

IFRS in Focus

IASB re-exposes proposals on lease accounting

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This edition of IFRS in Focus outlines the proposals included in the May 2013 exposure draft *Leases* (the "2013 ED" or the "proposals") and summarises some of the significant changes from existing IFRSs.

The Bottom Line

- The proposals would significantly affect the accounting for lease contracts by both lessees and lessors. Changes in recognition, measurement, and presentation of leases under the revised proposals may significantly impact financial statement metrics.
- For lessees:
 - Operating lease/off-balance sheet treatment would be eliminated for virtually all leases except for short-term leases.
 - The lease expense recognised each period could be significantly impacted depending on the nature of the underlying leased asset as property or non-property.
 - Detailed analysis of lease payments will be required for both classification and measurement.
- For lessors:
 - The nature of the underlying leased asset will dictate whether the asset is derecognised and the pattern of income recognition. Some leases previously treated as 'operating leases' may require the underlying asset to be derecognised and be replaced with a lease receivable and a residual asset.
- The proposals would require management to exercise significant judgement in areas including identifying a lease, determining the lease term, and measuring lease assets and liabilities.

Where are we in the standard setting process?

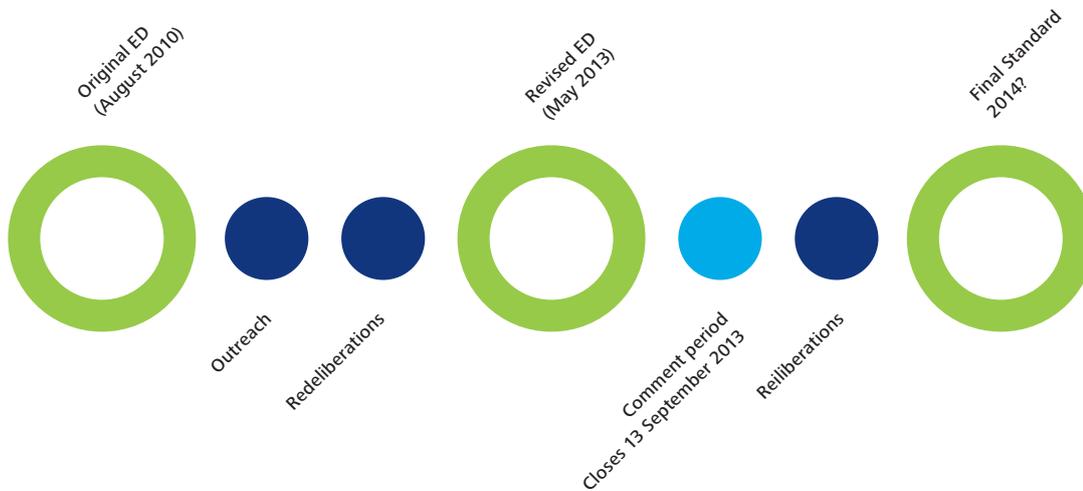
The 2013 ED is the latest step in a long-running project to improve the financial reporting of leases under IFRSs and US GAAP. The objective of the project is to address criticisms that the existing accounting model fails to meet the needs of users of financial statements.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Timeline for the development of the leasing standard



How will the proposals impact your business?

The proposals in the 2013 ED may significantly impact the operations and financial results of lessees and lessors. Some of the impacts include:

| | |
|------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Increased management judgements and estimates | Development of robust accounting policies and internal controls will be necessary as a result of the judgements and estimates required by lessees in recognising their right-of-use assets and lease liabilities, and the application of the receivable and residual approach for lessors. |
| Financial statement ratios and metrics | The recognition of right-of-use assets and lease liabilities for lessees and the application of the receivable and residual approach for lessors may affect gearing ratios, debt covenants and other key performance ratios. Timing of income and expense recognition may impact other financial metrics such as EBITDA and compensation agreements (e.g., stock-based compensation agreements). |
| Operational complexity and data collection | Detailed lease level data will be required to record the lease, perform required periodic reassessments, and assess the impact of lease modifications. This information may not be available through existing financial reporting systems. |
| Income tax considerations | Retrospective application is proposed which may result in significant deferred tax consequences upon initial application. |

What is now considered to be a lease?

The 2013 ED defines a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration”. A contract contains a lease if fulfilment of the contract depends on the use of an identified asset (identifiable either explicitly (e.g., by a specific serial number) or implicitly (e.g., the only asset available to satisfy the lease contract)) and the contract conveys the right to *control* the use of an identified asset for a period of time in exchange for consideration. The right to use an identified asset is conveyed only if the customer has the ability to both direct the use of the asset and receive the benefit from its use.

Leases with a maximum possible lease term, including renewal options, of 12 months or less (defined as short-term leases) would be eligible for current operating lease accounting. The election to apply the relief would be an accounting policy election on the basis of asset class, rather than on a lease-by-lease basis. Cancellable leases would be considered short-term leases if the initial non-cancellable period, together with any notice period, is 12 months or less.

Leases explicitly excluded from the scope of the proposals include (1) leases to explore for, or use, mineral, oil, natural gas, and similar non-regenerative resources, (2) leases of biological assets, (3) leases of intangible assets, although the IASB proposal would permit lessees to apply the proposals to leases of intangible assets, and (4) service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*.

For contracts containing non-lease components, an entity would be required to separate lease and non-lease components and account for the non-lease components in accordance with other standards. Lessees would allocate payments to the lease and non-lease components on the basis of the relative observable standalone prices of the individual components. If there is no observable standalone price for any component, lessees would combine all components and account for them as one. If there is an observable standalone price for one or more, but not all the components of the contract, the allocation is to be made based on the standalone price of each component and the remaining consideration. If more than one component is a lease, they are combined and accounted for as a single lease component. Lessors would allocate payments to lease and non-lease components based on the relative standalone selling prices of the individual components.

Observation

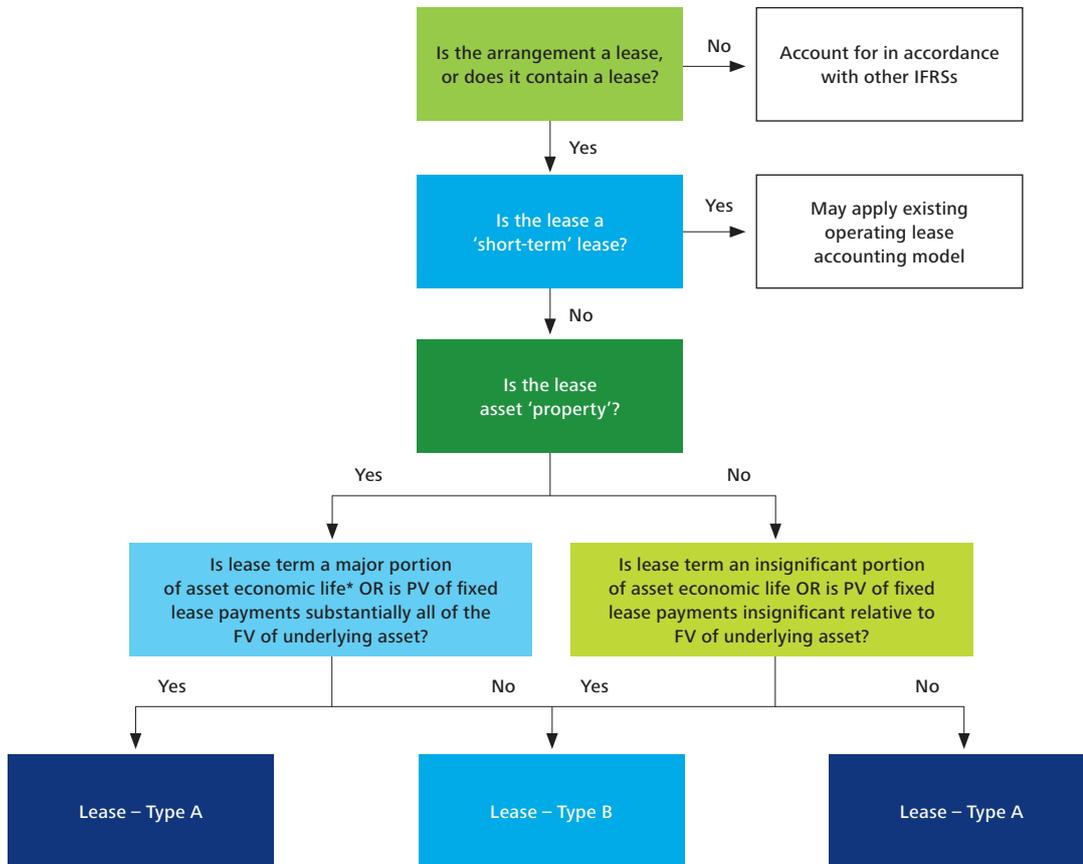
The definition of a lease will become an area of increased significance given the potential financial statement implications for arrangements that fall within the scope of the proposed guidance. For lessees, arrangements that are or contain a lease will generally be required to be recognised in the statement of financial position. The 'right of use' is of an identified asset and therefore distinct from a contract for the provision of services. The determination of whether an arrangement contains a lease is based on guidance similar to that in IFRIC 4 *Determining whether an Arrangement contains a Lease*, but some useful additional guidance is included. For example, contracts for 'capacity' rather than use of identified asset are not considered leases. Service contracts determined not to contain a lease would not be within the scope of the leasing standard and therefore would not be recognised in the statement of financial position under the proposed guidance. Similarly, for lessors, assessment of whether an arrangement contains a lease will dictate whether contractual income is accounted for under the leasing model or the revenue recognition model.

What drives the classification of leases?

Under the proposals, leases would be classified as either 'Type A' or 'Type B' depending on the nature of the underlying asset. Leases of property, including land, a building, or part of a building, would be classified as Type B leases unless the lease term is for a major part of the underlying asset's remaining economic life or the present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset. Leases other than property would be classified as Type A leases unless the lease term is an insignificant portion of the underlying asset's economic life or the present value of fixed lease payments is insignificant relative to the fair value of the underlying asset.

The diagram overleaf provides an overview of the proposed lease classification framework.

Overview of proposed lease classification for lessees and lessors



* For property, the assessment is based on the *remaining* not total economic life of the asset.

What are the proposals for lessees?

The 2013 ED proposes the application of a 'right-of-use' model to all leases except for short-term leases. Under this model, lessees would recognise a right-of-use asset and a lease liability in the statement of financial position for each lease. The right-of-use asset and lease liability would be initially measured at the present value of the lease payments. Initial direct costs incurred as a consequence of negotiating and arranging a lease may be capitalised to the right-of-use asset. The lessee's classification of the lease would determine the subsequent measurement of the right-of-use asset and accordingly, the pattern of expense recognition.

For Type A leases, the lessee would amortise the right-of-use asset using a systematic method. In addition, interest expense on the lease liability would be recognised using the effective interest method. Under this method, the interest expense would generally decrease over time whilst amortisation of the right-of-use asset is likely to either remain constant (under a straight-line method) or decrease over time (under a diminishing balance method). Accordingly, the total expense resulting from the lease arrangement would be front-loaded. This pattern of expense recognition is consistent with the treatment of finance leases under current lease accounting.

For Type B leases, the lessee would recognise a single lease expense on a straight-line basis.

Observation

The proposed introduction of a new dividing line in the leasing model is likely to generate significant debate given that one of the project's original objectives was to remove the existing "bright-line" between operating and finance leases. The Boards' original lease exposure draft published in August 2010 (the "2010 ED") proposed that lessees should apply a single model, the right-of-use model, to all leases within the scope of the proposals. This proposal would have resulted in an accelerated pattern of expense recognition for all leases. However, many constituents indicated that the expense recognition pattern proposed in the 2010 ED did not reflect the economics for all types of leases. Thus, the re-introduction of two types of leases for expense recognition purposes attempts to respond to those concerns. Under the revised proposals, most non-property leases will be subject to the same front-loaded expense recognition pattern which generated concern in response to the 2010 ED.

What are the proposals for lessors?

Lessors may elect to apply the existing operating lease accounting model for short-term leases. For those leases that are not considered short-term or for short-term leases which the lessor has not elected to apply the existing operating lease accounting model, lessors would be required to classify leases in a similar manner as lessees.

For Type A leases, the lessor would derecognise the leased asset and recognise a receivable for the lease payments and a residual asset. The residual asset represents the lessor's claim to the residual value of the leased asset at the end of the lease term. The residual asset would be measured as the net amount of (a) the gross residual asset, measured at the present value of the estimated residual value at the end of the lease term, and (b) deferred profit, if any. Profit on the residual asset would be deferred until sale or re-lease of the underlying asset. Although the two components of the net residual asset would be presented as a single amount, entities must calculate the two components to apply the subsequent accounting requirements. Lessors would be required to recognise upfront profit or loss related to the leased portion of the asset.

The lessor would subsequently account for the lease receivable at amortised cost under the effective interest method, recognising interest income at the rate the lessor charges the lessee. In addition, the lessor would subsequently accrete the gross residual asset over the lease term to an amount equal to the expected residual value of the leased asset at the end of the lease also using the rate the lessor charges the lessee in the lease contract.

Observation

While the lessor does not include variable lease payments (other than those dependent on an index or rate or those that are in-substance fixed payments) in the measurement of the lease receivable, they do need to be considered in the measurement of the residual asset. In the Basis for Conclusions, the Boards explain that "the gross residual asset not only represents the present value of the expected residual value of the underlying asset at end of the lease term, but it also represents the present value of any expected variable lease payments during the lease term". Accordingly, the income earned through expected variable lease payments is released into profit or loss each period with a corresponding consumption of the residual asset. This means that lessors will have to estimate *expected* variable lease payments in the initial measurement of the residual asset. This is based on the view that for the lessor, the total return on the leased asset should capture all the cash flows from the asset – those not reflected in the lease receivable must logically be part of the residual asset.

For Type B leases, the lessor would apply a model generally consistent with current operating lease accounting. The lessor would continue to recognise the leased asset in its statement of financial position. Lease payments would be recognised on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Observation

The 2010 ED proposed two approaches for lessor accounting based on whether the lessor retained exposure to significant risks or benefits associated with the underlying asset. Feedback on the 2010 ED proposal was mixed. Some favoured having only one approach, while others questioned whether the costs of implementing the proposed model were accompanied by an improvement in financial reporting. In the redeliberations, the Boards decided that the lessor accounting proposal should have two approaches. However, the Boards significantly changed the two approaches that would be applied.

What about leases with variable lease terms?

The 2013 ED proposes that the lease term is the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset. It also includes periods covered by options to extend the lease when there is a significant economic incentive to exercise that option and periods covered by an option to terminate the lease if there is a significant economic disincentive not to exercise an option to terminate a lease.

At the commencement date, an entity would consider contract-based, asset-based, entity-based, and market-based factors when making this assessment.

The lease term would be reassessed when there is a significant change in one or more of the factors, other than market-based factors (e.g., market rentals for a comparable asset), such that the entity would then have, or no longer have, a significant economic incentive to exercise an option to extend or terminate the lease.

Observation

The 2010 ED proposed that the lease term be measured as the “longest possible term that is more likely than not to occur”, taking into account options to renew. Comment letters expressed almost unanimous opposition to this either on conceptual grounds, arguing that a renewal option does not represent a liability until the lessee has actually exercised the option, or for practical reasons noting that estimating the lease term would be burdensome and costly to implement and could result in unreliable estimates for leases with multiple renewal options. In the redeliberations the Boards acknowledged the concerns raised in the comment letters and tentatively decided on the use of a higher threshold to define the lease term. The revised threshold is more consistent with the current treatment where renewal options are included in the lease term only when they are “reasonably certain” of being exercised. While this approach is more consistent with the current approach and should be understood in practice, there may still be practical differences in assessing the lease term under the proposals compared to current practice. For example, current lease accounting does not require the reassessment of the lease term on an on-going basis. In addition, under IAS 17 *Leases*, renewal options are only included in the lease term when they are ‘reasonably certain’ – the proposals in the 2013 ED are driven by a more comprehensive consideration of economic incentives and, therefore, may result in a different assessment from that under the existing standard.

What about leases with variable payments?

The 2013 ED proposes that lease payments would include fixed payments (or those which are, in-substance, fixed) and variable payments based on an index or rate (e.g., CPI or LIBOR). Termination penalties and purchase option payments would also be included when they were considered in the determination of the lease term. Variable lease payments based on performance or usage would be excluded from lease payments, by both lessees and lessors, and recognised in profit or loss in the period in which they occur. However, for lessors, *expected* variable lease payments (other than those based on an index or rate or are in-substance fixed payments) are included in the initial measurement of the residual asset.

Lessees would include amounts expected to be payable under residual value guarantees in the calculation of the lease liability. Lessors would only recognise amounts received or receivable under residual value guarantees as lease payments when the counter party also receives benefits of the residual asset at the end of the lease term. In all other situations the lessor would not recognise the residual value guarantee until the end of the lease but would consider the residual value guarantee in assessing the residual asset for impairment during the lease term.

Lessees and lessors would need to reassess variable payments based on an index or rate at each reporting date using the spot rate. To the extent that any reassessment changes affect the current period, a lessee would recognise the change through profit or loss. Any changes relating to future periods would result in a change to the right-of-use asset and lease liability. Conversely, a lessor would recognise all changes in lease payments that depend on an index or rate in profit or loss.

Observation

The 2010 ED would have required the use of a probability-weighted expected outcome approach to estimate lease payments that include contingent rentals. Many respondents to the 2010 ED objected to this proposal, noting that the approach could add significant earnings volatility and would be costly to implement. In the redeliberations, the Boards generally decided to exclude variable lease payments from the lease assets and liabilities recognised by lessees. The 2013 ED proposals attempt to balance the complexity of including contingent payments and the structuring concerns that arise if all contingent payments are excluded. However, judgement will still be necessary in identifying payments that are contractually described as variable, but are, in substance, fixed and thus should be included as lease assets and liabilities. The 2013 ED provides little explanation or guidance on what constitutes an in-substance fixed payment. The Boards explain in the Basis for Conclusions that they considered it sufficient to leave this as a principle and not provide further guidance.

The proposed requirement for lessors to recognise changes immediately in the right to receive lease payments due to movements in an index or rate in profit or loss represents a significant change from current practice. This proposal could result in significant volatility in earnings and is inconsistent with the proposals for lessees.

How will lease activities be presented in the financial statements?

Lessees

Statement of financial position

A lessee would report a right-of-use asset and a lease liability for all leases that do not meet the definition of a short term lease. Right-of-use assets and liabilities can either be presented separately in the statement of financial position or included within the same line item as similar assets and similar liabilities and disclosed separately in the notes to the financial statements. Right-of-use assets and lease liabilities would be distinguished between Type A and Type B leases in either the statement of financial position or in the notes.

Statement of comprehensive income and statement of cash flows

The presentation of lease-related expenses in the statement of comprehensive income, and cash paid for leases within the cash flow statement, depends on the classification of the lease.

For leases classified as Type A, the lessee would report amortisation/depreciation of the asset separately from interest on the lease liability in the statement of comprehensive income. A lessee would separate the total amount of cash paid into a principal portion (presented within financing activities) and interest portion (presented in accordance with IAS 7 *Statement of Cash Flows*).

For leases classified as Type B, the lessee would account for the lease in the statement of comprehensive income and statement of cash flows similarly to an operating lease in existing accounting standards; that is, a lessee would report amortisation/depreciation of the asset and interest on the lease liability as one amount (lease expense) in the statement of comprehensive income and would report cash paid within operating activities in the statement of cash flows.

Lessors

Statement of financial position

For leases classified as Type A, the lessor would either present separately in the statement of financial position or disclose separately in the notes lease receivables and residual assets.

Presentation would remain consistent with current practice for leases classified as Type B.

Statement of comprehensive income and statement of cash flows

Lease income and lease expense would be presented in the statement of comprehensive income either gross or net on the basis of which presentation best reflects the lessor's business model. For leases classified as Type A, the lessor would present the accretion of the residual asset as interest income.

Cash inflows from a lease would be classified as operating activities in the statement of cash flows.

What disclosures will be required?

The 2013 ED proposes extensive disclosure requirements for both lessees and lessors designed to enable users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases.

Some of the significant disclosure requirements for lessees include:

- a description of its leasing activities, including information about contingent rentals and term options;
- a maturity analysis outlining undiscounted lease commitments, with reconciliation to the amount reported in the statement of financial position; and
- a reconciliation of the opening and closing balances of the assets and liabilities recognised by the lessee.

Some of the significant disclosure requirements for lessors include:

- a description of its leasing activities, including information about contingent rentals and term options;
- a table of all lease-related income items;
- a maturity analysis of the undiscounted cash flows that are included in the right to receive lease payments; and
- a reconciliation of the opening and closing balance of the right to receive lease payments and residual assets.

What are other key proposals?

| Topic | Proposals |
|--------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Contract modifications | Modifications to the contractual terms and conditions that result in a significant change to the existing lease to be accounted for as a new contract with any differences recognised in profit or loss. |
| Discount rate | <p>Lessees should discount lease payments using the rate charged by the lessor (for example, the rate implicit in the lease, or the property yield), if available. Otherwise, the lessee's incremental borrowing rate should be used. In any case, the discount rate should reflect the nature of the transaction as well as the specific terms of the lease.</p> <p>Lessors should discount lease payments using the rate they charge in the lease.</p> <p>The discount rate should be reassessed only when there is a change in the lease term, in the factors relevant in the assessment of whether the lessee has (or no longer has) a significant economic incentive to exercise an option to purchase the underlying asset or in the reference interest rate (if variable payments are determined using that rate).</p> |
| Impairment | Lessees and lessors would follow guidance in IAS 36, <i>Impairment of Assets</i> , when evaluating the right-of-use asset and residual asset. The lease receivable would be assessed for impairment by lessors consistent with other financial assets under IAS 39 <i>Financial Instruments: Recognition and Measurement</i> . |
| Inception versus commencement | The lessee and lessor would initially classify, measure, and recognise lease assets and lease liabilities at the date of commencement of the lease. This is the date on which the lessor makes the underlying asset available to the lessee. |
| Initial direct costs | Initial direct costs (defined as under IAS 17) would be capitalised and added to the lessee's right-of-use asset and to the amount recognised as the lessor's lease receivable. |

| | |
|----------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Sale and leaseback transactions | In determining whether the transferee has obtained control of the asset (indicating a sale transaction), entities would apply the requirements in the proposed revenue recognition standard to establish when a performance obligation is satisfied. When a sale is determined to have occurred, the leaseback transaction is accounted for by the transferor and transferee as any other lease. Gains or losses would be deferred if the consideration for the sale is not at fair value or if the lease payments do not reflect current market rates. |
| Subleases | Subleases would be accounted for as a separate transaction from the head lease. The sub-lessor would apply lessee accounting on the head lease and lessor accounting on the sublease. When classifying a sublease, an entity would evaluate the sublease with reference to the underlying asset rather than the right-of-use asset. |

What transition arrangements are proposed?

The 2013 ED proposes application of the proposals to all leases existing at the beginning of the earliest comparative period presented.

Entities would have the option to apply either a full retrospective approach or a modified retrospective approach at transition. Under the full retrospective approach, lessees and lessors would apply the final standard from the lease commencement date. In contrast, the modified retrospective approach provides relief from certain provisions on transition such as allowing lessees to apply a single discount rate to portfolio of leases (previously classified as operating leases) with similar characteristics. For leases previously classified as finance leases, these do not need to be remeasured and the proposed requirements effectively apply to subsequent measurement.

An entity may also use hindsight on transition for judgements such as whether a contract contains a lease, in classifying a lease or determining the lease term if a contract includes options to extend or terminate a lease.

Observation

The modified retrospective approach provides several practical expedients in applying the provisions of the proposed requirements to existing leases. However, it will still require entities to reclassify their existing leases in accordance with the new classification criteria.

Key contacts

IFRS global office

Global IFRS Leader

Veronica Poole

ifrglobalofficeuk@deloitte.co.uk

Global IFRS Communications Director

Mario Abela

ifrglobalofficeuk@deloitte.co.uk

IFRS centres of excellence

Americas

Canada

LATCO

United States

Karen Higgins

Fermin del Valle

Robert Uhl

iasplus@deloitte.ca

iasplus-LATCO@deloitte.com

iasplusamericas@deloitte.com

Asia-Pacific

Australia

China

Japan

Singapore

Anna Crawford

Stephen Taylor

Shinya Iwasaki

Shariq Barmaky

iasplus@deloitte.com.au

iasplus@deloitte.com.hk

iasplus-tokyo@tohmatu.co.jp

iasplus-sg@deloitte.com

Europe-Africa

Belgium

Denmark

France

Germany

Italy

Luxembourg

Netherlands

Russia

South Africa

Spain

United Kingdom

Thomas Carlier

Jan Peter Larsen

Laurence Rivat

Andreas Barckow

Franco Riccomagno

Eddy Termaten

Ralph ter Hoeven

Michael Raikhman

Graeme Berry

Cleber Custodio

Elizabeth Chrispin

BEIFRSBelgium@deloitte.com

dk_iasplus@deloitte.dk

iasplus@deloitte.fr

iasplus@deloitte.de

friccomagno@deloitte.it

luiasplus@deloitte.lu

iasplus@deloitte.nl

iasplus@deloitte.ru

iasplus@deloitte.co.za

iasplus@deloitte.es

iasplus@deloitte.co.uk

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