivable. This also means that the receivable is initially recorded at the fair value of the asset being derecognized. The discount rate amortizes the fair value of the entire asset down to the expected residual value at the end of the lease when the asset is returned to the lessor. Everyone already understands this model since it is used in both FASB and IASB standards. I refer to this as "corrected method 2." However, I used the "historic allocation" method in my comparative illustration in Appendix A.

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **DERECOGNITION METHOD - EXAMPLE 4** | | | | AS IN THE EXPOSURE DRAFT | | | | |
| | | | *This version uses the "strange" ED allocation method when lease term changes* | | | | | |
| **Presentation on Balance Sheet per Para. 60** | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
| Right to receive lease payments | 6,247 | 4,623 | 3,993 | 3,312 | 2,577 | 1,783 | 926 | 0 |
| Residual assets (within PP&E) | 207 | 242 | 242 | 242 | 242 | 242 | 242 | 242 |
| | 6,454 | 4,864 | 4,234 | 3,554 | 2,819 | 2,025 | 1,167 | 242 |
| | | | | | | | | |
| **Presentation on income statement per Para. 61 & 62** | | | | | | | | |
| For year ending | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
| Interest income (separate from other interest income) | 537 | 417 | 370 | 319 | 265 | 206 | 143 | 74 |
| | | | | | | | | |
| Possibility (a) - sales-type | | | | | | | | |
| Sales (at PVELP) | 6,710 | (1,041) | - | - | - | - | - | - |
| Cost of sales | (4,793) | 34 | - | - | - | - | - | - |
| | 1,917 | (1,006) | - | - | - | - | - | - |
| Possibilty (b) - direct financing type | | | | | | | | |
| Net lease income (expense) | 1,917 | (1,006) | - | - | - | - | - | - |
| Total impact on net income | 2,454 | (590) | 370 | 319 | 265 | 206 | 143 | 74 |
| | | | | | | | | |
| **Presentation on statement of cash flows per Para. 63** | | | | | | | | |
| Direct method: | | | | | | | | |
| Lease payments received | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| Indirect method: | | | | | | | | |
| Change in right to receive lease payments (on separate row) | 6,454 | (1,590) | (630) | (681) | (735) | (794) | (857) | (926) |

# Appendix D (continued) – corrected versions of Example 4

**DERECOGNITION METHOD - EXAMPLE 4** Corrected Version 1

*This version uses the "historial" allocation method when lease term changes*

| **Presentation on Balance Sheet per Para. 60** | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
|---|---|---|---|---|---|---|---|---|
| Right to receive lease payments | 6,247 | 4,623 | 3,993 | 3,312 | 2,577 | 1,783 | 926 | 0 |
| Residual assets (within PP&E) | 207 | 895 | 895 | 895 | 895 | 895 | 895 | 895 |
| | 6,454 | 5,518 | 4,888 | 4,207 | 3,472 | 2,679 | 1,821 | 895 |

**Presentation on income statement per Para. 61 & 62**

| For year ending | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
|---|---|---|---|---|---|---|---|---|
| Interest income (separate from other interest income) | 537 | 417 | 370 | 319 | 265 | 206 | 143 | 74 |
| Possibility (a) - sales-type | | | | | | | | |
| Sales (at PVELP) | 6,710 | (1,041) | - | - | - | - | - | - |
| Cost of sales | (4,793) | 688 | - | - | - | - | - | - |
| | 1,917 | (352) | - | - | - | - | - | - |
| Possibilty (b) - direct financing type | | | | | | | | |
| Net lease income (expense) | 1,917 | (352) | - | - | - | - | - | - |
| Total impact on net income | 2,454 | 64 | 370 | 319 | 265 | 206 | 143 | 74 |

**Presentation on statement of cash flows per Para. 63**

| Direct method: For year ending | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
|---|---|---|---|---|---|---|---|---|
| Lease payments received | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| Indirect method: | | | | | | | | |
| Change in right to receive lease payments (on separate | 6,454 | (936) | (630) | (681) | (735) | (794) | (857) | (926) |

**DERECOGNITION METHOD - EXAMPLE 4** Corrected Version 2

*This version follows "current GAAP" and includes the residual value as part of lease receivable*

| **Presentation on Balance Sheet per Para. 60** | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
|---|---|---|---|---|---|---|---|---|
| Right to receive lease payments | $6,246.89 | $4,622.88 | $3,992.71 | $3,312.13 | $2,577.10 | $1,783.26 | $925.93 | $0.00 |
| Residual assets (within PP&E) | $103.55 | $564.00 | $609.12 | $657.85 | $710.48 | $767.32 | $828.70 | $895.00 |
| | 6,350.44 | 5,186.88 | 4,601.83 | 3,969.98 | 3,287.58 | 2,550.58 | 1,754.63 | 895.00 |

*Note that with my recommended change, there would be no need to report the residual value separately since it is part of the receivable.*

**Presentation on income statement per Para. 61 & 62**

| For year ending | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
|---|---|---|---|---|---|---|---|---|
| Interest income (separate from other interest income) | 544.48 | 458.29 | 414.95 | 368.15 | 317.60 | 263.01 | 204.05 | 140.37 |
| Possibility (a) - sales-type | | | | | | | | |
| Sales (at PVELP) | 6,710.08 | (1,040.52) | - | - | - | - | - | - |
| Cost of sales | (4,904.12) | 418.67 | - | - | - | - | - | - |
| | 1,805.96 | (621.85) | - | - | - | - | - | - |
| Possibilty (b) - direct financing type | | | | | | | | |
| Net lease income (expense) | 1,805.96 | (621.85) | - | - | - | - | - | - |
| Total impact on net income | 2,350.44 | (163.56) | 414.95 | 368.15 | 317.60 | 263.01 | 204.05 | 140.37 |

**Presentation on statement of cash flows per Para. 63**

| Direct method: For year ending | Dec 31, Yr 1 | Dec 31, Yr 2 | Dec 31, Yr 3 | Dec 31, Yr 4 | Dec 31, Yr 5 | Dec 31, Yr 6 | Dec 31, Yr 7 | Dec 31, Yr 8 |
|---|---|---|---|---|---|---|---|---|
| Lease payments received | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 | 1,000.00 |
| Indirect method: | | | | | | | | |
| Change in right to receive lease payments (on separate | 6,350.44 | (1,163.56) | (585.05) | (631.85) | (682.40) | (736.99) | (795.95) | (859.63) |

For Example 5, please refer to Excel file posted at my website.

## Appendix E – Sublease Presentation

The facts for this example are exactly the same – a 5-year CU 5,000 original lease for a facility that is subleased for the last 4 years for CU 4,000. The interest rate is 8%. Please see my website for Excel file with complete problem and several variations for each method. I believe that the derecognition method is more appropriate for this fact situation. Subleases 4 & 5 are 4 years out of a remaining 9 year lease term which makes the performance obligation approach more likely. Sublease 3 (on website) presents a situation where the net position is an asset, but that appears to be a rare situation in the variations I explored. Note that the impact on the balance sheet is probably not material even though the performance obligation method is far more confusing since there are two lease liabilities being reported. The derecognition method would have been more confusing too if the lessor anticipated an unguaranteed residual value to be reported.

| Derecognition Method for Sublease | | | Performance Obligation Method for Sublease | | |
|---|---|---|---|---|---|
| **Balance sheet presentation - end of year 2 per Para. 43** | | | **Balance sheet presentation - end of year 2 per Para. 43** | | |
| Right to use asset | 6,715 | | Right to use asset | 19,964 | |
| Less acc'd amortiztion | (4,673) | 2,042 | Less acc'd amortiztion | (7,985) | 11,978 |
| Right to receive sublease payments | | 10,308 | Right to receive sublease payments | | 13,530 |
| Lease liabilities | | (12,885) | Liability to make lease payments | | (12,885) |
| Net lease liability (presented in liability section) | | (535) | Performance obligation - sublease | | (13,041) |
| | | | Net lease liability (presented in liability section) | | (419) |
| | | | | | |
| **Balance sheet presentation - end of year 3 per Para. 43** | | | **Balance sheet presentation - end of year 3 per Para. 43** | | |
| Right to use asset | 6,715 | | Right to use asset | 19,964 | |
| Less acc'd amortiztion | (5,354) | 1,361 | Less acc'd amortiztion | (11,978) | 7,985 |
| Right to receive sublease payments | | 7,133 | Right to receive sublease payments | | 9,362 |
| Lease liabilities | | (8,916) | Liability to make lease payments | | (8,916) |
| Net lease liability (presented in liability section) | | (422) | Performance obligation - sublease | | (8,694) |
| | | | Net lease liability (presented in liability section) | | (263) |
| | | | | | |
| **Balance sheet presentation - end of year 4 per Para. 43** | | | **Balance sheet presentation - end of year 4 per Para. 43** | | |
| Right to use asset | 6,715 | | Right to use asset | 19,964 | |
| Less acc'd amortiztion | (6,034) | 681 | Less acc'd amortiztion | (15,971) | 3,993 |
| Right to receive sublease payments | | 3,704 | Right to receive sublease payments | | 4,861 |
| Lease liabilities | | (4,630) | Liability to make lease payments | | (4,630) |
| Net lease liability (presented in liability section) | | (245) | Performance obligation - sublease | | (4,347) |
| | | | Net lease liability (presented in liability section) | | (123) |

## Appendix F – Sale-leaseback Example

A seller/lessee owns an office building with a remaining useful life of 20 years. The carrying amount of the building is CU 80k and its fair value is CU 100k.
The lessee's incremental borrowing rate is 10 per cent.
The seller/lessee sells the building to a buyer/lessor for its fair value (CU 100k) and leases back under two scenarios as follows:

| | | Scenario A - not a true "sale" | | Scenario B - a true sale | |
|---|---|---|---|---|---|
| Annual payment (in arrears) | | | 12,014 | 12,014 | |
| Base lease term = | | 5 | years | | |
| Renewable for at total of | | 15 | years | | |
| Bargain purchase option at end of 15 years: | | | 36,000 | no bargain purchase option | |
| Expected lease term | | 15 | years | 5 | years |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | Scenario A | Scenario B |
| | Building - carrying values: | | | Present values | Renewed | Without renewal |
| 200,000 | Historical cost | | | Lease term= | 15 | 5 |
| 120,000 | Accumulated depreciation | | | Discount rate | 10% | 10% |
| 80,000 | Book value at date of transaction | | | Annual pymt | 12,014 | 12,014 |
| 100,000 | Fair value at date of transaction | | | BPO (future va | 36,000 | - |
| 20 | remaining useful life of building (in years) | | | Ord annuity | - | - |
| | | | | PVELP= | 100,000 | 45,544 |

**Scenario A - not a real sale to buyer/lessor**

| Period | Payment | Interest | Principal | Balance |
|---|---|---|---|---|
| - | | | | 100,000 |
| 1 | 12,014 | 10,000 | 2,014 | 97,986 |
| 2 | 12,014 | 9,799 | 2,216 | 95,770 |
| 3 | 12,014 | 9,577 | 2,437 | 93,333 |
| 4 | 12,014 | 9,333 | 2,681 | 90,652 |
| 5 | 12,014 | 9,065 | 2,949 | 87,702 |
| 6 | 12,014 | 8,770 | 3,244 | 84,458 |
| 7 | 12,014 | 8,446 | 3,568 | 80,890 |
| 8 | 12,014 | 8,089 | 3,925 | 76,964 |
| 9 | 12,014 | 7,696 | 4,318 | 72,647 |
| 10 | 12,014 | 7,265 | 4,750 | 67,897 |
| 11 | 12,014 | 6,790 | 5,225 | 62,672 |
| 12 | 12,014 | 6,267 | 5,747 | 56,925 |
| 13 | 12,014 | 5,693 | 6,322 | 50,603 |
| 14 | 12,014 | 5,060 | 6,954 | 43,649 |
| 15 | 48,014 | 4,365 | 43,649 | 0 |
| TRUE | 216,215 | 116,215 | 100,000 | |

**Scenario B - transfer of asset to buyer/lessor**

| Period | Payment | Interest | Principal | Balance |
|---|---|---|---|---|
| - | | | | 45,544 |
| 1 | 12,014 | 4,554 | 7,460 | 38,084 |
| 2 | 12,014 | 3,808 | 8,206 | 29,878 |
| 3 | 12,014 | 2,988 | 9,027 | 20,851 |
| 4 | 12,014 | 2,085 | 9,929 | 10,922 |
| 5 | 12,014 | 1,092 | 10,922 | 0 |
| | 60,072 | 14,528 | 45,544 | |

Appendix F, continued

| | Scenario A - not a real sale to buyer/lessor | | | | Scenario B - transfer of asset to buyer/lessor | | | |
|---|---|---|---|---|---|---|---|---|
| | Lessee/seller (transferor) | | Lessor/buyer (tranferee) | | Lessee/seller (transferor) | | Lessor/buyer (tranferee) | |
| Lease term= | 15 | | | | 5 | | | |
| At inception of contract: | Debit | Credit | Debit | Credit | Debit | Credit | Debit | Credit |
| Cash | 100,000 | | | 100,000 | 100,000 | | | 100,000 |
| Financial liability | | 100,000 | | | | | | |
| Financial receivable | | | 100,000 | | | | | |
| Building | | | | | | 200,000 | | |
| Accumulated depreciation | | | | | 120,000 | | 100,000 | |
| Gain on sale of asset | | | | | | 20,000 | | |
| | | | | | | | | |
| Lease liability (performance obligation) | | | | | | | 45,544 | |
| Lease payments receivable | | | - | | | | | 45,544 |
| Right-to-use asset | | | | | 45,544 | | | |
| Liability for lease payments | | | | | | 45,544 | | |
| | 100,000 | 100,000 | 100,000 | 100,000 | 265,544 | 265,544 | 145,544 | 145,544 |

| | Scenario A - not a real sale to buyer/lessor | | | | Scenario B - transfer of asset to buyer/lessor | | | |
|---|---|---|---|---|---|---|---|---|
| | Lessee/seller (transferor) | | Lessor/buyer (tranferee) | | Lessee/seller (transferor) | | Lessor/buyer (tranferee) | |
| *Repeat this entry for 20 years* | Debit | Credit | Debit | Credit | Debit | Credit | Debit | Credit |
| Depreciation expense | 4,000 | | | | | | 5,000 | |
| Accumulated depreciation | | 4,000 | | | | | | 5,000 |
| | | | | | | | | |
| Cash | | 12,014 | 12,014 | | | 12,014 | 12,014 | |
| Financial receivable | | | | 2,014 | | | | |
| Lease payments receivable | | | | | | | | 7,460 |
| Interest revenue | | | | 10,000 | | | | 4,554 |
| Financial liability | 2,014 | | | | | | | |
| Liability for lease payments | | | | | 7,460 | | | |
| Interest expense | 10,000 | | | | 4,554 | | | |
| | | | | | | | | |
| Lease liability (performance obligation) | | | | | | | 9,109 | |
| Lease income | | | | | | | | 9,109 |
| | | | | | | | | |
| Amortization of right-to-use asset | | | | | 9,109 | | | |
| Acc'd amortization | | | | | | 9,109 | | |
| | 16,014 | 16,014 | 12,014 | 12,014 | 21,123 | 21,123 | 26,123 | 26,123 |

## Appendix G – A comparison of the information content of roll-forward versus cash-flow schedules related to leases

The information content added by the roll-forward disclosures is quite limited:

To reconcile the prior year cash flow disclosure to the new ending balances in liability for lease payments and the receivable for sublease payments, information in the financial statements or notes is already available.

- The amount for payments on new leases is readily obtained from subtracting the prior disclosure of 2012 payments from the new disclosure of 2012 payments [605-430=175].
- Interest expense on leases and the amortization expense on the right-to-use assets should be separately disclosed on the face of the financial statements or in the notes according to paragraph 26.
- New leases are noncash financing and investing activities and should be disclosed in conjunction with the statement of cash flows.
- The increase in the liability to make lease payments and the increase in the right-to-use assets from new leases differs only by initial direct costs which would rarely be material to anyone's decisions.

Accordingly, the roll-forward schedule is largely redundant and adds little useful information for financial statement users.

The next page demonstrates my argument. The example includes five leases (some in arrears and some with the first payment coming immediately) and two subleases. The fact set is available on my website. Either schedule would be tedious to develop "by hand" and increasingly costly in as the number of lease contracts increases. However, the cash-flow disclosures are already being reported for both capital and most operating leases.

Appendix G, continued

Two year roll-forward disclosure for lessee, per paragraph 77:

| | | Liability for Lease Payments | Right-to-use Assets | Sublease Payments Receivable | Sublease Performance Liability |
|---|---|---|---|---|---|
| 1/1/2011 | Balance forward | (1,584) | 1,536 | 18 | (19) |
| 2011 | New leases* | (892) | 900 | 129 | (129) |
| 2011 | Payments made | 605 | | (60) | |
| 2011 | Interest expense | (155) | | 12 | |
| 2011 | Amortization expense | | (471) | | |
| 2011 | Sublease income | | | | 52 |
| 12/31/2011 | Ending balance | (2,026) | 1,964 | 98 | (95) |
| 2012 | New leases | - | | | |
| 2012 | Payments made | 605 | | (60) | |
| 2012 | Interest expense | (168) | | 8 | |
| 2012 | Amortization expense | | (471) | | |
| 2012 | Sublease income | | | | 52 |
| 12/30/2012 | Ending balance | (1,589) | 1,493 | 46 | (43) |

*The difference between the additon to the lease liability and the right to use asset is initial direct costs.

Cash flow disclosure per paragraph 85
For year ending 12/31/2011

| Year | Lease Payments | Sublease Payments |
|---|---|---|
| 2012 | 605 | (60) |
| 2013 | 605 | (50) |
| 2014 | 305 | - |
| 2015 | 190 | - |
| 2016 | 190 | - |
| 2017-21 | 670 | - |
| Thereafter | 240 | - |
| Total | 2,805 | (110) |
| Less interest | 779 | (12) |
| 12/31/11 Liability | 2,026 | (98) |

Cash flow disclosure per paragraph 85
For year ending 12/31/2010

| Year | Lease Payments | Sublease Payments |
|---|---|---|
| 2011 | 430 | (10) |
| 2012 | 430 | (10) |
| 2013 | 430 | - |
| 2014 | 130 | - |
| 2015 | 130 | - |
| 2016-20 | 500 | - |
| thereafter | - | - |
| Total | 2,050 | (20) |
| Less interest | 466 | (2) |
| 12/31/10 Liability | 1,584 | (18) |
| New leases in 2011 | 892 | (129) |
| Payments on new leases* | (175) | 50 |
| Payments on existing leases | (430) | 10 |
| Interest portion of payments | 155 | (12) |
| 12/31/11 liability | 2,026 | (98) |

## Appendix H – Decelerated Depreciation Approach Compared to Straight-line Depreciation

A lease contract is signed on February 1, Year 1. The monthly lease payment is CU 1,000 and the first payment due immediately. The lease is for three years (36 months) at an incremental borrowing rate of 8%. There are no renewal options, penalties for nonrenewal, or early cancellation options. If a nonpublic company has a bookkeeper with insufficient expertise, he or she might continue to book the monthly payments as rent expense. At year end, a CPA firm could be hired to fix things up. The entries shown compare the "decelerated" depreciation method to straight-line.

| Summary Table (compounded Monthly) | | | | | | Decelerated | Straight-line |
|---|---|---|---|---|---|---|---|
| | Payment | Interest | Principal = Decelerated Depreciation Expense | Ending Balance | Straight-line Depreciation Expense | Total Expense on Income Statement | Total Expense on Income Statement |
| Year 1 | 11,000 | 9,020 | 1,980 | 10,675 | 3,867 | 11,000 | 12,887 |
| Year 2 | 12,000 | 9,229 | 2,771 | 7,904 | 4,218 | 12,000 | 13,447 |
| Year 3 | 12,000 | 5,022 | 6,978 | 926 | 4,218 | 12,000 | 9,240 |
| Year 4 | 1,000 | 74 | 926 | 0 | 352 | 1,000 | 426 |
| Totals | 36,000 | 23,345 | 12,655 | | 12,655 | 36,000 | 36,000 |

The complete amortization table and journal entries are available on my website.

The unsophisticated bookkeeper makes the following monthly entry:

| | | |
|---|---|---|
| Lease expense | 1,000 | |
| Cash | | 1,000 |

The professional accountant could readily make the following entries at year end.

| | | | | Decelerated Mtd | | Straight-line Method | |
|---|---|---|---|---|---|---|---|
| **End of first year, auditor or other CPA adjustment:** | | | | Debit | Credit | Debit | Credit |
| | Right to Use Asset | | | 12,655 | | 12,655 | |
| | Lease liability | | | | 12,655 | | 12,655 |
| | | | | | | | |
| | Amortization expense | | | 1,980 | | 3,867 | |
| | Accumulated amortization expense | | | | 1,980 | | 3,867 |
| | Interest expense | | | 9,020 | | 9,020 | |
| | Lease liability | | | 1,980 | | 1,980 | |
| | Lease expense | | | | 11,000 | | 11,000 |
| | | | | 25,634 | 25,634 | 27,521 | 27,521 |

| Ending balance sheet Yr 1 | Decel Mtd | SL Mtd | Income statement - Yr 1 | Decel Mtd | SL Mtd |
|---|---|---|---|---|---|
| Right to Use Asset | 12,655 | 12,655 | Interest expense | 9,020 | 9,020 |
| Less Acc'd Amortization | (1,980) | (3,867) | Amortization expense | 1,980 | 3,867 |
| | 10,675 | 8,788 | | 11,000 | 12,887 |
| | | | | | |
| Lease liability | 10,675 | 10,675 | | | |

Appendix H, continued

| | | | | Decelerated Mtd | | Straight-line Method | |
|---|---|---|---|---|---|---|---|
| **End of SECOND year, auditor or other CPA adjustment:** | | | | Debit | Credit | Debit | Credit |
| | Amortization expense | | | 2,771 | | 4,218 | |
| | Accumulated amortization expense | | | | 2,771 | | 4,218 |
| | Interest expense | | | 9,229 | | 9,229 | |
| | Lease liability | | | 2,771 | | 2,771 | |
| | Lease expense | | | | 12,000 | | 12,000 |
| | | | | 14,771 | 14,771 | 16,218 | 16,218 |
| | | | | | | | |
| Ending balance sheet Yr 2 | | Decel Mtd | SL Mtd | Income statement - Yr 2 | | Decel Mtd | SL Mtd |
| Right to Use Asset | | 12,655 | 12,655 | Interest expense | | 9,229 | 9,229 |
| Less Acc'd Amortization | | (4,751) | (8,085) | Amortization expense | | 2,771 | 4,218 |
| | | 7,904 | 4,570 | | | 12,000 | 13,447 |
| | | | | | | | |
| Lease liability | | 7,904 | 7,904 | | | | |
| | | | | Decelerated Mtd | | Straight-line Method | |
| **End of THIRD year, auditor or other CPA adjustment:** | | | | Debit | Credit | Debit | Credit |
| | Amortization expense | | | 6,978 | | 4,218 | |
| | Accumulated amortization expense | | | | 6,978 | | 4,218 |
| | Interest expense | | | 5,022 | | 5,022 | |
| | Lease liability | | | 6,978 | | 6,978 | |
| | Lease expense | | | | 12,000 | | 12,000 |
| | | | | 18,978 | 18,978 | 16,218 | 16,218 |
| | | | | | | | |
| Ending balance sheet Yr 3 | | Decel Mtd | SL Mtd | Income statement - Yr 3 | | Decel Mtd | SL Mtd |
| Right to Use Asset | | 12,655 | 12,655 | Interest expense | | 5,022 | 5,022 |
| Less Acc'd Amortization | | (11,729) | (12,303) | Amortization expense | | 6,978 | 4,218 |
| | | 926 | 352 | | | 12,000 | 9,240 |
| | | | | | | | |
| Lease liability | | 926 | 926 | | | | |

The last payment would be made in the fourth year (not shown).

Comment:

It is hard to imagine that the small difference in the amount shown for plant, property and equipment on the balance sheet would be significant to users of the financial statements! The liability could still be recognized and that seems to be the primary focus of the change in accounting by lessees. The preparation of the statement of cash flows would also be easier because the lease payment would always equal the interest expense plus the depreciation/amortization expense for the right-to-use asset.

Justification for the use of the method: The value-in-use to the entity increases as its use becomes integrated into operations (okay it is a weak argument but not much worse than what we might use for the SOYD method!). All allocation methods are arbitrary – this one is systematic if not completely rational on the surface. The real rationale is to avoid complexities that arise when there are small and unimportant differences between expenses on the income statement and operating cash outflows.