FASB **EXPOSURE DRAFT**

Two Proposed Accounting Standards Updates

Issued: September 27, 2017
Comments Due: November 13, 2017

Technical Corrections and Improvements to Recently Issued Standards

I. Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

II. Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

The Board issued this Exposure Draft to solicit public comment on proposed changes to Subtopic 825-10 and Topic 842 of the *FASB Accounting Standards Codification*®. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to "Technical Director, (I) File Reference No. 2017-300 and (II) File Reference No. 2017-310, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

Financial Accounting Standards Board

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft until November 13, 2017. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at Exposure Documents Open for Comment
- Emailing comments to director@fasb.org, (I) File Reference No. 2017-300 and (II) File Reference No. 2017-310
- Sending a letter to "Technical Director, (I) File Reference No. 2017-300 and (II) File Reference No. 2017-310, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

All comments received are part of the FASB's public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD®

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FASB

Proposed Accounting Standards Update

Technical Corrections and Improvements to Recently Issued Standards

I. Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

On January 5, 2016, the FASB issued Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* which retained the current framework for accounting for financial instruments in generally accepted accounting principles (GAAP) but made targeted improvements to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. In addition to amending Topic 825, Financial Instruments, the Board added Topic 321, Investments—Equity Securities, and made a number of consequential amendments to the Codification.

The Board has an ongoing project on its agenda about technical corrections and improvements to clarify the Codification or to correct unintended application of guidance. Those items generally are not expected to have a significant effect on current accounting practice or create a significant administrative cost for most entities. The amendments in this proposed Update are of a similar nature to the items typically addressed in the Codification improvements project. However, the Board decided to issue a separate proposed Update for technical corrections and improvements related to Update 2016-01 to increase stakeholder awareness of the proposed amendments and to expedite the improvements.

The amendments in this proposed Update include items brought to the Board's attention by stakeholders. The proposed amendments clarify certain aspects of the guidance issued in Update 2016-01 as described in the table below.

Area for Correction or Improvement	Summary of Proposed Amendments
Issue 1: Equity Securities without a Readily Determinable Fair Value—Discontinuation	
Once the measurement alternative in paragraph 321-10-35-2 is elected, an entity must continue to apply the alternative until the investment has a readily determinable fair value or becomes eligible for the net asset value practical expedient. Stakeholders raised questions about additional situations that	The proposed amendment would clarify that an entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method in accordance with Topic 820, Fair Value Measurement,

Area for Correction or Improvement	Summary of Proposed Amendments
may allow for the measurement alternative in paragraph 321-10-35-2 to be discontinued by an entity.	through an election that would apply to that security and all other securities of the same type.
Issue 2: Equity Securities without a Readily Determinable Fair Value—Adjustments When an observable transaction occurs for a similar security, paragraph 321-10-55-9 states that adjustments made should reflect the current fair value of the security. Stakeholders raised questions about whether adjustments should be made to reflect the fair value as of the observable transaction date or the current reporting date.	 The proposed amendment would clarify that the adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place.
Issue 3: Forward Contracts and Purchased Options Forward contracts and purchased options on equity securities for which the measurement alternative is expected to be applied are accounted for on a *look-through* basis in accordance with paragraph 815-10-35-6. Stakeholders raised questions about whether a change in observable price or impairment of the underlying equity investment would result in remeasuring the entire value of the forward contract or purchased option.	 The proposed amendment would clarify that remeasuring the *entire* value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities.
Issue 4: Presentation Requirements for Certain Fair Value Option Liabilities Stakeholders raised questions about whether certain hybrid financial liabilities for which the fair value option has been elected would be within the scope of the presentation requirement in paragraph 825-10-45-5.	 The proposed amendment would clarify that when the fair value option is elected for a financial liability, the guidance in paragraph 825-10-45-5 should be applied, regardless of whether the fair value option was elected under either Subtopic 815-15, Derivatives and Hedging—

Area for Correction or Improvement	Summary of Proposed Amendments
	Embedded Derivatives, or 825-10.
Issue 5: Fair Value Option Liabilities Denominated in a Foreign Currency Paragraph 825-10-45-5 requires an entity to present separately the portion of the total change in the fair value of a liability attributable to a change in the instrument-specific credit risk within other comprehensive income. Stakeholders raised questions about how an entity should apply Topic 830, Foreign Currency Matters, when determining the amount of fair value changes that are attributable to instrument-specific credit risk for a foreign-currency-denominated liability for which the fair value option is elected.	 The proposed amendments would clarify that for financial liabilities for which the fair value option is elected, the amount of change in fair value that relates to the instrument-specific credit risk should first be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates.
Issue 6: Transition Guidance for Equity Securities without a Readily Determinable Fair Value Stakeholders raised a question about whether a prospective transition approach is required for all equity securities without a readily determinable fair value, including those for which the measurement alternative is not applied upon transition.	 The proposed amendment would clarify that the prospective transition approach for equity securities without a readily determinable fair value in Update 2016-01 is meant only for instances in which the measurement alternative is applied.

When Would the Amendments Be Effective?

For entities that have early adopted the guidance on the presentation change related to fair value option liabilities, the amendments in this proposed Update that are relevant to fair value option liabilities would be effective upon issuance of a final Update and the transition requirements would be the same as those in Update 2016-01. For the remaining proposed amendments, the effective date and transition requirements would be the same as the effective date and transition requirements in Update 2016-01.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: The proposed amendments are intended to improve the clarity of the guidance in Update 2016-01. Would the proposed amendments clarify that guidance? If not, please explain which proposed amendment(s) would not provide clarification, and why.

Question 2: Will any of the proposed amendments result in substantive changes to the application of Update 2016-01 that would require transition provisions or an effective date for the final amendments other than as noted in the Summary section "When Would the Amendments Be Effective?" If so, please describe.

Question 3: Should other changes be made that are directly or indirectly related to the proposed amendments? Please note that the Board will conduct Codification improvements projects on a periodic basis and additional changes may be postponed to a subsequent Codification improvements project.

Amendments to the *FASB Accounting Standards Codification*®

Summary of Proposed Amendments to the Accounting Standards Codification

1. The following table summarizes the proposed amendments to the Accounting Standards Codification. The proposed amendments are organized by area.

Areas for Improvement	**Paragraphs**
Issue 1: Equity Securities without a Readily Determinable Fair Value—Discontinuation	3 and 4
Issue 2: Equity Securities without a Readily Determinable Fair Value—Adjustments	5 and 6
Issue 3: Forward Contracts and Purchased Options	7 and 8
Issue 4: Presentation Requirements for Certain Fair Value Option Liabilities	9–11
Issue 5: Fair Value Option Liabilities Denominated in a Foreign Currency	12–14
Issue 6: Transition Guidance for Equity Securities without a Readily Determinable Fair Value	15 and 16

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–16. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Issue 1—Equity Securities without a Readily Determinable Fair Value—Discontinuation

3. The amendments to paragraph 321-10-35-2 relate to the measurement alternative for equity securities without a readily determinable fair value. The amendments clarify that an entity measuring equity securities using the measurement alternative may change its measurement approach to fair value in accordance with Topic 820, Fair Value Measurement, through an election that applies to that security and all other securities of the same type. The amendments allow an entity to optionally determine a more precise measurement, but once an accounting policy is established to measure the securities in accordance with Topic 820, any further changes are subject to the guidance on changes in accounting policy in Topic 250, Accounting Changes and Error Corrections.

Amendments to Subtopic 321-10

4. Amend paragraph 321-10-35-2, with a link to transition paragraph 825-10-65-2, as follows:

Investments—Equity Securities—Overall

Subsequent Measurement

> Equity Securities without Readily Determinable Fair Values

321-10-35-2 An entity may elect to measure an equity security without a **readily determinable fair value** that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in **orderly transactions** for the identical or a similar investment of the same issuer. An election to measure an equity security in accordance with this paragraph shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this paragraph, the entity shall continue to apply the measurement guidance in this paragraph until the investment does not qualify to be measured in accordance with this paragraph (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59). The entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies to be measured in accordance with this paragraph. <u>If an entity measures an equity security in accordance with this paragraph (and the security continues to qualify for measurement in accordance with this paragraph), it may subsequently elect an accounting policy to measure the equity security, and all equity securities of the same type, at fair value in</u>

accordance with Topic 820. Any resulting gains or losses on the securities for which that election is made shall be recorded in earnings at the time of the election.

Issue 2—Equity Securities without a Readily Determinable Fair Value—Adjustments

5. The amendments to paragraph 321-10-55-9 clarify the Board's intended application of the measurement alternative for equity securities without a readily determinable fair value. The amendments clarify that the adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place.

Amendments to Subtopic 321-10

6. Amend paragraph 321-10-55-9, with a link to transition paragraph 825-10-65-2, as follows:

Investments—Equity Securities—Overall

Implementation Guidance and Illustrations

> Implementation Guidance

> > Equity Securities without Readily Determinable Fair Values

> > > Identifying Similar Investment of Same Issuer

321-10-55-9 To identify whether a security issued by the same issuer is similar to the equity security held by the entity, the entity should consider the different rights and obligations of the securities. Differences in rights and obligations could include characteristics such as voting rights, distributions rights and preferences, and conversion features. The entity should adjust the observable price of a similar security for the different rights and obligations to determine the amount that should be recorded as an upward or downward adjustment in the carrying value of the security measured in accordance with paragraph 321-10-35-2 to reflect the ~~current~~ fair value of the security as of the date that the observable transaction for the similar security took place.

Issue 3—Forward Contracts and Purchased Options

7. Certain amendments made by Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* to Topic 815, Derivatives and Hedging, relate to the accounting for forward contracts and purchased options on

equity securities for which the guidance in the Certain Contracts on Debt and Equity Securities Subsections apply. The amendments clarify that when remeasuring forward contracts and purchased options on equity securities that do not have a readily determinable fair value, for which the measurement alternative in paragraph 321-10-35-2 is applied, an entity is required to update all inputs to the fair value calculation and not just the input related to the change in the value of the underlying security.

Amendments to Subtopic 815-10

8. Amend paragraph 815-10-35-6, with a link to transition paragraph 825-10-65-2, as follows:

Derivatives and Hedging—Overall

Subsequent Measurement

Certain Contracts on Debt and Equity Securities

815-10-35-6 Changes in the fair value of forward contracts and purchased options on equity securities within the scope of this Subsection shall be recognized in earnings as they occur. Changes in observable price or impairment of forward contracts and purchased options on equity securities without readily determinable fair value within the scope of this Subsection measured in accordance with paragraph 321-10-35-2 shall be recognized in earnings as they occur. <u>A change in observable price or impairment of the underlying securities of forward contracts and purchased options on equity securities shall result in a remeasurement of the entire fair value of the forward contracts and purchased options as of the date that the observable transaction took place.</u> Equity securities within the scope of this Subsection purchased under a forward contract or by exercising an option shall be recorded at their fair values at the settlement date.

Issue 4—Presentation Requirements for Certain Fair Value Option Liabilities

9. Before the issuance of Update 2016-01, instrument-specific credit risk was required to be disclosed for the fair value of fair value option financial liabilities for which the fair value has been significantly affected by changes in instrument-specific credit risk. Update 2016-01 was meant to amend only the presentation of instrument-specific credit risk and not how it should be measured. The proposed amendment clarifies that when the fair value option is elected for a financial liability, the guidance in paragraph 825-10-45-5 should be applied, regardless of whether the fair value option was elected under either Subtopic 815-15 or Subtopic

825-10. The proposed amendment adds an explanatory paragraph to Subtopic 815-15 and adds a reference to that Subtopic in paragraph 825-10-45-5.

Amendments to Subtopic 815-15

10. Add paragraph 815-15-45-2, with a link to transition paragraph 825-10-65-2, as follows:

Derivatives and Hedging—Embedded Derivatives

Other Presentation Matters

815-15-45-2 <u>If an entity has designated a financial liability under the fair value election in accordance with paragraphs 815-15-25-4 through 25-6, the entity shall apply the guidance in paragraph 825-10-45-5 on the presentation of changes in the liability's fair value that result from changes in instrument-specific credit risk.</u>

Amendments to Subtopic 825-10

11. Amend paragraph 825-10-45-5, with a link to transition paragraph 825-10-65-2, as follows:

Financial Instruments—Overall

Other Presentation Matters

Fair Value Option

> Statement of Comprehensive Income

> > Financial Liabilities for Which Fair Value Option Is Elected

825-10-45-5 If an entity has designated a financial liability under the fair value option in accordance with this Subtopic <u>or Subtopic 815-15</u>, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income. The entity shall present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk. The entity may consider the portion of the total change in fair value that excludes the amount resulting from a change in a base market risk, such as a risk-free rate or a benchmark interest rate, to be the result of a change in instrument-specific credit risk. Alternatively, an entity may use another method that it considers to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. The entity shall apply the method consistently to each financial liability from period to period.

Issue 5—Fair Value Option Liabilities Denominated in a Foreign Currency

12. The amendments to Topic 825 and Topic 830, Foreign Currency Matters, relate to how an entity should measure and present changes in fair value of a foreign-currency-denominated financial liability for which the fair value option has been elected. The amendments clarify that for foreign-currency-denominated financial liabilities for which the fair value option is elected, the amount of the change in fair value that relates to instrument-specific credit risk first should be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Both components of the change in fair value of the liability should then be remeasured into the functional currency of the reporting entity using end-of-period spot rates. The remeasurement of the change in fair value of the instrument-specific credit risk should be presented in accumulated other comprehensive income.

Amendments to Subtopic 825-10

13. Add paragraph 825-10-45-5A, with a link to transition paragraph 825-10-65-2, as follows:

Financial Instruments—Overall

Other Presentation Matters

Fair Value Option

> Statement of Comprehensive Income

> > Financial Liabilities for Which Fair Value Option Is Elected

825-10-45-5 If an entity has designated a financial liability under the fair value option in accordance with this Subtopic, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income. The entity shall present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk. The entity may consider the portion of the total change in fair value that excludes the amount resulting from a change in a base market risk, such as a risk-free rate or a benchmark interest rate, to be the result of a change in instrument-specific credit risk. Alternatively, an entity may use another method that it considers to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. The entity shall apply the method consistently to each financial liability from period to period.

825-10-45-5A If the liability is denominated in a currency other than the functional currency of the entity, the change in fair value of the liability resulting from changes in instrument-specific credit risk shall be presented separately from other changes in fair value of the liability in the liability's currency of denomination. The component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall then be adjusted to reflect the current exchange rate in accordance with paragraph 830-20-35-2. The remeasurement of the component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall be presented in accumulated other comprehensive income.

Amendments to Subtopic 830-20

14. Add paragraph 830-20-35-7A and its related heading, with a link to transition paragraph 825-10-65-2, as follows:

Foreign Currency Matters—Foreign Currency Transactions

Subsequent Measurement

> Transaction Gains and Losses

> > Financial Liabilities for Which Fair Value Option Is Elected

830-20-35-7A Paragraph 825-10-45-5A requires that for a financial liability for which the fair value option is elected, the change in the liability's fair value resulting from changes in instrument-specific credit risk shall be presented separately from other changes in the liability's fair value in the liability's currency of denomination. The component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall then be adjusted to reflect the current exchange rate in accordance with paragraph 830-20-35-2. The remeasurement of the component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall be presented in accumulated other comprehensive income.

Issue 6—Transition Guidance for Equity Securities without a Readily Determinable Fair Value

15. The transition guidance in Update 2016-01 generally requires a modified retrospective transition approach, but a prospective transition approach is required for equity securities without a readily determinable fair value. The Board decided to allow a prospective transition approach for equity securities without a readily determinable fair value because it may be difficult for entities to determine the last observable transaction price that is required under the new measurement alternative described in paragraph 321-10-35-2. The Board received feedback asking whether a prospective transition approach would be applied to equity securities without a readily determinable fair value for which the measurement alternative is not applied upon transition (instead, the equity securities would be measured at fair value under Topic 820). The Board believes that the transition approach was meant only for instances in which the measurement alternative is applied; therefore, the Board decided to clarify the transition guidance.

Amendments to Subtopic 825-10

16. Amend paragraph 825-10-65-2(e), with no link to a transition paragraph, as follows:

Financial Instruments—Overall

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

825-10-65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*:

e. An entity shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the fiscal year in which the pending content that links to this paragraph is applied. The pending content that links to this paragraph related to equity securities without **readily determinable fair values** (including disclosure requirements) shall be applied prospectively to all equity investments <u>for which an entity elects the measurement alternative in accordance with paragraph 321-10-35-2</u> that exist as of the date of adoption of the pending content that links to this paragraph.

The amendments in this proposed Update were approved for publication by six members of the Financial Accounting Standards Board. Ms. Hunt abstained.

Members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Marsha L. Hunt
Harold L. Monk, Jr.
R. Harold Schroeder
Marc A. Siegel

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. On January 5, 2016, the FASB issued Update 2016-01, which retained the current framework for accounting for financial instruments in GAAP but made targeted improvements to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. In addition to amending Topic 825, the Board added Topic 321 and made a number of consequential amendments to the Codification.

BC3. The Board has an ongoing project on its agenda about technical corrections and improvements to the Codification. The amendments in this proposed Update are of a similar nature to the items typically addressed in that project. However, the Board decided to issue a separate proposed Update for technical corrections related to Update 2016-01 to increase stakeholder awareness of the proposed amendments and to expedite the improvements.

BC4. The amendments in this proposed Update include items brought to the Board's attention by stakeholders. The amendments would clarify certain aspects of the guidance issued in Update 2016-01 and would not change any of the principles of that guidance. Therefore, the Board does not anticipate that entities will incur significant costs as a result of the proposed amendments. The proposed amendments should provide the benefit of improving consistent application of GAAP by clarifying current or pending guidance within the Codification.

Basis for Conclusions

Issue 1—Equity Securities without a Readily Determinable Fair Value—Discontinuation

BC5. Paragraph 321-10-35-2 provides a measurement alternative that can be elected for individual equity securities that do not have a readily determinable fair value and do not qualify for the net asset value practical expedient in accordance with paragraph 820-10-35-59. Under the measurement alternative, the security is measured on the basis of its cost minus impairment, plus or minus changes resulting from observable price changes. Once elected, an entity must continue to apply the measurement alternative until the investment no longer qualifies for the measurement alternative, for example, if the investment has a readily determinable fair value or becomes eligible for the net asset value practical expedient. Stakeholders asked whether there are additional situations that may allow an entity to discontinue the measurement alternative.

BC6. The proposed amendment would clarify that an entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method in accordance with Topic 820 through an election that would apply to that security and all other securities of the same type. The Board's intent was not to prohibit an entity from using a more precise measurement method; therefore, the amendments would allow an entity to apply a more precise measurement method if it subsequently elects to do so. The Board decided that any resulting gains or losses on the securities for which that election is made would be recorded in earnings at the time of the election.

BC7. The Board decided that the guidance on changes in accounting policy in Topic 250 would not apply to the election to measure the same type of securities in accordance with Topic 820 because the initial election to apply the measurement alternative is made for each investment separately, and, therefore, is not viewed as the adoption of an *accounting principle*. If an election is made to measure the same type of securities in accordance with Topic 820, the Board views this as establishing an accounting principle. Therefore, any further changes would be subject to the guidance on changes in accounting principle in Topic 250.

Issue 2—Equity Securities without a Readily Determinable Fair Value—Adjustments

BC8. Paragraph 321-10-55-9 provides implementation guidance related to the measurement alternative for equity securities without a readily determinable fair value permitted by paragraph 321-10-35-2. This implementation guidance states that when an observable transaction occurs for a similar security, adjustments may be needed to reflect the current fair value of the security on the basis of different rights and obligations. Stakeholders asked whether adjustments should be made to reflect the fair value as of the observable transaction date or the current reporting date (for example, quarter end) because those two dates may differ.

BC9. The Board intended for any adjustments to the price of an observable transaction for a similar security to reflect fair value as of the observable transaction date. The Board understands that the current language in paragraph 321-10-55-9 referencing "current fair value" could be misinterpreted to mean not only should the price be adjusted as of the transaction date for differences in rights and obligations, but it also should be adjusted to reflect events or other circumstances that occurred from the transaction date to the reporting date.

BC10. The proposed amendment would clarify that the adjustments made under the measurement alternative should reflect the security's fair value as of the date that the observable transaction for a similar security took place. The basis of the guidance is to remeasure when the similar transaction is observed; therefore, it would be inappropriate to perform the remeasurement on another date because that date would not reflect the same market conditions.

Issue 3—Forward Contracts and Purchased Options

BC11. Before the issuance of the amendments in Update 2016-01, paragraph 815-10-35-5 required certain forward contracts and purchased options to be accounted for on a *look-through* basis in which the instrument is accounted for consistent with the future classification of the securities. The amendments in Update 2016-01 changed the look-through guidance in paragraph 815-10-35-5 to apply only to debt securities because the amendments require all equity securities to be accounted for at fair value through net income. The amendments in Update 2016-01 also added paragraph 815-10-35-6, which states that the changes in the fair value of forward contracts and purchased options on equity securities must be recognized in earnings as they occur and specifies that changes in observable price or impairment should be recognized in earnings as they occur for the forward contract or purchased option on an equity security without a readily determinable fair value for which the measurement alternative in paragraph 321-10-35-2 is applied.

BC12. Stakeholders questioned whether a look-through approach for forward contracts and purchased options on equity securities for which the measurement alternative is expected to be applied would result in a complete remeasurement of the forward or option (which would involve updating all inputs to the valuation) or only an update to the input related to the fair value of the underlying security (as determined by applying the measurement alternative).

BC13. The proposed amendments would clarify that when measuring a forward contract or purchased option an entity would be required to update all inputs to the valuation and not just the input related to the change in the value of the underlying security.

Issue 4—Presentation Requirements for Certain Fair Value Option Liabilities

BC14. Paragraph 825-10-45-5 requires an entity that has elected to measure a financial liability at fair value with changes in fair value recognized in net income (that is, the fair value option) in accordance with Subtopic 825-10 to present separately the portion of the total change in the fair value of a liability attributable to a change in instrument-specific credit risk within other comprehensive income. Some stakeholders questioned whether hybrid financial liabilities for which the fair value option has been elected in accordance with paragraph 815-15-25-4 would be within the scope of this requirement, or whether the guidance in paragraph 825-10-45-5 is limited to financial liabilities for which the fair value option has been elected in accordance with Subtopic 825-10.

BC15. Before the issuance of the amendments in Update 2016-01, instrument-specific credit risk needed to be disclosed for the fair value of fair value option financial liabilities for which the fair value has been significantly affected by changes in instrument-specific credit risk. As described in paragraph BC112 of Update 2016-01, the Board did not intend to amend practice on how instrument-specific credit risk should be measured. Therefore, when the fair value option is elected for a financial liability, the Board believes that the liability should be considered to have instrument-specific credit risk if it is a general obligation of the entity, regardless of whether the fair value option was elected under either Subtopic 815-15 or Subtopic 825-10. The proposed amendments would provide that clarification in paragraph 825-10-45-5 and would add a paragraph in Section 815-15-45 to provide similar guidance.

Issue 5—Fair Value Option Liabilities Denominated in a Foreign Currency

BC16. Paragraph 825-10-45-5 requires an entity to present separately the portion of the total change in the fair value of a liability attributable to a change in instrument-specific credit risk within other comprehensive income. Some stakeholders asked how an entity should determine the amount of the fair value change attributable to instrument-specific credit risk for a foreign-currency-denominated liability for which the fair value option is elected.

BC17. The Board did not intend for the amendments in Update 2016-01 to change current practice on the measurement of liabilities in which the fair value option was elected or the measurement of instrument-specific credit risk (which is required to be disclosed under current GAAP). Therefore, the Board believes that for financial liabilities for which the fair value option is elected, the amount of the change in fair value that relates to instrument-specific credit risk should *first* be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates. The Board understands that this approach is consistent with current practice in this area on the basis of outreach with stakeholders that have fair value option liabilities for which they currently measure instrument-specific credit risk. The proposed amendments to Topic 825 and Topic 830 clarify that this is the approach that should be applied.

BC18. Furthermore, the Board noted that accounting for the change in the fair value of the liability because of changes in instrument-specific credit risk through the approach described in paragraph BC17 above is similar to accounting for changes in the fair value of foreign-currency-denominated available-for-sale securities, in accordance with paragraphs 320-10-35-36 and 830-20-35-6. The Board considered this reasonable because those are only two instances within GAAP, excluding hedge accounting, for which changes in value of financial assets and liabilities are measured through other comprehensive income.

Issue 6—Transition Guidance for Equity Securities without a Readily Determinable Fair Value

BC19. The transition guidance in Update 2016-01 generally requires a modified retrospective approach; however, a prospective transition approach is required for equity securities without a readily determinable fair value. The Board decided to require a prospective transition approach for equity securities without a readily determinable fair value because it may be difficult for entities to determine the last observable transaction price that would be required under the new measurement alternative described in paragraph 321-10-35-2. Stakeholders asked the Board whether a prospective transition approach is required for all equity securities without a readily determinable fair value, including those in which the measurement alternative guidance is not applied upon transition (instead, the equity securities would be measured at fair value under Topic 820).

BC20. The Board believes that the transition approach was meant only for instances in which the measurement alternative is applied because of operability concerns that could arise if an entity needed to evaluate historical observable transactions. These same operability concerns would not exist if an entity elected to measure the security at fair value under Topic 820.

Effective Date and Transition

BC21. The Board decided that for entities that have early adopted the guidance on the presentation change related to fair value option liabilities, the amendments in this proposed Update that are relevant to the fair value option would be effective upon issuance of a final Update and the transition requirements would be the same as those in Update 2016-01. For the remaining proposed amendments, the effective date and transition requirements would be the same as the effective date and transition requirements in Update 2016-01.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). We welcome comments on these proposed changes to the Taxonomy through ASU Taxonomy Changes provided at www.fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, proposed amendments to the Taxonomy will be made available for public comment at www.fasb.org and finalized as part of the annual release process.

FASB

Proposed Accounting Standards Update

Technical Corrections and Improvements to Recently Issued Standards

II. Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

On February 25, 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases (Topic 842),* to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions.

The Board has an ongoing project on its agenda about technical corrections and improvements to clarify the Codification or to correct unintended application of guidance. Those items generally are not expected to have a significant effect on current accounting practice or create a significant administrative cost for most entities. The amendments in this proposed Update are of a similar nature to the items typically addressed in the Codification improvements project. However, the Board decided to issue a separate proposed Update for technical corrections and improvements related to Update 2016-02 to increase stakeholder awareness of the proposed amendments and to expedite the improvements.

The FASB did not create a transition resource group (TRG) to address the leases guidance because many of the concepts used in Topic 842 are similar to those currently used in Topic 840, Leases. Although a formal TRG was not created, the Board and staff have been assisting stakeholders during this transitional period by responding to inquiries received and proactively seeking feedback on potential implementation issues that could arise as organizations implement Topic 842. The amendments in this proposed Update include items brought to the Board's attention through those stakeholder interactions.

The amendments in this proposed Update would affect narrow aspects of the guidance issued in Update 2016-02 as described in the table below.

Area for Correction or Improvement	**Summary of Proposed Amendments**
Issue 1: Residual Value Guarantees Stakeholders noted that paragraph 460-10-60-32 incorrectly refers readers to the guidance in Topic 842 about sale-leaseback-sublease transactions, when, in fact, it should refer readers to the guidance about guarantees by a seller-lessee of the	 The proposed amendment would correct the cross reference in paragraph 460-10-60-32.

Area for Correction or Improvement	Summary of Proposed Amendments
underlying asset's residual value in a sale and leaseback transaction.	
Issue 2: Rate Implicit in the Lease Stakeholders raised questions about the treatment of certain sales-type leases with significant variable payments under Topic 842 and whether the application of Topic 842 could result in a negative rate implicit in the lease, rather than a loss at the commencement date of the lease.	The proposed amendment would clarify that the rate implicit in the lease cannot be less than zero.
Issue 3: Lessee Reassessment of Lease Classification Topic 842 makes it clear that when a lease is modified and that modification is not accounted for as a separate contract, an entity (that is, a lessee or a lessor) should reassess, at the effective date of the modification, lease classification on the basis of the modified terms and conditions and the facts and circumstances existing as of that date. Although Topic 842 also requires a lessee to reassess lease classification if there is a change in the lease term or the assessment of a lessee option to purchase the underlying asset, stakeholders expressed that it is not clear whether the lessee should reassess lease classification on the basis of the facts and circumstances existing as of the date the reassessment is required.	The proposed amendment would consolidate the requirements about lease classification reassessments into one paragraph and better articulate how an entity should perform the lease classification reassessment, that is, on the basis of the facts and circumstances, and the modified terms and conditions if applicable, as of the date the reassessment is required.

Area for Correction or Improvement	Summary of Proposed Amendments
Issue 4: Lessor Reassessment of Lease Term and Purchase Option Topic 842 requires a lessor to not reassess the lease term or a lessee purchase option unless the lease is modified and that modification is not accounted for as a separate contract. Topic 842 also requires a lessor to account for the exercise of a lessee option to extend or terminate the lease, or to purchase the underlying asset, in the same manner as a lease modification. Stakeholders questioned why a lessor should account for a lessee exercise of such options in a manner similar to a lease modification when the exercise of those options is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification that is not accounted for as a separate contract).	 The proposed amendment would clarify that a lessor should account for the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset as a lease modification unless the exercise of that option by the lessee is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification that is not accounted for as a separate contract).
Issue 5: Variable Lease Payments That Depend on an Index or a Rate Stakeholders noted that the guidance in paragraph 842-10-35-4(b) about remeasurement of the lease payments when a contingency upon which some or all of the variable lease payments are based is resolved might be perceived as applying to any variable lease payments, including those that depend on an index or rate, which would be inconsistent with the Board's decisions on this issue.	 The proposed amendment would clarify that a change to a reference index or rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to the guidance in paragraph 842-10-35-4(b). Variable lease payments that depend on an index or a rate should be remeasured, using the index or rate at the remeasurement date, only when the lease payments are remeasured for another reason (that is, when one or more of the events

Area for Correction or Improvement	Summary of Proposed Amendments
	described in paragraph 842-10-35-4(a) or (c) occur or when a contingency unrelated to a change in a reference index or rate under paragraph 842-10-35-4(b) is resolved).
Issue 6: Investment Tax Credits Stakeholders indicated that there is an inconsistency in terminology used about the effect that investment tax credits have on the fair value of the underlying asset between the definition of the term *rate implicit in the lease* and the lease classification guidance in paragraph 842-10-55-8.	 The proposed amendment would remove that inconsistency in terminology.
Issue 7: Lease Term and Purchase Option Stakeholders indicated that the description in paragraph 842-10-55-24 about lessor-only termination options is not consistent with the description in paragraph 842-10-55-23 about the noncancellable period of a lease.	 The proposed amendment would remove that inconsistency by clarifying that a lessor-only option to terminate the lease is an input to the determination of the lease term and does not affect the noncancellable period of the lease.
Issue 8: Transition Guidance for Amounts Previously Recognized in Business Combinations Stakeholders indicated that the transition guidance for lessors in paragraph 842-10-65-1(h)(3) is unclear because it relates to leases classified as direct financing leases or sales-type leases under Topic 840, while the lead-in sentence to paragraph 842-10-65-1(h) provides transition guidance for leases classified as operating leases under Topic 840.	 The proposed amendment would clarify that paragraph 842-10-65-1(h)(3) applies to lessors for leases classified as direct financing leases or sales-type leases under Topic 842, not Topic 840. In other words, paragraph 842-10-65-1(h)(3) would apply when an entity does not elect the package of practical expedients in paragraph 842-10-65-1(f), and, for a lessor, an operating lease acquired as part of a previous business combination is classified as a direct

Area for Correction or Improvement	Summary of Proposed Amendments
	financing lease or a sales-type lease when applying the lease classification guidance in Topic 842.
Issue 9: Certain Transition Adjustments When an entity does not elect the package of practical expedients in Topic 842, paragraph 842-10-65-1(p) requires a lessee to write off, as an adjustment to equity, any unamortized initial direct costs that do not meet the definition of *initial direct costs* under Topic 842 for leases previously classified as operating leases under Topic 840. Stakeholders questioned why those nonqualifying costs should be charged to equity when such costs are incurred after the beginning of the earliest period presented in the financial statements in which an entity adopts Topic 842. Similar issues also were noted elsewhere in the transition guidance.	 The proposed amendments would clarify whether to recognize a transition adjustment to earnings rather than through equity.
Issue 10: Transition Guidance for Leases Previously Classified as Capital Leases under Topic 840 Paragraph 842-10-65-1(r) provides guidance to lessees for leases previously classified as capital leases under Topic 840 and classified as finance leases under Topic 842. Paragraph 842-10-65-1(r)(4) provides subsequent measurement guidance before the effective date, but it refers readers to the subsequent measurement guidance in Topic 840 about operating leases. It should refer them to the subsequent measurement guidance applicable to capital leases.	 The proposed amendment would correct that reference.

Area for Correction or Improvement	Summary of Proposed Amendments
Issue 11: Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases under Topic 840 Paragraph 842-10-65-1(x) provides transition guidance applicable to lessors for leases previously classified as direct financing leases or sales-type leases under Topic 840 and classified as direct financing leases or sales-type leases under Topic 842. For modifications to those leases beginning after the effective date, paragraph 842-10-65-1(x)(4) refers readers to other applicable guidance in Topic 842 to account for the modification, specifically paragraphs 842-10-25-16 through 25-17, depending on how the lease is classified after the modification. Stakeholders noted that it should refer to how the lease is classified *before* the modification to be consistent with the guidance provided in paragraphs 842-10-25-16 through 25-17.	 The proposed amendment would correct that inconsistency.
Issue 12: Transition Guidance for Sale and Leaseback Transactions Stakeholders noted that the heading above the transition guidance on sale and leaseback transactions appears to suggest that there is no transition guidance for sale and leaseback transactions that occur after the earliest comparative period presented in the financial statements in which an entity adopts Topic 842 but before the effective date. Some stakeholders also questioned some of the	 The proposed amendments would clarify that the transition guidance on sale and leaseback transactions in paragraph 842-10-65-1(aa) through (ee) applies to all sale and leaseback transactions that occur before the effective date and would correct the referencing issues noted.

Area for Correction or Improvement	Summary of Proposed Amendments
references included in paragraph 842-10-65-1(bb).	
Issue 13: Impairment of Net Investment in the Lease Paragraph 842-30-35-3 provides guidance to lessors for determining the loss allowance of the net investment in the lease and describes the cash flows that should be considered when the lessor determines that loss allowance. Stakeholders questioned whether the guidance, as written, would accelerate and improperly measure the loss allowance because the cash flows associated with the unguaranteed residual asset appear to be excluded from the evaluation.	 The proposed amendment would clarify the application of the guidance for determining the loss allowance of the net investment in the lease, including the cash flows to consider in that assessment.
Issue 14: Unguaranteed Residual Asset Paragraph 842-30-35-4 provides guidance explaining that if a lessor sells the lease receivable associated with a direct financing lease or a sales-type lease and retains an interest in the residual value of the asset, the lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term. Stakeholders questioned whether the Board intended to change the application as compared with current generally accepted accounting principles (GAAP) because the guidance in paragraph 840-30-35-53 (which will be superseded by the amendments in Update 2016-02) requires a lessor to continue to recognize interest resulting from accretion of the unguaranteed residual asset to its	 The proposed amendment would clarify that a lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term to the extent that the lessor sells substantially all of the lease receivable associated with a direct financing lease or a sales-type lease, consistent with Topic 840.

Area for Correction or Improvement	Summary of Proposed Amendments
estimated value unless the lessor sells *substantially all* of the minimum rental payments.	
Issue 15: Effect of Initial Direct Costs on the Rate Implicit in the Lease Stakeholders noted that the ordering of the illustration in Case C of Example 1 in paragraphs 842-30-55-31 through 55-39 has raised questions about how initial direct costs factor into the determination of the rate implicit in the lease for lease classification purposes for lessors only.	 The proposed amendment would more clearly align the illustration to the guidance in paragraph 842-10-25-4.
Issue 16: Failed Sale and Leaseback Transaction In accordance with Subtopic 842-40, Leases—Sale and Leaseback Transactions, when a sale and leaseback transaction does not qualify as a sale, the entity should account for the transaction as a financing arrangement. Paragraph 842-40-30-6(a) further requires a seller-lessee to adjust the interest rate as necessary to prevent negative amortization of the financial liability recognized. Some stakeholders questioned whether the language used in paragraph 842-40-30-6(a) actually meets the objective of preventing negative amortization of the financial liability recognized by a seller-lessee in a failed sale and leaseback transaction.	 The proposed amendment would clarify that a seller-lessee in a failed sale and leaseback transaction should adjust the interest rate on its financial liability as necessary to ensure that the interest on the financial liability does not exceed the total payments (rather than the principal payments) on the financial liability.

When Would the Amendments Be Effective?

The amendments in this proposed Update would affect the amendments in Update 2016-02, which are not yet effective, but for which early adoption upon issuance is permitted. For entities that have early adopted Topic 842, the proposed amendments would be effective upon issuance of a final Update and the transition requirements would be the same as those in Topic 842. For entities that have not adopted Topic 842, the effective date and transition requirements would be the same as the effective date and transition requirements in Topic 842.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: Would the amendments in this proposed Update clarify the guidance in Topic 842 or provide a better link between paragraphs within Topic 842 or between the guidance in Topic 842 and other Topics? If not, please explain which proposed amendment(s) you disagree with and why.

Question 2: Will any of the proposed amendments result in substantive changes to the application of Topic 842 that would require transition provisions or an effective date for the final amendments other than those noted in the Summary section “When Would the Amendments Be Effective?” If so, please describe.

Question 3: Should other changes that are directly or indirectly related to the proposed amendments be made? Please note that the Board will conduct Codification improvements projects on a periodic basis and additional changes may be postponed to a subsequent Codification improvements project.

Amendments to the *FASB Accounting Standards Codification*®

Summary of Proposed Amendments to the Accounting Standards Codification

1. The following table summarizes the proposed amendments to the Accounting Standards Codification. The proposed amendments are organized by area.

Areas for Improvement	**Paragraphs**
Issue 1: Residual Value Guarantees	3 and 4
Issue 2: Rate Implicit in the Lease	5 and 6
Issue 3: Lessee Reassessment of Lease Classification	7 and 8
Issue 4: Lessor Reassessment of Lease Term and Purchase Option	9 and 10
Issue 5: Variable Lease Payments That Depend on an Index or a Rate	11 and 12
Issue 6: Investment Tax Credits	13 and 14
Issue 7: Lease Term and Purchase Option	15 and 16
Issue 8: Transition Guidance for Amounts Previously Recognized in Business Combinations	17 and 18
Issue 9: Certain Transition Adjustments	19 and 20
Issue 10: Transition Guidance for Leases Previously Classified as Capital Leases under Topic 840	21 and 22

Areas for Improvement	Paragraphs
Issue 11: Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases under Topic 840	23 and 24
Issue 12: Transition Guidance for Sale and Leaseback Transactions	25 and 26
Issue 13: Impairment of Net Investment in the Lease	27 and 28
Issue 14: Unguaranteed Residual Asset	29 and 30
Issue 15: Effect of Initial Direct Costs on Rate Implicit in the Lease	31 and 32
Issue 16: Failed Sale and Leaseback Transaction	33 and 34

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–34. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Issue 1: Residual Value Guarantees

3. This proposed amendment would provide a better link between the cross-reference in Section 460-10-60 and the implementation guidance in Topic 842 about residual value guarantees by a seller-lessee in a sale and leaseback transaction.

Amendments to Subtopic 460-10

4. Amend paragraph 460-10-60-32, with a link to transition paragraph 842-10-65-1, as follows:

Guarantees—Overall

Relationships

> Leases

460-10-60-32 For a guarantee by the seller-lessee of the underlying asset's residual value in a sale and leaseback transaction, see ~~paragraph 842-40-55-19~~paragraphs 842-40-55-20 through 55-21.

Issue 2: Rate Implicit in the Lease

5. This proposed amendment would clarify that the rate implicit in the lease, as defined and applied in Topic 842, cannot be less than zero.

Amendments to Master Glossary

6. Amend the Master Glossary term *Rate Implicit in the Lease*, with a link to transition paragraph 842-10-65-1, as follows:

Rate Implicit in the Lease

The rate of interest that, at a given date, causes the aggregate present value of (a) the **lease payments** and (b) the amount that a **lessor** expects to derive from the **underlying asset** following the end of the **lease term** to equal the sum of (1) the **fair value** of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred **initial direct costs** of the lessor. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used. The rate implicit in the lease, as defined and applied in Topic 842, shall not be less than zero.

Issue 3: Lessee Reassessment of Lease Classification

7. These proposed amendments would clarify certain aspects of the guidance about lease classification reassessments when, for a lessee, there is a change in the lease term or the assessment of a lessee purchase option of the underlying asset.

Amendments to Subtopic 842-10

8. Amend paragraphs 842-10-25-1 through 25-2 and 842-10-25-9, with a link to transition paragraph 842-10-65-1, as follows:

Leases—Overall

Recognition

> Lease Classification

842-10-25-1 An entity shall classify each separate **lease** component at the **commencement date**. An entity shall not reassess the lease classification after the commencement date unless the **contract** is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. In addition, a **lessee** also shall reassess the lease classification after the commencement date if there is a change in the **lease term** or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the **underlying asset**. When an entity (that is, a lessee or lessor) is required to reassess lease classification, the entity shall reassess classification of the lease on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment is required (for example, on the basis of the **fair value** and the remaining **economic life** of the underlying asset as of the date there is a change in the lease term or in the assessment of a lessee option to purchase the underlying asset, or as of the effective date of a modification not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

842-10-25-2 A lessee shall classify a lease as a **finance lease** and a **lessor** shall classify a lease as a **sales-type lease** when the lease meets any of the following criteria at lease commencement:

a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
c. The lease term is for the major part of the remaining **{remove glossary link}economic life{remove glossary link}** of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
d. The present value of the sum of the **lease payments** and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the **{remove glossary link}fair value{remove glossary link}** of the underlying asset.

e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

> Lease Modifications

842-10-25-9 If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall reassess the classification of the lease in accordance with paragraph 842-10-25-1 as of the **effective date of the modification** ~~based on its modified terms and conditions and the facts and circumstances as of that date (for example, the **fair value** and remaining **economic life** of the **underlying asset** as of that date)~~.

Issue 4: Lessor Reassessment of Lease Term and Purchase Option

9. This proposed amendment would clarify that the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset should be accounted for as a lease modification by a lessor unless the exercise of the option by the lessee is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or at the most recent effective date of a modification not accounted for as a separate contract).

Amendments to Subtopic 842-10

10. Amend paragraph 842-10-35-3, with a link to transition paragraph 842-10-65-1, as follows:

Subsequent Measurement

> Lease Term and Purchase Options

842-10-35-3 A **lessor** shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. When a lessee exercises an option to extend ~~or terminate~~ the lease or purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise or exercises an option to terminate the lease that the lessor previously determined the lessee was reasonably certain not to exercise, the lessor shall account for the exercise of that option in the same manner as a **lease modification**.

Issue 5: Variable Lease Payments That Depend on an Index or a Rate

11. These proposed amendments would clarify that a change to a reference index or rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to the guidance in paragraph 842-10-35-4(b) about remeasurement of the lease payments.

Amendments to Subtopic 842-10

12. Amend paragraphs 842-10-35-4 through 35-5, with a link to transition paragraph 842-10-65-1, as follows:

Subsequent Measurement

> Subsequent Measurement of the Lease Payments

842-10-35-4 A **lessee** shall remeasure the **lease payments** if any of the following occur:

a. The **lease** is modified, and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.
b. A contingency upon which some or all of the **variable lease payments** that will be paid over the remainder of the **lease term** are based is resolved such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the **underlying asset** becoming fixed payments for the remainder of the lease term. <u>However, a change in a reference index or a rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to (b) (see paragraph 842-10-35-5 for guidance on the remeasurement of variable lease payments that depend on an index or a rate).</u>
c. There is a change in any of the following:
    1. The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments on the basis of the revised lease term.
    2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.

3. Amounts **probable** of being owed by the lessee under **residual value guarantees**. A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.

842-10-35-5 When one or more of the events described in paragraph 842-10-35-4(a) or (c) occur or when a contingency unrelated to a change in a reference index or rate under paragraph 842-10-35-4(b) is resolved~~a lessee remeasures the lease payments in accordance with paragraph 842-10-35-4~~, variable lease payments that depend on an index or a rate shall be remeasured~~measured~~ using the index or rate as of the date the reassessment is required~~at the remeasurement date~~.

Issue 6: Investment Tax Credits

13. This proposed amendment would clarify the effect that investment tax credits have when determining lease classification and would better align with how investment tax credits are considered when determining the rate implicit in the lease.

Amendments to Subtopic 842-10

14. Amend paragraph 842-10-55-8, with a link to transition paragraph 842-10-65-1, as follows:

Implementation Guidance and Illustrations

> Implementation Guidance

> > Lease Classification

> > > Effect of Investment Tax Credits

842-10-55-8 When evaluating the **lease** classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1), the **fair value** of the **underlying asset** should ~~exclude~~be reduced by any related investment tax credit retained by the **lessor** and expected to be realized by the lessor.

Issue 7: Lease Term and Purchase Option

15. This proposed amendment would clarify that a period covered by a lessor-controlled option to terminate a lease is an input to the determination of the lease term and does not affect the noncancellable period of the lease.

Amendments to Subtopic 842-10

16. Amend paragraph 842-10-55-24, with a link to transition paragraph 842-10-65-1, as follows:

Implementation Guidance and Illustrations

> Implementation Guidance

> > Lease Term and Purchase Options

842-10-55-23 An entity should determine the noncancellable period of a **lease** when determining the **lease term**. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a **contract** and determine the period for which the contract is enforceable. A lease is no longer enforceable when both the **lessee** and the **lessor** each have the right to terminate the lease without permission from the other party with no more than an insignificant **penalty**.

842-10-55-24 If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph ~~842-10-30-1~~842-10-30-1(b). If only a lessor has the right to terminate a lease, ~~the noncancellable period of~~ the lease term includes the period covered by the option to terminate the lease, as described in paragraph 842-10-30-1(c).

Issue 8: Transition Guidance for Amounts Previously Recognized in Business Combinations

17. This proposed amendment would clarify the intent of the transition guidance provided to lessors in paragraph 842-10-65-1(h)(3) for assets or liabilities recognized in accordance with Topic 805, Business Combinations, for favorable or unfavorable terms of an operating lease acquired as part of a business combination.

Amendments to Subtopic 842-10

18. Amend paragraph 842-10-65-1(h) as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842):*

Amounts previously recognized in respect of business combinations

h. If an entity has previously recognized an asset or a liability in accordance with Topic 805 on **business combinations** relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity shall do all of the following:
    1. Derecognize that asset and liability (except for those arising from operating leases for which the entity is a lessor).
    2. Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee.
    3. Make a corresponding adjustment to equity ~~at the beginning of the earliest comparative period presented~~ if assets or liabilities arise from leases that are classified as **sales-type leases** or **direct financing leases** in accordance with Topic ~~840~~842 for which the entity is a lessor. Also see (w).

Issue 9: Certain Transition Adjustments

19. This proposed amendment would clarify whether certain transition adjustments should be recognized to earnings rather than to equity.

Amendments to Subtopic 842-10

20. Amend paragraph 842-10-65-1(p), (r)(3), (s)(5), (v)(3), (w)(3), and (y)(3) as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842):*

Lessees

Leases previously classified as operating leases under Topic 840

p. Any unamortized initial direct costs ~~at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease~~ that do not meet the definition of initial direct costs in this Topic shall be written off as an adjustment to equity (if incurred before~~at the later of~~ the beginning of the earliest period presented in the financial ~~statements and the commencement date of the lease~~statements) or to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented), unless the lessee elects the practical expedients described in (f).

Leases previously classified as capital leases under Topic 840

r. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of the following:

3. Write off~~, as an adjustment to equity,~~ any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic and that are not included in the measurement of the capital lease asset under Topic 840 as an adjustment to equity (if incurred before ~~at the later of~~ the beginning of the earliest period presented in the financial ~~statements~~statements) or ~~the commencement date of the lease that do not meet the definition of initial direct costs in this Topic and that are not included in the measurement of the capital lease asset under Topic 840~~to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented), ~~(unless~~unless the lessee elects the practical expedients described in ~~(f))~~(f).

s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:

5. Write off~~, as an adjustment to equity,~~ any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic as an adjustment to equity (if incurred before ~~at the later of~~ the beginning of the earliest period presented in the financial ~~statements~~statements) or ~~the commencement date of the lease that do not meet the definition of initial direct costs in this Topic~~to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented), unless the lessee elects the practical expedients described in (f).

Lessors

Leases previously classified as operating leases under Topic 840

v. For each lease classified as an operating lease in accordance with this Topic, a lessor shall do all of the following:

3. Write off~~, as an adjustment to equity,~~ any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic

as an adjustment to equity (if incurred before~~at the later of~~ the beginning of the earliest period presented in the financial ~~statements~~statements) or ~~the commencement date of the lease~~to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented), ~~that do not meet the definition of initial direct costs in this Topic~~ ~~(unless~~unless the lessor elects the practical expedients described in ~~(f))~~(f).

w. For each lease classified as a direct financing or a sales-type lease in accordance with this Topic, the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with this Topic. Consequently, a lessor shall do all of the following:

   3. Record any difference between the amounts in (w)(1) and (w)(2) as an adjustment to equity (if the commencement date of the lease was before the beginning of the earliest period presented or if the lease was acquired as part of a business combination; also see (h)(3)) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).

Leases previously classified as direct financing or sales-type leases under Topic 840

y. For each lease classified as an operating lease in accordance with this Topic, the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as an operating lease in accordance with this Topic. Consequently, a lessor shall do all of the following:

   3. Record any difference between the amounts in (y)(1) and (y)(2) as an adjustment to equity (if the commencement date of the lease was before the beginning of the earliest period presented or if the lease was acquired as part of a business combination) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).

Issue 10: Transition Guidance for Leases Previously Classified as Capital Leases under Topic 840

21. This proposed amendment would correct a reference in the transition guidance about subsequent measurement of the lease before the effective date

that is applicable to lessees for leases previously classified as capital leases under Topic 840 and classified as finance leases under Topic 842.

Amendments to Subtopic 842-10

22. Amend paragraph 842-10-65-1(r)(4) as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842):*

Leases previously classified as capital leases under Topic 840

- r. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of the following:
  - 4. Subsequently measure the right-of-use asset and the lease liability in accordance with Section ~~840-20-35~~840-30-35 before the effective date.

Issue 11: Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases under Topic 840

23. This proposed amendment would clarify the transition guidance about modifications beginning on the effective date that are applicable to lessors for leases previously classified as direct financing leases or sales-type leases under Topic 840 and classified as direct financing leases or sales-type leases under Topic 842.

Amendments to Subtopic 842-10

24. Amend paragraph 842-10-65-1(x)(4) as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842):*

Leases previously classified as direct financing or sales-type leases under Topic 840

x. For each lease classified as a direct financing lease or a sales-type lease in accordance with this Topic, do all of the following:

    4. Beginning on the effective date, if a lessor modifies the lease (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), it shall account for the modified lease in accordance with paragraph 842-10-25-16 if the ~~modified~~ lease is classified as a direct financing lease ~~after~~before the modification or paragraph 842-10-25-17 if the ~~modified~~ lease is classified as a sales-type lease ~~after~~before the modification. A lessor shall not remeasure the net investment in the lease on or after the effective date unless the lease is modified (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

Issue 12: Transition Guidance for Sale and Leaseback Transactions

25. These proposed amendments would clarify that the transition guidance on sale and leaseback transactions in paragraph 842-10-65-1(aa) through (ee) applies to all sale and leaseback transactions that occur before the effective date and would update referencing issues.

Amendments to Subtopic 842-10

26. Amend the heading preceding paragraph 842-10-65-1(aa) and paragraph 842-10-65-1(bb) as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2016-02, *Leases (Topic 842)*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842):*

Sale and leaseback transactions before the effective date~~beginning of the earliest comparative period presented~~

aa. If a previous sale and leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity shall not reassess the transaction to determine whether the transfer of the asset would have been a sale in accordance with paragraphs 842-40-25-1 through 25-3.

bb. If a previous sale and leaseback transaction was accounted for as a failed sale and leaseback transaction in accordance with Topic 840 and remains a failed sale at the effective date, the entity shall reassess whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with paragraphs 842-40-25-1 through 25-3. The sale and leaseback transaction shall be accounted for on a modified retrospective basis from the date a sale is determined to have occurred~~, in accordance with the requirements in (cc) through (dd)~~.

cc. An entity shall account for the leaseback in accordance with the lessee and lessor transition requirements in (k) through (y).

dd. If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in accordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that exists at the later of the beginning of the earliest comparative period presented in the financial statements or the date of the sale of the underlying asset as follows:

1. If the underlying asset is land only, straight line over the remaining lease term.
2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the right-of-use asset.
3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition in profit or loss of the total lease cost.

ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:

1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at **fair value** or the lease payments are not at market rates) as a cumulative-effect adjustment at the later of the date of initial application (to equity) or the date of sale (to earnings of the comparative period presented).
2. Recognize any deferred loss resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-of-use asset at the date of initial application.
3. Recognize any deferred gain resulting from the consideration for the sale of the asset not being at fair value or the lease payments

not being at market rates as a financial liability at the date of initial application.

Issue 13: Impairment of Net Investment in the Lease

27. This proposed amendment would clarify the application of the impairment guidance to lessors for net investment in leases, including the cash flows to consider in that impairment assessment.

Amendments to Subtopic 842-30

28. Amend paragraph 842-30-35-3, with a link to transition paragraph 842-10-65-1, as follows:

Leases—Lessor

Subsequent Measurement

> Sales-Type and Direct Financing Leases

> > Impairment of the Net Investment in the Lease

842-30-35-3 A **lessor** shall determine impairment related to the **net investment in the lease** and shall recognize any impairment in accordance with Topic 310 on receivables (as described in paragraphs 310-10-35-16 through 35-30). When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to receive (or derive)~~derive~~ from the **lease receivable** and the **unguaranteed residual asset** ~~**underlying asset**~~ during and following the end of the remaining **lease term** ~~(for example, from sale of the asset or release of the asset for the remainder of the lease term), which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term)~~.

In addition, amend the following pending content and its related heading for paragraph 842-30-35-3, with a link to transition paragraph 326-10-65-1, as follows:

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2020* | **Transition Guidance:** 326-10-65-1

> > ~~Credit Losses~~Loss Allowance on the Net Investment in the Lease

842-30-35-3 A **lessor** shall determine the loss allowance~~credit losses~~ related to the **net investment in the lease** and shall record any loss allowance~~credit losses~~ in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to receive (or derive)~~derive~~ from the **lease receivable** and the **unguaranteed residual asset**~~**underlying asset**~~ during and following the end of the remaining **lease term**~~, which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term)~~.

Issue 14: Unguaranteed Residual Asset

29. This proposed amendment would clarify that a lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term to the extent that the lessor sells substantially all of the lease receivable associated with a direct financing lease or a sales-type lease.

Amendments to Subtopic 842-30

30. Amend paragraph 842-30-35-4, with a link to transition paragraph 842-10-65-1, as follows:

Subsequent Measurement

> Sales-Type and Direct Financing Leases

> > Sale of the Lease Receivable

842-30-35-4 If a **lessor** sells substantially all of the **lease receivable** associated with a **sales-type lease** or a **direct financing lease** and retains an interest in the **unguaranteed residual asset**, the lessor shall not continue to accrete the unguaranteed residual asset to its estimated value over the remaining **lease term**. The lessor shall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

Issue 15: Effect of Initial Direct Costs on Rate Implicit in the Lease

31. This proposed amendment would clarify for lessors the effect that initial direct costs have on the determination of the rate implicit in the lease for lease classification purposes.

Amendments to Subtopic 842-30

32. Amend paragraphs 842-30-55-20 and 842-30-55-32 and add paragraph 842-30-55-32A, with a link to transition paragraph 842-10-65-1, as follows:

Implementation Guidance and Illustrations

> Illustrations

> > Illustration of Lessor Accounting

842-30-55-18 Example 1 illustrates how a lessor would account for sales-type leases and direct financing leases.

> > > Example 1—Lessor Accounting Example

> > > > Case A—Lessor Accounting—Sales-Type Lease

842-30-55-19 Lessor enters into a 6-year lease of equipment with Lessee, receiving annual lease payments of $9,500, payable at the end of each year. Lessee provides a residual value guarantee of $13,000. Lessor concludes that it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. The equipment has a 9-year estimated remaining economic life, a carrying amount of $54,000, and a fair value of $62,000 at the commencement date. Lessor expects the residual value of the equipment to be $20,000 at the end of the 6-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs $2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent.

842-30-55-20 Lessor classifies the lease as a sales-type lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the lessee amounts to substantially all of the fair value of the equipment. None of the other criteria to be classified as a sales-type lease are met. <u>In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments and the present value of the residual value</u>

guaranteed by Lessee (5.4839 percent) for purposes of assessing whether the lease is a sales-type lease under the criterion in paragraph 842-10-25-2(d) assumes that no initial direct costs will be capitalized because the fair value of the equipment is different from its carrying amount.

> > > > Case C—Lessor Accounting—Direct Financing Lease

842-30-55-31 Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that the $13,000 residual value guarantee is provided by a third party, not by Lessee. Collectibility of the lease payments and any amount necessary to satisfy the third party residual value guarantee is probable.

842-30-55-32 None of the criteria in paragraph 842-10-25-2 to be classified as a sales-type lease are met. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments (5.4839 percent) for purposes of assessing whether the lease is a sales-type lease under the criterion in paragraph 842-10-25-2(d) assumes that no initial direct costs will be capitalized because the fair value of the equipment is different from its carrying amount.~~Lessor classifies the lease as a direct financing lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the third party amounts to substantially all of the fair value of the equipment. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments and the guaranteed residual value (5.4839 percent) assumes that no initial direct costs will be deferred because, at the commencement date, the fair value of the equipment is different from its carrying amount~~. **[Content amended and moved to paragraph 842-30-55-32A]**

842-30-55-32A Rather, Lessor classifies the lease as a direct financing lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the third party amounts to substantially all of the fair value of the equipment, and it is probable that Lessor will collect the lease payments plus any amount necessary to satisfy the third-party residual value guarantee. The discount rate used to determine the present value of the lease payments and the present value of the third-party residual value guarantee for purposes of assessing whether the lease meets the criterion in paragraph 842-10-25-3(b)(1) to be classified as a direct financing lease is the rate implicit in the lease of 4.646 percent, which includes the initial direct costs of $2,000 that Lessor incurred. ~~In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments and the guaranteed residual value (5.4839 percent) assumes that no initial direct costs will be deferred because, at the commencement date, the fair value of the equipment is different from its carrying amount.~~ **[Content amended as shown and moved from paragraph 842-30-55-32]**

Issue 16: Failed Sale and Leaseback Transaction

33. This proposed amendment would clarify that a seller-lessee in a failed sale and leaseback transaction should adjust the interest rate on its financial liability as necessary to ensure that the interest on the financial liability does not exceed the total payments (rather than the principal payments) on the financial liability.

Amendments to Subtopic 842-40

34. Amend paragraph 842-40-30-6, with a link to transition paragraph 842-10-65-1, as follows:

Leases—Sale and Leaseback Transactions

Initial Measurement

> Transfer of the Asset Is Not a Sale

842-40-30-6 The guidance in paragraph 842-40-25-5 notwithstanding, the seller-lessee shall adjust the interest rate on its financial liability as necessary to ensure that both of the following apply:

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

The amendments in this proposed Update were approved for publication by six members of the Financial Accounting Standards Board. Ms. Hunt abstained.

Members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Marsha L. Hunt
Harold L. Monk, Jr.
R. Harold Schroeder
Marc A. Siegel

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. On February 25, 2016, the FASB issued Update 2016-02 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions.

BC3. The Board has an ongoing agenda project about improvements to the Codification. The amendments in this proposed Update are of a similar nature to the items typically addressed in that project. However, the Board decided to issue a separate proposed Update for technical corrections and improvements related to Topic 842 and other Topics amended by Update 2016-02 to increase stakeholder awareness of the proposed amendments and to expedite improvements to the amendments in Update 2016-02.

BC4. The FASB did not create a TRG to address the leases guidance because many of the concepts used in Topic 842 are similar to those currently used in Topic 840. Although a formal TRG was not created, the Board and staff have been assisting stakeholders by responding to inquiries received and proactively seeking feedback on potential implementation issues that could arise as organizations implement Topic 842.

BC5. The amendments in this proposed Update include items brought to the Board's attention by stakeholders. The proposed amendments would affect narrow aspects of the amendments in Update 2016-02 and would not change any of the principles of those amendments. Therefore, the Board does not anticipate that entities will incur significant costs as a result of the proposed amendments. The proposed amendments should provide the benefit of improving consistent application of GAAP by clarifying guidance that already exists in Topic 842. The proposed amendments would not create new accounting requirements.

Basis for Conclusions

Issue 1: Residual Value Guarantee

BC6. Paragraph 460-10-60-32 refers readers to the guidance in Topic 842 about sale-leaseback-sublease transactions when, in fact, it should refer readers to the guidance about guarantees by the seller-lessee of the underlying asset's residual value in a sale and leaseback transaction. The amendment in this proposed Update would correct the cross-reference between Topic 460, Guarantees, and the relevant guidance in Subtopic 842-40 about a seller-lessee's guarantee of the underlying asset's residual value in a sale and leaseback transaction.

Issue 2: Rate Implicit in the Lease

BC7. Variable lease payments that do not depend on an index or a rate (such as those that are based on the performance of the underlying asset or usage of the underlying asset by the lessee) generally do not meet the definition of lease payments. For a direct financing lease or a sales-type lease, variable lease payments that do not depend on an index or a rate are not included in the net investment in the lease. Rather, a lessor recognizes those payments as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur. For a lease with significant variable lease payments that is classified as a direct financing lease or a sales-type lease, stakeholders questioned whether, for a lessor, the application of Topic 842 should result in the recognition of a "day-1 loss" at the commencement date of the lease or whether there are other approaches that could be acceptable. Specifically, some stakeholders noted that a literal application of the guidance, particularly the definition of the term *rate implicit in the lease*, could result in the determination of an implicit rate that is less than zero.

BC8. At the November 30, 2016 Board meeting, the Board clarified that a day-1 loss is the intended accounting outcome and, accordingly, the use of a negative rate implicit in the lease is not appropriate. At that meeting, the Board noted that the decisions made about variable lease payments under Topic 842 that future variable lease payments would be too costly and complex to estimate and should be excluded, unless they depend on an index or a rate, were based on specific feedback received from stakeholders during the leases project. Those decisions and feedback are summarized in paragraphs BC205–BC212 of Update 2016-02. Nonetheless, because this issue was raised multiple times by various stakeholders and could be significant in certain industries, the Board decided that it would be beneficial to make a technical correction in the guidance to clarify the Board's intent.

Issue 3: Lessee Reassessment of Lease Classification

BC9. Some stakeholders observed that when a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the guidance in paragraph 842-10-25-9 is clear that an entity should reassess, as of the effective date of the modification, lease classification on the basis of the modified terms and conditions and the facts and circumstances existing as of that date (for example, on the basis of the fair value and remaining economic life of the underlying asset as of the effective date of the modification). Although paragraph 842-10-25-1 also requires a lessee to reassess lease classification when there is a change in the lease term or the assessment of a lessee option to purchase the underlying asset in accordance with paragraph 842-10-35-1, those stakeholders noted that it is less clear whether the lessee also should reassess lease classification on the basis of the facts and circumstances existing as of the date the reassessment is required or, rather, whether the lessee could continue to, for example, use the fair value and remaining economic life of the underlying asset as determined at the commencement date of the lease (or the most recent modification not accounted for as a separate contract).

BC10. The Board intended for the guidance in paragraphs 842-10-25-1 and 842-10-25-9 to be applied in a similar manner. That is, an entity should reassess lease classification on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment is required (for lessees only) or as of the effective date of a modification not accounted for as a separate contract (for both lessees and lessors). The amendments in this proposed Update would clarify the guidance in paragraph 842-10-25-1 in that regard.

Issue 4: Lessor Reassessment of Lease Term and Purchase Option

BC11. Paragraph 842-10-35-3 requires that a lessor not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. Paragraph 842-10-35-3 also requires that a lessor account for the exercise of a lessee option to extend or terminate the lease or to purchase the underlying asset in the same manner as a lease modification. However, some stakeholders indicated that it is unclear why a lessor should account for a lessee exercise of an option to extend or terminate the lease or to purchase the underlying asset in a manner similar to a lease modification when the exercise of that option is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification not accounted for as a separate contract).

BC12. The amendments in this proposed Update would clarify that a lessor should account for the exercise of a lessee option to extend or terminate the lease or to purchase the underlying asset as a lease modification unless the exercise of that option is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification not accounted for as a separate contract), in which case no change in accounting would be required.

Issue 5: Variable Lease Payments That Depend on an Index or a Rate

BC13. In accordance with paragraph 842-10-35-4, a lessee is required to remeasure the lease payments when certain events occur—one (paragraph 842-10-35-4(b)) being the resolution of a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments. Paragraph 842-10-35-5 also notes that when a lessee remeasures the lease payments in accordance with paragraph 842-10-35-4, variable lease payments that depend on an index or a rate should be remeasured using the index or rate at the remeasurement date. Some stakeholders noted that the guidance in paragraph 842-10-35-4(b), as written, might be perceived as applying to any variable lease payments, including those that depend on an index or a rate. However, they noted that this is not consistent with other areas of Topic 842, including Case A of Example 25 (paragraphs 842-10-55-226 through 55-231), which indicates that a lessee is not required to remeasure its lease liability using an updated index or rate unless the lease liability is remeasured for another reason. Those stakeholders also noted that Case A of Example 25 is consistent with the Board's intent discussed in paragraphs BC234–BC237 of Update 2016-02; that is, the Board decided that the cost and complexity associated with a continual remeasurement of the lease payments for changes in an index or a rate did not justify the benefits.

BC14. The amendments in this proposed Update would therefore clarify that a change to a reference index or rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to the guidance in paragraph 842-10-35-4(b).

Issue 6: Investment Tax Credits

BC15. Some stakeholders noted that there is an inconsistency in terminology on the effect that investment tax credits have on the fair value of the underlying asset between the definition of the term *rate implicit in the lease* and the lease classification guidance in paragraph 842-10-55-8. Specifically, the Master Glossary of the Codification defines the term *rate implicit in the lease* by referring to the "fair value of the underlying asset *minus* any related investment tax credit . . ." (emphasis added), while paragraph 842-10-55-8 states that "the fair value of the underlying asset should *exclude* any related investment tax credit . . ." (emphasis added). Those stakeholders noted that the differences in terminology could result in differences in application between the determination of the rate implicit in the lease and lease classification, which did not exist under Topic 840.

BC16. The Board did not intend to change practice in that regard. To avoid confusion, the Board believes that it would be beneficial to align the terminology used in the definition of the term *rate implicit in the lease* in the Master Glossary and the guidance in paragraph 842-10-55-8 on lease classification.

Issue 7: Lease Term and Purchase Option

BC17. Stakeholders observed that paragraph 842-10-55-24, which indicates that the period covered by an option controlled by the lessor to terminate a lease is included as part of the noncancellable period of a lease, is not consistent with the description in paragraph 842-10-55-23 about how the noncancellable period of a lease is described. Paragraph 842-10-55-23 explains that when assessing the noncancellable period of a lease, an entity should determine the period for which a contract is enforceable. It goes on to explain that "a lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty."

BC18. The amendment in this proposed Update would correct the inconsistency noted in paragraph 842-10-55-24. The proposed amendment would not result in any change to the determination of the lease term because, in accordance with paragraph 842-10-30-1(c), periods covered by an option to extend (or, in this case, not to terminate) the lease in which exercise of the option is controlled by the lessor are automatically included in the determination of the lease term.

Issue 8: Transition Guidance for Amounts Previously Recognized in Business Combinations

BC19. Paragraph 842-10-65-1(h) provides transition guidance for an entity that previously recognized an asset or a liability relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination in accordance with Topic 805. Paragraph 842-10-65-1(h)(1) through (2) provides transition guidance for lessees, while paragraph 842-10-65-1(h)(3) provides transition guidance for lessors. Several stakeholders noted that the transition guidance provided to lessors in paragraph 842-10-65-1(h)(3) is unclear because that guidance applies to leases classified as direct financing leases or sales-type leases under Topic 840, while the lead-in sentence of paragraph 842-10-65-1(h) refers to leases classified as operating leases also under Topic 840.

BC20. The language in paragraph 842-10-65-1(h)(3) is a carryforward from the 2013 proposed Accounting Standards Update, *Leases (Topic 842)*. That paragraph, as drafted in the 2013 proposed Update, related to situations in which a lease classified as an operating lease by a lessor under Topic 840 becomes classified as a Type A lease under the amendments in the 2013 proposed Update. While the amendments on lease classification in the 2013 proposed Update were different from the final guidance as issued in Topic 842, they indicate that paragraph 842-10-65-1(h)(3) was intended to provide transition guidance for changes in lease classification from operating leases under Topic 840 to Type A leases under the new (proposed) guidance. Therefore, the Board believes that the reference to leases classified as direct financing leases or sales-type leases in paragraph 842-10-65-1(h)(3) should be made in relation to lease classification as determined under Topic 842, not Topic 840. The Board also notes that paragraph 842-10-65-1(h)(3) would apply when an entity does not elect the package of practical expedients in paragraph 842-10-65-1(f) and, for a lessor, when an operating lease acquired as part of a previous business combination is classified as a direct financing lease or a sales-type lease under Topic 842.

Issue 9: Certain Transition Adjustments

BC21. Initial direct costs are defined in Topic 842 as incremental costs of a lease that would not have been incurred had the lease not been obtained. Paragraph 842-10-30-9 provides examples of initial direct costs, which include commissions and payments to an existing tenant to incentivize that tenant to terminate its lease. Costs that meet the definition of *initial direct costs* in Topic 842 are capitalized and included, for a lessee, in the initial measurement of the right-of-use asset for both finance leases and operating leases. The definition of the term *initial direct costs* under Topic 842 is narrower than the previous definition under Topic 840.

BC22. When an entity does not elect the package of practical expedients provided in paragraph 842-10-65-1(f), the transition guidance provided in paragraph 842-10-65-1(p) for leases previously classified as operating leases under Topic 840 requires a lessee to write off any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 as an adjustment to equity at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease. Stakeholders questioned why a lessee would write off those nonqualifying costs to equity when those costs are incurred after the beginning of the earliest period presented, noting that those costs instead should be recognized in the earnings of the period in which they are incurred. Those stakeholders noted similar inconsistencies elsewhere in the transition guidance.

BC23. The amendments in this proposed Update would clarify whether to record a transition adjustment to equity or to the earnings of the comparative period presented. For example, for a lease previously classified as an operating lease under Topic 840, a lessee that does not elect the package of practical expedients in paragraph 842-10-65-1(f) should write off the initial direct costs that do not meet the definition of initial direct costs under Topic 842 as a transition adjustment to equity (if incurred before the beginning of the earliest period presented) or to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented). Similarly, a lessor with an existing operating lease that is reclassified as a sales-type or direct financing lease under Topic 842 should recognize the selling profit or loss on that lease as an adjustment to equity only if the commencement date of the lease was before the beginning of the earliest period presented.

Issue 10: Transition Guidance for Leases Previously Classified as Capital Leases under Topic 840

BC24. Paragraph 842-10-65-1(r) provides transition guidance applicable to lessees for leases previously classified as capital leases under Topic 840 and those classified as finance leases under Topic 842 (whether because the entity elects the package of practical expedients in paragraph 842-10-65-1(f) or because the entity does not elect the package of practical expedients but lease classification does not change). Regarding subsequent measurement guidance of the right-of-use asset and lease liability before the effective date, paragraph 842-10-65-1(r)(4) refers readers to the subsequent measurement guidance of operating leases in Topic 840 when it should refer them to the subsequent measurement guidance of capital leases. The amendment in this proposed Update would correct that reference.

Issue 11: Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases under Topic 840

BC25. Paragraph 842-10-65-1(x) provides transition guidance applicable to lessors for leases previously classified as direct financing leases or sales-type leases under Topic 840 and classified as direct financing leases or sales-type leases under Topic 842. Regarding the guidance on modifications on or after the effective date, paragraph 842-10-65-1(x)(4) provides references to other applicable guidance in Topic 842—specifically, paragraphs 842-10-25-16 through 25-17—that a lessor should apply to account for the lease modification depending on how the lease is classified after the modification. Stakeholders noted that the guidance should refer to how the lease is classified *before* the modification to be consistent with the guidance provided in paragraphs 842-10-25-16 through 25-17. The amendment in this proposed Update would clarify paragraph 842-10-65-1(x)(4) in that regard.

Issue 12: Transition Guidance for Sale and Leaseback Transactions

BC26. This issue encompasses two separate proposed amendments to the transition guidance provided for sale and leaseback transactions in paragraph 842-10-65-1(aa) through (ee).

BC27. Some stakeholders noted that the heading above the transition guidance on sale and leaseback transactions appears to suggest that there is no transition guidance for sale and leaseback transactions that occur after the earliest comparative period presented of the financial statements in which an entity adopts Topic 842 but before the effective date. The amendment in this proposed Update would revise the heading such that the transition guidance in paragraph 842-10-65-1(aa) through (ee) applies to all sale and leaseback transactions entered into before the effective date of Topic 842.

BC28. In addition, paragraph 842-10-65-1(bb) provides transition guidance for existing failed sale and leaseback transactions. That paragraph requires an entity to reassess whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with paragraphs 842-40-25-1 through 25-3. However, paragraph 842-10-65-1(bb) also refers to other transition guidance on sale and leaseback transactions that is not applicable to a failed sale and leaseback transaction (specifically, paragraph 842-10-65-1(dd), which provides transition guidance for sale and leaseback transactions accounted for as sale and capital leaseback transactions under Topic 840). The second proposed amendment would remove that reference.

Issue 13: Impairment of Net Investment in the Lease

BC29. Paragraph 842-30-35-3 requires a lessor to determine the loss allowance related to the net investment in the lease by looking to the guidance in Topic 310, Receivables (or Topic 326, Financial Instruments—Credit Losses, once effective). When determining the loss allowance for a net investment in the lease, paragraph 842-30-35-3 notes that a lessor should:

> . . . take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (for example, from sale of the asset or release of the asset for the remainder of the lease term), *which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term)*. [Emphasis added.]

BC30. Stakeholders questioned the meaning of that guidance—particularly, the emphasized portion of the guidance—noting that it would accelerate and improperly measure the loss allowance of the net investment in the lease because the expected cash flows associated with the unguaranteed residual asset appear to be excluded from that assessment.

BC31. The amendments in this proposed Update would clarify the Board's intent about the determination of the loss allowance of the net investment in the lease, which is that the net investment in the lease is a single unit of account for purposes of determining the loss allowance, consistent with paragraphs BC310–BC313 in Update 2016-02. Specifically, for purposes of determining the loss allowance, lessors would evaluate the net investment in the lease using the cash flows that the lessor expects to receive (or derive) from the lease receivable *and* the unguaranteed residual asset during (and following the end of) the remaining lease term. The amount that the lessor expects to derive from the unguaranteed residual asset would be based on the expected value of the residual asset following the end of the lease term (excluding any amounts guaranteed by the lessee or any other third party unrelated to the lessor because those expected cash flows would already be considered as part of the lease receivable), effectively incorporating residual asset risk into the loss allowance analysis, together with credit risk. That is, even though the risk associated with the residual asset is risk related to the end-of-lease value of that asset (rather than credit risk), the credit risk assessment model is used to measure the residual asset risk, thereby accomplishing the Board's objective of using a single impairment approach for the entire net investment in the lease.

Issue 14: Unguaranteed Residual Asset

BC32. Paragraph 842-30-35-4 prohibits a lessor from continuing to accrete the unguaranteed residual asset to its estimated value over the remaining lease term if the lessor sells the lease receivable associated with a direct financing lease or a sales-type lease and retains an interest in the unguaranteed residual asset. Some stakeholders noted that this paragraph is silent on circumstances in which a lessor retains *a portion* of the lease receivable. Those stakeholders noted that superseded paragraph 840-30-35-53 only prohibited a lessor that sells *substantially all* of the minimum rental payments associated with a sales-type lease, a direct financing lease, or a leveraged lease and retains an interest in the residual value of the asset from recognizing increases in the value of the lease residual to its estimated value. Because it was not the Board's intent to change GAAP in that regard, the amendment in this proposed Update would add back the term *substantially all* in paragraph 842-20-35-4.

Issue 15: Effect of Initial Direct Costs on Rate Implicit in the Lease

BC33. Under Topic 842, initial direct costs have a different effect on the rate implicit in the lease to use for lease classification depending on whether a lessor is determining whether to classify the lease as (a) a sales-type lease or (b) a direct financing lease or an operating lease. This is because there is different initial measurement guidance for initial direct costs depending on the classification of a lease. For a sales-type lease, paragraph 842-30-25-1(c) requires a lessor to expense initial direct costs at the commencement date if the fair value of the underlying asset is different from its carrying amount. If the fair value of the underlying asset is equal to its carrying amount, then those initial direct costs are deferred. For a direct financing lease (paragraph 842-30-25-8) or an operating lease (paragraph 842-30-25-10), initial direct costs are deferred at the commencement date. For those reasons, when determining the rate implicit in the lease to use for lease classification purposes, paragraph 842-10-25-4 has different guidance depending on the lease classification test to be performed. When determining whether the lease is a sales-type lease, the lessor is required to assume that no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. In contrast, if the lease is not a sales-type lease, the rate implicit in the lease would consider initial direct costs when determining whether the lease is a direct financing lease or an operating lease.

BC34. While the above guidance is clear, some stakeholders noted that the ordering of the illustration in Case C of Example 1 (paragraphs 842-30-55-31 through 35-39) has raised questions about how initial direct costs factor into the determination of the rate implicit in the lease for lease classification purposes. Therefore, the amendments in this proposed Update would more closely align the examples with the aforementioned guidance.

Issue 16: Failed Sale and Leaseback Transaction

BC35. In accordance with Subtopic 842-40, when a sale and leaseback transaction does not qualify as a sale, an entity should account for the transaction as a financing arrangement. Paragraph 842-40-25-5(a) requires a seller-lessee to not derecognize the transferred asset but, instead, to account for any amounts received from the buyer-lessor as a financial liability in accordance with other Topics. The seller-lessee also should continue to recognize depreciation of the underlying asset. In addition, paragraph 842-40-30-6(a) requires the seller-lessee to adjust the interest rate on the financial liability as necessary to ensure that the "interest on the financial liability is not greater than the *principal* payments on the financial liability over the shorter of the lease term and the term of the financing" (emphasis added). This requirement was put in place to prevent the seller-lessee from having cumulative negative amortization of the financial liability. However, cumulative negative amortization of the liability would occur when the interest on the financial liability is greater than the *total* payment, not the *principal* payment. Therefore, the amendment in this proposed Update would clarify that the interest on the financial liability should not exceed the total payments on the financial liability.

Effective Date and Transition

BC36. The Board decided that for entities that have early adopted Topic 842, the amendments in this proposed Update would be effective upon issuance of a final Update and the transition requirements would be the same as those in Topic 842. For entities that have not adopted Topic 842, the Board decided that the effective date and transition requirements of the proposed amendments would be the same as the effective date and transition requirements in Topic 842.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). We welcome comments on these proposed changes to the Taxonomy through ASU Taxonomy Changes provided at www.fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, proposed amendments to the Taxonomy will be made available for public comment at www.fasb.org and finalized as part of the annual release process.