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IFRS in Focus
On track for a revised exposure draft on leases

Contents

The Bottom Line

The forthcoming revised exposure draft on the leases project is expected to propose:

- Recognition of assets and liabilities by lessees for all leases other than short-term leases. The concept of an 'operating lease' would no longer exist. The proposals would increase the lease-related assets and liabilities in the statement of financial position, affecting financial ratios in debt covenants.
- Two approaches for lessee expense recognition resulting in straight-line expense recognition for many real estate leases and accelerated expense recognition for many equipment leases.
- A revision to the presentation of lease-related expenses in the statement of comprehensive income based on the type of lease. For some leases currently classified as operating leases, rent expense would be replaced with amortisation expense and interest expense, with total expense being recognised earlier in the lease term. Accordingly, financial metrics such as earnings before interest, taxes, depreciation and amortisation ('EBITDA') would be affected.
- A 'dual' model for lessors resulting in application of the 'receivable and residual' model or an operating lease model.
- A 'lease classification' test based on the extent of consumption of the underlying asset.
- Revisions to existing guidance in areas including identification of leases, lease term and variable lease payments.
- Extensive disclosure requirements for both lessees and lessors.
- Application of either a full retrospective or modified retrospective approach to existing operating leases; both requiring adjustment of comparative periods. Entities maintaining existing finance leases (referred to as 'capital leases' in US GAAP) may elect to either carry forward the amounts recognised as at the date of initial application or to apply a full retrospective approach.

For more information please see the following websites:

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Introduction

In August 2010, the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (collectively, 'the Boards') issued an exposure draft (ED) proposing fundamental changes to the accounting for lease arrangements. The Boards have been redeliberating the proposals in the ED since January 2011, while considering feedback from comment letters, roundtables and outreach sessions. The Boards substantially concluded their redeliberations and have made significant changes to many of the proposals in the 2010 ED. Among these changes are proposals that lessees recognise all leases with a maximum lease term of more than 12 months in the statement of financial position. The pattern of total noncontingent lease expense recognised by lessees generally would be either front-loaded or straight-lined depending on the outcome of a new lease classification test that would include consideration of the characteristics of the underlying asset and the terms of the lease.

Similar to lessee accounting, the Boards are proposing two types of leases for lessor accounting – a model that is similar to the straight-line operating lease accounting of today, with no derecognition of the underlying asset or gain/loss on lease commencement, and the 'receivable and residual' (R&R) model which recognises a lease receivable and retained interest in a residual asset. The classification test for distinguishing between lessor models would be symmetrical with that proposed for lessees.

Because of the significance of changes to the proposals from those outlined in the ED, the Boards decided to re-expose the lease accounting proposals for comment with a revised exposure draft expected to be issued in the first quarter of 2013.

This edition of IFRS in Focus compares the proposals expected to be included in the forthcoming revised exposure draft, based on Board redeliberations in 2011 and 2012, to that of the 2010 ED. However, the anticipated proposals may be revised yet again in the process of finalising the revised exposure draft. The requirements in the new leasing standard will be dependent on the outcome of due process procedures.

Scope

The revised exposure draft is expected to affirm the tentative decisions in the ED and exclude from its scope:

- Leases for the right to explore for or use minerals, oils, natural gas and similar nonregenerative resources.
- Leases of service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements* (IFRS only).
- Leases of biological assets, including, for US GAAP, timber.

Similarly, because the proposed scope would cover all assets rather than only property, plant and equipment, the Boards tentatively decided that entities would not be required to account for leases of intangible assets in accordance with the proposed leasing standard.

Definition of a lease

The ED's lease definition was largely based on the existing definition in IFRIC 4 *Determining whether an Arrangement contains a Lease* that requires lease accounting if an arrangement conveys the right to control the use of a specific asset. Constituents expressed concern that the lease definition was too broad and that many service arrangements would be considered leases. The definition of a lease becomes much more important to many lessees due to the ED's proposal to eliminate operating lease accounting.

During redeliberations, the Boards tentatively decided to change the ED's proposed definition. The revised exposure draft is expected to propose that a contract would be considered a lease if fulfilment of the contract depends on the use of a *specified asset* and the contract conveys the right to *control* the use of a specified asset for a period of time in exchange for consideration. The revised proposal would retain the concept in the ED that a specified asset must be either explicitly (e.g., by a specific serial number) or implicitly identifiable but an entity would need to consider the lessor's right to substitute the underlying asset. A contract would not be a lease if it is practical and economically feasible for the owner to substitute an alternative asset and the owner can do so without the customer's consent. The revised proposals are also expected to highlight that the underlying asset can be a physically distinct portion of a larger asset (e.g., a floor of a building) if that portion is explicitly or implicitly specified. A capacity portion of a larger asset that is not physically distinct (e.g., 50 percent usage of a pipeline) would not be a specified asset.

The revised exposure draft is expected to provide a similar concept of control to that in the revenue recognition project, whereby a contract would convey the right to control the use of a specified asset if the customer has the ability to direct the use, and receive benefits from use, of that asset throughout the lease term. Such benefits would include economic benefits that arise directly from the use of the asset, such as renewable energy credits, and secondary physical output, but would exclude income tax benefits. The ability to direct the use of a specified asset would include determining how, when and in what manner the specified asset is used. If the customer can specify the output or benefit from the use of the asset but is unable to make decisions about the input or process that results in that output, the ability to specify the output would not, in and of itself, be determinative that the customer has the ability to direct the use of the asset.

In situations in which the owner directs how an asset is used to perform services for a customer, the customer and owner would be required to assess whether the use of the asset is separable from the services provided to the customer. If the asset is separable, the arrangement could contain a lease. However, if the use of an asset is an inseparable part of the services requested by the customer, the arrangement would not be accounted for as a lease. Indicators for use in determining whether the asset is separable would include whether the asset is sold or leased separately by the owner and whether the customer can use the asset on its own or together with other available resources.

Observation

The revised lease definition could significantly reduce the number of take-or-pay and supply contracts subject to lease accounting since it removes the notion included in the IFRIC 4 model that an arrangement contains a lease simply because the purchaser obtains all but an insignificant amount of the output of an asset.

Short-term leases

The ED defined a short-term lease as a lease with a maximum possible lease term, including renewal options, of 12 months or less and proposed to provide lessees and lessors limited relief for these types of leases. Under the ED, a lessee would recognise an asset and liability at an undiscounted amount rather than a discounted amount and a lessor could elect, on a lease-by-lease basis, to apply current operating lease accounting. Several respondents expressed concern that the ED's exception for lessees was too limited and not consistent with the relief provided to lessors.

During redeliberations of the proposals in the ED, the Boards responded to this feedback. The revised exposure draft is expected to retain the short-term lease definition from the ED, however, both lessees and lessors would be provided an election to apply an approach that is similar to the current operating lease accounting of today for short-term leases. Furthermore, the election to apply the relief would not be made on a lease-by-lease basis but would be an accounting policy election on the basis of asset class.

Observation

Cancellable leases would meet the definition of short-term leases if the noncancellable period, together with the termination or notice period, is 12 months or less. Cancellable leases refer to leases that are cancellable by both the lessee and lessor with minimal termination payments or include renewal options that must be agreed to by both the lessee and lessor. For example, a lessee enters into a lease that has a three-month initial noncancellable period. After three months, the lease continues until further notice. Either the lessee or lessor can cancel the lease at any point after the initial noncancellable period subject to a one-month termination penalty. In this example, the maximum term of the lease is four months (three-month initial noncancellable period together with an effective one-month notice period as a result of the termination penalty). In this example, the lessee and lessor would be able to apply short-term lease accounting.

Inception versus commencement

The ED proposed that a lease arrangement be measured at the lease inception date and then recognised at lease commencement. Respondents expressed concern that gains and losses could develop between lease inception and commencement and assumptions about options and contingent rentals could change between the two dates leading to changes in accounting before lease commencement. To simplify this accounting, during redeliberations of the proposals in the ED, the Boards tentatively decided that initial measurement and recognition of the lease should apply at the date of commencement of the lease.

Lease term

The 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 redeliberating the proposals in the ED, the Boards agreed with many of the concerns raised in the comment letters and tentatively decided on the use of a higher threshold to define the lease term.

The revised exposure draft is expected to define the 'lease term' as the noncancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a *significant economic incentive* for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. The criteria entities would use to determine whether there is a significant economic incentive are similar to those in current guidance in identifying when renewal periods should be included in the lease term.

The criteria entities would use at lease commencement when evaluating whether there is a significant economic incentive include:

Factor	Example
Contract-based factors	Terms that are written into the lease contract that could create a significant economic incentive to exercise an option at the date of commencement, or subsequently if there is a change in the lease contract, including substantial penalties for early contract termination, the obligation of the lessee to incur material costs to restore the asset prior to returning it to the lessor and the existence of bargain renewal or purchase options.
Asset-based factors	Characteristics of the underlying leased asset that exist either at lease commencement or subsequently that could create a significant economic incentive to exercise an option, including the existence of significant leasehold improvements installed by the lessee, asset customisation and geographic location.
Entity-specific factors	Historical practice of the entity, management intent and common industry practice.
Market-based factors	Market rental or asset values.

The forthcoming revised proposals are also expected to require reassessment of the lease term when the relevant factors change so significantly that a lessee would begin or cease to have a significant economic incentive to renew. However, market-based factors would not be considered in the reassessment. Changes in lease payments that are due to a reassessment would result in a lessee adjusting its obligation to make lease payments and its right-of-use asset, as illustrated in Appendix A. Lessors applying the R&R model, as discussed in the 'Lessor accounting' section below, would adjust assets and liabilities recognised, while lessors applying the operating lease model would account for changes in lease income prospectively from the date of reassessment.

Observation

Entities may have concerns with the practicality of applying some of the factors, particularly when performing a reassessment.

For example, an entity enters into a lease agreement that includes fixed-rate renewal options. At lease commencement, the entity determines that it does not have a significant economic incentive to exercise the renewal options and therefore does not include these in the initial lease term. At some point during the lease term, appreciation of the underlying asset's value (a market-based factor) results in the renewal option becoming a significant bargain. Although the proposed guidance states that market-based factors should not be considered as part of the reassessment, management's intent would be considered because it is an entity-specific factor. Market rates would factor into management's intent and therefore might be difficult to exclude.

Lease payments

The 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 ED objected to this proposal, noting that the approach could add significant earnings volatility and would be costly to implement.

As a result of Board redeliberations, the revised exposure draft is expected to change the proposals in the ED by requiring lessees and lessors applying the R&R model to include variable payments that are:

- structured in such a way that they are in-substance fixed lease payments (commonly referred to as 'disguised minimum lease payments');
- based on an index or rate, in which case indices or the prevailing (spot) rate at lease commencement would be used for calculating the variable lease payments; or
- expected to be paid by the lessee under residual value guarantees (i.e., difference between the expected residual value and the guaranteed residual value). Lessors, on the other hand, would not recognise amounts expected to be received relating to residual value or guarantees until the end of the lease.

Lessees would be required to reassess the estimate of variable lease payments under residual value guarantees and when those payments are based on an index or rate.

Variable payments that are not based on an index or rate and are not in-substance fixed lease payments would be excluded from the measurement of the lessee's lease liability and, for lessor's applying the R&R model, the lessor's lease receivable. Lessees and lessors would recognise variable lease payments as an expense as incurred or income as earned.

Indicators of in-substance fixed lease payments

During the redeliberations of the proposals in the ED, the IASB staff developed possible indicators to identify 'in-substance fixed lease payments' which include lease arrangements based on a factor that is unrelated to the underlying asset, arrangements in which the variable lease payment has an insignificant level of uncertainty, arrangements to compensate for below-market fixed lease payments, arrangements in which performance in the lease arrangement is based on a minimum level of output or sales that are required by the lease arrangement, arrangements that have immediate value to the lessor without considering future increases in the rate or index or arrangements that do not include any fixed payments. However, no decisions were made on the factors that should be considered and therefore it is unclear the extent to which variable lease payments would be considered "in-substance fixed lease payments". The revised exposure draft is expected to provide additional guidance including the factors that should be considered.

Observation

Based on our observations at Board meetings, the Boards appear to be introducing an anti-avoidance measure designed to capture in-substance minimum lease payments which are structured solely to enable the exclusion of rental payments from the measurement of the right-of-use asset and lease liability.

Reassessment of an index or rate

As a result of tentative decisions reached in redeliberating proposals in the ED, the forthcoming exposure draft is expected to propose that lease payments which depend upon an index or rate be reassessed using the index or rate that exists at the end of each reporting period. Changes in the lessee's liability as a result of a reassessment would be reflected in profit or loss to the extent that the change relates to the current reporting period and as an adjustment to the right-of-use asset to the extent that the change relates to future reporting periods. However, changes in a lessor's lease receivable under the R&R model as a result of reassessment would be recognised immediately in profit or loss.

Appendix B illustrates the revised proposals to reassess variable lease payments that are based on an index or rate.

Observation

The proposed inconsistency in the treatment of changes in lease payments that depend on an index or rate by lessees and lessors does not appear to have a conceptual basis. Instead, the proposed lessor accounting was reached by the Boards in an attempt to simplify an accounting requirement to separate current reporting period changes from that of future reporting periods.

While the Boards tentatively decided that lessees would be required to separate lease payment variability as a result of a change in an index and rate between changes related to the current reporting period and changes related to future reporting periods, the staffs intend to develop further guidance on methods to be used in allocating changes in rates or indices to reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or was consumed.

While the lessor accounting approach offers simplicity when compared to the lessee model, it may also lead to significant volatility in a lessor's profit or loss given that changes in a lessor's lease receivable as a result of reassessment would be recognised immediately in profit or loss as opposed to being recognised proportionately over the remaining lease term.

Subsequent measurement and reassessment of residual value guarantees

During the redeliberations of the proposals in the ED, the Boards discussed subsequent measurement and reassessment of the amount expected to be paid by a lessee under a residual value guarantee. As a result, the revised exposure draft is expected to propose that the amount of a residual value guarantee included in the initial measurement of a lessee's right-of-use asset be amortised on a systematic basis from the date of commencement of the lease to the end of the lease term, or over the useful life of the underlying asset, if shorter. The method of amortisation should reflect the pattern in which the economic benefits of the right-of-use asset are consumed. If a pattern of consumption cannot be readily determined, a straight-line amortisation method would be used.

A lessee would reassess the amount expected to be paid under a residual value guarantee if facts and circumstances indicate that there is a significant change in the amount expected to be payable under the guarantee. Changes in the lessee's liability arising from current or prior periods would be recognised in profit or loss, while changes relating to future periods would adjust the right-of-use asset.

A lessor's right to receive lease payments would not include residual value guarantees.

Purchase options

In a departure from the ED, the revised exposure draft is expected to propose that purchase options be accounted for similarly to options to renew. Therefore, purchase options that provide a lessee with a "significant economic incentive to exercise" would be included in the liability to make lease payments. In addition, the reassessment guidance for purchase options should be the same as that for the lease term.

Discount rate

The ED noted that the rate the lessor charges the lessee could be the lessee's incremental borrowing rate; the rate implicit in the lease; or, for property leases, the yield on the property. However, no hierarchy was established for use of these rates. During redeliberations of the proposals in the ED, the Boards tentatively decided that the revised exposure draft should establish a hierarchy for use of these rates. The revised proposals would clarify that if the rate the lessor charges the lessee is available, that rate should be used rather than the lessee's incremental borrowing rate. Otherwise, the lessee's incremental borrowing rate should be used.

The discount rate would only be reassessed when there is a change in lease payments that is due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease.

Lessee accounting – Expense recognition

The expense recognition pattern for lessees proposed in the ED differed significantly from that under current operating lease accounting. Under the ED, rent expense would have generally been eliminated and replaced with amortisation and interest expense.

This proposed expense recognition pattern is a function of treating the lease arrangement as a financing. The right-of-use asset would be amortised on a systematic basis (typically, straight-line) that reflects the pattern of consumption of the expected future economic benefits. Conversely, the liability would be amortised using the effective interest method, which results in higher interest expense in earlier periods.

However, as a result of concerns expressed by many constituents that the pattern proposed in the ED for recognising lease expense does not reflect the economics of all types of leases, Board redeliberations resulted in the reversal of the proposals outlined in the ED. The revised exposure draft is expected to propose two types of leases for expense recognition purposes – an approach resulting in an accelerated pattern of expense recognition based on that which was proposed in the ED (the interest and amortisation (I&A) approach) and an approach resulting in a straight-line pattern of expense recognition (the single lease expense (SLE) approach).

Under both approaches, a lessee would initially recognise a right-of-use asset and a liability to make lease payments at the present value of the lease payments.

A lessee applying the I&A approach would subsequently measure the liability at amortised cost; recognising interest expense in profit or loss. The right-of-use asset would be amortised/depreciated using a systematic and rational method. Therefore, the expense recognition pattern would be on an accelerated basis. Interest and amortisation/depreciation expense would be presented separately within profit or loss.

A lessee applying the SLE approach would, subsequent to initial recognition, measure the liability at amortised cost while the right-of-use asset would be measured as a balancing figure such that total lease expense would be recognised on a straight-line basis regardless of whether this represents the pattern of consumption of the underlying asset. Total lease expense would be presented as a single-line item in profit or loss.

The forthcoming proposals are expected to propose a new lease classification test in determining whether lessees apply the I&A or SLE approach, based on the extent of consumption of the underlying asset (i.e., whether the lessee acquires and consumes more than an insignificant portion of the utility of the underlying asset). However, the principle should be applied using a practical expedient based on the nature of the underlying asset.

Under the practical expedient, it is presumed that leases of property, defined as land and/or a building or part of a building, should be accounted for as a SLE lease. However, this presumption is rebutted if:

- the lease term is for the major part of the underlying asset's economic life; or
- the present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

Observation

The assessment of the practical expedient tests for leases of real estate may result in different outcomes depending on whether land and buildings are assessed as one unit of account or treated separately. This was not discussed by the Boards.

For leases of assets other than property, it is presumed that leases should be accounted for as an I&A lease unless:

- the lease term is an insignificant portion of the underlying asset's economic life; or
- the present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

A lessee would determine the lease classification at lease commencement. An entity would not be required to reassess its classification unless the lease is subsequently modified and accounted for as a new lease.

Appendix C illustrates examples of the lessee approaches expected to be proposed in the revised exposure draft.

Observation

In redeliberating the proposals in the ED, the Boards considered retaining the current IAS 17 *Leases* classification test but rejected that alternative, in part, because the Boards considered the new lease classification test to be easier to apply. Additionally, the practical expedient is expected, in the view of many Board members, to better capture the economics of different leasing transactions.

The impact of the proposed revision to the lease classification test is likely to impact lessees of assets other than real estate most significantly. Leases of equipment that are currently classified as operating leases under IAS 17 are likely, under the new lease classification test, to be accounted for using the I&A approach; thereby resulting in the acceleration of expenses in the statement of comprehensive income.

Impairment of the right-of-use asset

Consistent with the ED, the forthcoming proposals are expected to propose that the right-of-use asset would be subject to impairment testing in a manner similar to other long-lived assets. If the right-of-use asset for a lease accounted for under the SLE approach is impaired, the lessee would adjust the subsequent amortisation of the right-of-use asset to ensure that a straight-line expense is maintained through the remainder of the lease unless, because of the impairment, the total lease expense for any subsequent period would be lower than the interest expense on the lease obligation. In such situations, rather than continuing a straight-line expense approach, the subsequent amortisation of the right-of-use asset would be consistent with the I&A approach. Accordingly, if the right-of-use asset is fully impaired under the SLE approach, the lessee would subsequently recognise lease expense in a manner consistent with the unwinding of the liability to make lease payments.

Contracts that contain lease and nonlease components

Under the ED, for a contract that contains both lease and service elements, the services that are 'distinct' would have been separated and accounted for separately from the lease elements (nondistinct elements would have been accounted for as part of the lease contract). However, in redeliberating the proposals in the ED, the Boards tentatively decided to eliminate the distinct criterion and generally require an entity to separate all nonlease elements from the lease elements and to account for the nonlease elements in accordance with other standards. Thus, all nonlease elements would typically be separated from the lease accounting, regardless of whether the nonlease elements are distinct. Lessors would allocate payments to lease components and nonlease components in a manner consistent with the allocation methods in the revenue recognition project. Lessees would allocate payments to the lease and nonlease components on the basis of the relative observable purchase price of the individual components. If there are no observable purchase prices, lessees would account for all payments as a lease.

Observation

The ED resulted in many questions about whether certain elements common in many leases (e.g., property taxes, insurance and common area maintenance) meet the definition of a distinct service. The Boards' tentative decision during redeliberations to eliminate the distinct versus nondistinct guidance, and instead, require separation of all nonlease elements from the lease elements is meant to clarify that such elements would typically not be part of the lease liability that is recognised in the statement of financial position.

In-substance purchase/sale

The ED proposed excluding contracts that automatically transfer title to the underlying asset at the end of the contract or included a bargain purchase option and transfer all but a trivial amount of the risks and benefits associated with the underlying asset. In redeliberating proposals in the ED, the Boards tentatively decided that in-substance purchases/sales would not be explicitly addressed or excluded from the scope of a final standard. Therefore, if an arrangement does not contain a lease, it should be accounted for in accordance with other applicable standards.

Lease payments before commencement date and lease incentives

The revised exposure draft is expected to propose that any lease payments made by the lessee before the asset is available for use (commencement date) should be accounted for as prepayments for the right-of-use asset. These prepayments would then be added to the right-of-use asset on the commencement date. This topic was not addressed in the ED.

In addition, because the ED did not discuss lease incentive payments, a common question in comment letters was how to account for these payments. In redeliberating the proposals in the ED, the Boards tentatively decided that a lessee should include lease incentives in the initial measurement of the right-of-use asset (i.e., receipts from the lessor would reduce the right-of-use asset).

Contract modifications or changes in circumstances

The ED did not address how to account for modifications to lease agreements. In redeliberating the proposals in the ED, the Boards tentatively decided that a modification that is a substantive change would result in the termination of the existing contract and that the modified contract should be treated as a new lease. In addition, any changes that would affect the determination of whether an arrangement contains a lease should result in the reassessment of whether the arrangement contains a lease.

Lessor accounting

The ED proposed a hybrid or dual accounting model for lessors. The choice of model depended on whether the lessor retained exposure to significant risks or benefits associated with the underlying asset. A lessor that retained exposure to significant risks or benefits associated with the underlying asset would have kept the underlying asset on its statement of financial position and recognised a receivable and a performance obligation. If the lessor did not retain exposure to significant risks or benefits, the underlying asset would have been derecognised and replaced with a receivable and a residual asset and profit might be recognised at lease commencement. Many respondents to the ED stated that the lessor accounting proposals need significant further development and refinement and that lessors would need additional guidance to determine which approach to apply. In addition, many respondents believed that the current lessor accounting model was “not broken” and questioned whether the costs of implementing the new model were accompanied by an improvement in financial reporting.

In redeliberating the proposals in the ED, the Boards tentatively confirmed a dual accounting model for lessors (excluding short-term leases). However, the nature of the lessor models expected to be included in the revised exposure draft is unique from those proposed in the ED.

Lessors would apply a lease classification test that is symmetrical with that proposed for lessees. The lease classification test would determine whether an entity applies the R&R model or the operating lease model similar to current requirements in IAS 17. That is, lessors would apply the R&R model to leases in which the lessor is deemed to have sold more than an insignificant portion of the utility of the underlying asset to the lessee that the lessee then consumes over the lease term. The operating lease model would be applied for leases in which the lessor is not deemed to have sold more than an insignificant portion of the underlying asset to the lessee. The lease classification test would be performed at lease commencement only unless the lease is subsequently modified and accounted for as a new lease.

Under the R&R model, the lessor would replace the underlying asset with a lease receivable measured as the present value of the lease payments discounted using the rate the lessor charges the lessee and a residual asset measured as an allocation of the carrying amount of the underlying asset. Lessors would recognise profit related to the leased portion of the asset for any difference between the lease receivable recognised and the cost derecognised.

The residual asset comprises the gross residual asset, measured at the present value of the estimated residual value at the end of the lease term discounted using the rate the lessor charges the lessee, net of deferred profit. Deferred profit is measured as the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset leased.

Deferred profit is representative of profit embedded in the residual asset. A lessor must first allocate the carrying amount of the underlying asset between the portion leased (i.e., cost derecognised) and the portion retained by the lessor (i.e., residual asset). The allocation would be based on the ratio of the present value of the lease payments to the fair value of the underlying asset being leased.

For example, if the total profit in the underlying asset (i.e., the difference between the fair value and the carrying amount of the underlying asset) is CU 200 and 60 percent of the underlying asset’s carrying amount was derecognised (i.e., the present value of lease receivable represents 60 percent of the fair value of underlying asset), CU 120 (CU 200 x 60 percent) of profit would be recognised at lease commencement for the portion of the underlying asset leased and CU 80 of profit would be embedded in the residual asset.

The profit or loss recognition pattern following initial measurement of the lease arrangement is a function of treating the lease arrangement as a financing arrangement. The lease receivable would be amortised using the effective interest method, while the gross residual asset would be accreted to the estimated residual value at the end of the lease term using the rate the lessor charges the lessee; thus resulting in an accelerated pattern of income recognition. The deferred profit would not be recognised in profit or loss until the residual asset is sold, re-leased or a reassessment of the lease receivable occurs.

The operating lease model would be similar to operating lease accounting under IAS 17. The lessor would continue to recognise the underlying asset. Lease payments would be recognised on a straight-line basis over the lease term unless another more systematic and rational basis is more representative of the time pattern of the user's benefit. A lease receivable would not be recognised at lease commencement.

Appendix D illustrates examples of the lessor models expected to be proposed in the revised exposure draft.

Observation

In developing the proposals expected to be included in the revised exposure draft, the Boards considered multiple iterations of a receivable and residual approach, including a model which considered the assuredness of profit on the transfer of the right-of-use asset (akin to the revenue recognition proposals). Ultimately, the Boards found the above R&R model to be the most conceptually sound and consistent with decisions reached on the lessee accounting model. However, some Board members and constituents have expressed concern with the lack of symmetry between the lessor accounting model and the proposed revenue recognition model.

Variable lease payments

The Boards discussed the subsequent measurement of a lessor's residual asset under the R&R model when the lease contract includes variable lease payments that are not recognised as a part of the lease receivable at lease commencement. The revised exposure draft is expected to propose that when the rate the lessor charges the lessee reflects an observable expectation of variable lease payments, the lessor would subsequently adjust the residual asset based on its expectation of variable lease payments and recognise an expense as variable lease payments are received. Any difference between actual and expected variable lease payments would not result in a further adjustment to the residual asset. However, when the rate the lessor charges the lessee does not reflect an expectation of variable lease payments, the lessor would not make any subsequent adjustments to the residual asset with respect to variable lease payments.

For example, a lease of a vehicle has fixed payments in which a particular level of mileage is permitted over the lease term. If the specified mileage is exceeded, an additional rental based on excess mileage is due at the end of the contract. At lease commencement, the lessor has no expectation that the lessee will use the vehicle beyond the specified mileage, so the excess mileage charge is included simply to protect the lessor's return on the underlying asset. The lessor has priced the contract based on the fixed payments and the expected residual value, assuming that the number of miles driven by the lessee will not exceed the mileage allowed under the terms of the fixed payments. Pricing for the variable component is separate. Therefore, the lessor would not likely make any subsequent adjustments to the residual asset if use of the vehicle goes beyond the specified mileage.

However, consider a property lease which has a minimum fixed payment plus payments that depend on the lessee's sales at that property. At lease commencement, the lessor has an expectation of a particular level of sales by the lessee, and therefore, an expectation of variable lease payment to be received. The lessor has included variable payments in the contract to provide the lessee with some relief in the initial period of operation or during turbulent economic times and to receive a share in the lessee's upside performance due to the lessor's investment in the underlying asset. In this example, the lessor is likely to have priced the contract such that the total fixed and variable payments would provide the desired yield on the underlying asset. If so, the lessor would subsequently adjust the residual asset based on its expectation of variable lease payments and recognise an expense as variable lease payments are received.

Observation

The Boards acknowledged the practical complexities with the above tentative decision, but noted that the absence of an adjustment to the residual asset when there is an expectation of variable lease payments could overstate profit during the lease term or necessitate impairment of the residual asset. Both results were seen as potentially leading to structuring opportunities, while resulting in inconsistent residual asset valuation depending on the pricing underlying a lease contract.

However, the Boards indicated that they expected adjustments to residual assets with respect to variable lease payments to occur infrequently.

Subsequent measurement

Under the R&R model expected to be proposed in the revised exposure draft, the lease receivable would be assessed for impairment in accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Classification and Measurement* (IFRSs only) and Topic 310 *Receivables* in the FASB Accounting Standards Codification® (US GAAP only).

The residual asset would be assessed for impairment in accordance with IAS 36 *Impairment of Assets* (IFRSs only) and Topic 360 *Property, Plant and Equipment* (US GAAP only). Revaluation of the residual asset would be prohibited under IFRSs.

Transferred/securitised lease receivables

The Boards discussed the measurement of lease receivables under the R&R model which are held for the purpose of sale and the derecognition guidance to be applied when lease receivables are transferred or sold. The Boards tentatively decided that a lessor would not measure a lease receivable at fair value, even if part or all of the receivable is held for the purpose of sale. Likewise, a lessor would apply existing derecognition requirements in IFRS 9 or IAS 39 (IFRSs only) or Topic 860 *Transfers and Servicing* (US GAAP only) to lease receivables, but allocate the carrying amount of a lease receivable on the basis of its fair value excluding any option elements and variable lease payments that are not transferred.

Disclosure and presentation requirements

Presentation – Lessee

The revised exposure draft is expected to propose that lessees present a right-of-use asset as if the underlying asset were owned by the lessee. Entities are expected to be given the choice of presenting right-of-use assets and lease liabilities either separately within the statement of financial position or within a larger line item. If the latter option is taken, disclosure of those assets and liabilities and the line item in which they are included would be required in the notes to the financial statements.

Under the I&A approach expected to be proposed, lessees should present separately interest expense and amortisation expense in the statement of comprehensive income. Under the SLE approach expected to be proposed, lessees would combine interest expense and the adjustment of the right-of-use asset as a single lease expense in the statement of comprehensive income.

The Boards also discussed classification of cash paid for various lease components within the statement of cash flows. The revised exposure draft is expected to propose that under the I&A approach:

- cash paid related to both principal and interest should be classified in accordance with applicable IFRS or US GAAP requirements;
- cash paid for variable lease payments that are not included in the measurement of the lease liability should be classified as an operating cash flow.

Cash paid under the proposed SLE approach and for short-term leases that are excluded from the lease liability should be classified as an operating cash flow.

Lessees would be require to include as a supplemental noncash transaction disclosure the acquisition of a right-of-use asset in exchange for a liability to make lease payments for leases accounted for under both the I&A and SLE approaches.

Observation
The Boards' proposal not to combine amortisation and interest expense and label it as lease expense for those leases classified under the I&A approach could affect entities that have "cost-plus" contracts. These contracts will often allow for reimbursement of rent expense but not interest expense. This could pose practical issues for lessees in complying with the proposals expected to be included in the revised exposure draft.

Disclosure – Lessee

In redeliberating the proposals in the ED, the Boards voted to generally retain the ED's disclosure requirements but made certain editorial changes and added new disclosures. The more significant required disclosures expected to be proposed in the revised exposure draft include:

- a reconciliation of the beginning and ending balances of the right-of-use assets, disaggregated by class of underlying asset and segregated between leases accounted for as I&A leases and those accounted for as SLE leases (IFRS only);
- a separate reconciliation of the beginning and ending balances of liabilities to make lease payments segregated between leases accounted for as I&A leases and those accounted for as SLE leases;
- a maturity analysis of the undiscounted cash flows that are included in the liability to make lease payments, with reconciliation to the amount reported in the statement of financial position;
- aggregated expenses relating to variable lease payments not included in the liability to make lease payments.

Redeliberations of the proposals in the ED resulted in the Boards proposing to remove the requirements in the ED to disclose (a) the existence and principal terms of any options for the lessee to purchase the underlying asset and (b) initial direct costs incurred on a lease.

Presentation – Lessor

The Boards are expected to propose that the lease receivable and the residual asset under the R&R model be presented either separately in the statement of financial position under the caption 'lease assets', or aggregated as a single line item ('lease assets') in the statement of financial position with separate disclosure in the notes to the financial statements. The gross residual asset and the deferred profit outlined in the R&R model would be presented together as a net residual asset in the statement of financial position or in the notes to the financial statements.

For those leases classified under the R&R model, the revised exposure draft is expected to propose that the statement of comprehensive income present the accretion of the residual asset as interest income and the amortisation of initial direct costs as an offset to interest income. Lease income and lease expense would be reported either gross or net on the basis of which presentation best reflects the lessor's business model. For example, if a lessor's business model uses leases as an alternative means of realising value from the goods it would otherwise sell, the proposals are expected to require separate presentation of lease income and lease expense by the lessor. However, if a lessor's business model uses leases for the purposes of providing finance, the proposals are expected to require that the lessor net lease income and lease expense in a single line item in the statement of comprehensive income.

The forthcoming proposals are also expected to permit a lessor's to present income and expense from lease transactions separately from other income and expense in the statement of comprehensive income or disclose those amounts in the notes to the financial statements. If disclosed, the notes should reference the line items in which the income and expenses are presented.

The Boards also discussed classification of cash receipts from lease payments within the statement of cash flows. The revised exposure draft is expected to propose that cash receipts from lease payments be classified as operating cash flows, except those cash receipts relating to securitised receivables. Existing guidance would be applied in classifying cash flows from securitised receivables.

Disclosure – Lessor

In redeliberating the proposals in the ED, the Boards voted to retain most of the disclosure requirements in the ED but made certain editorial changes and added new disclosures. The more significant required disclosures expected to be proposed in the revised exposure draft for those leases accounted for under the R&R model include:

- A reconciliation of the beginning and ending balances of the lease receivable and the residual asset.
- A maturity analysis of the undiscounted cash flows that are included in the lease receivable, with reconciliation to the amounts reported in the statement of financial position.
- Information about the lessor's exposure to the risks or benefits associated with the underlying asset, including its risk management strategy, the carrying amount of the residual asset that is covered by residual value guarantees and the unguaranteed portion of the carrying amount of the residual asset and whether it has other means of reducing its exposure to residual asset risk (e.g., buyback agreements with the manufacturer from whom the lessor purchased the underlying asset or options to put the underlying asset to the manufacturer).

The revised exposure draft is expected to propose a single disclosure detailing all various income components (e.g., for leases accounted for under the R&R model, profit recognised at lease commencement, interest income on the lease receivable and accretion of the residual asset; for leases accounted for under the operating lease model and short-term leases for which the lessor elects not to apply the R&R model, income from noncontingent lease payments; and variable lease payment income for all leases). However, the FASB and IASB's revised proposals are not expected to be converged in the area of interim disclosures of income components. The FASB's revised exposure draft is expected to propose a disaggregated disclosure of various income components in interim financial statements consistent with proposals for annual financial statements. However, the IASB's revised exposure draft is not expected to propose disaggregation of lease income unless that information is significant to the interim financial statements. Instead, lessors would disclose aggregated lease income in interim periods.

In a change from the proposals in the ED, the revised exposure draft is not expected to propose that a lessor disclose initial direct costs incurred in the reporting period and included in the lease receivable.

For leases excluded from the scope of the R&R model, the revised exposure draft is expected to propose the following disclosures:

- a maturity analysis of the undiscounted future noncancellable lease payments, separate from the maturity analysis for the R&R model.
- the cost and carrying amount of assets on lease or held for lease by major classes according to nature or function and the amount of accumulated depreciation in total as of the date of the latest statement of financial position presented.
- information about leases which are excluded from the scope of the R&R model such as the basis and terms on which variable lease payments are determined, the existence and terms of options and restrictions imposed by the lease arrangements.

Other lease considerations

Subleases

The ED did not include detailed guidance on subleasing, other than noting that an intermediate lessor in a sublease "would account for the assets and liabilities arising from the head lease in accordance with the lessee model" and "would account for the assets and liabilities arising from the sublease in accordance with the lessor model." In redeliberating the proposals in the ED, the Boards reaffirmed this guidance on accounting for subleases and are expected to provide similar guidance in the revised exposure draft. When determining which lessor accounting model to apply to a sublease agreement, an intermediary lessor should evaluate the transaction on the basis of the underlying leased asset, not the right-of-use asset. Similarly, the sublessee would determine whether to apply the I&A or SLE approach on the basis of the underlying leased asset. As a result, the assessment of whether the sublessee consumes a more-than-insignificant portion of the leased asset – and consequently, which model the intermediate lessor and the sublessee should apply – will focus on the economic useful life and fair value of the underlying leased asset.

Observation

Consistent with the ED, the forthcoming proposals are not expected to propose any measurement exceptions for subleases. Therefore, the anticipated proposals may result in an intermediate lessor, depending on facts and circumstances, measuring the lease liability related to a head lease differently from its lease asset related to a sublease of the same underlying asset. For example, differences may arise from the determination of the appropriate discount rate as the head lease may be calculated using the lessee's incremental borrowing rate at lease commencement (if the rate the lessor charges the lessee is not known), while the sublease would apply the rate the sublessor charges the lessee.

Embedded derivatives

The ED was silent on how to account for embedded derivatives included in lease contracts. In redeliberating the proposals in the ED, the Boards tentatively decided to retain current accounting guidance. Therefore, under the anticipated proposals, entities would be required to assess whether lease contracts include embedded derivatives that should be separated and accounted for in accordance with the applicable financial instrument guidance.

Term option penalties

The revised exposure draft is expected to propose that the accounting for term option penalties be consistent with the accounting for options to extend or terminate a lease. Thus, a penalty should be included in the recognised lease payments if a lessee would be required to pay a penalty if it does not renew the lease and the renewal period has not been included in the lease term.

Foreign exchange differences

The ED did not address the accounting for foreign exchange differences. During redeliberations of the proposals in the ED, the Boards discussed the accounting by lessees for leases denominated in a foreign currency. The revised exposure draft is expected to propose that foreign exchange differences related to the liability to make lease payments be recognised in profit or loss. This is consistent with the foreign exchange guidance in existing IFRSs.

Sale-and-leaseback transactions

Under the proposals in the ED, the threshold for achieving a sale in a sale-and-leaseback transaction would have been higher than if applying the proposals under the revenue recognition project. Many respondents to the ED noted this inconsistency. Therefore, in redeliberations, the Boards tentatively decided to eliminate the ED's proposal. Instead, the revised exposure draft is expected to propose that entities apply the requirements under the forthcoming revenue recognition standard, once finalised, in determining whether the conditions of a sale are met. If such conditions are met, the seller/lessee would use a "whole asset approach" in accounting for the transaction – derecognising the entire underlying asset and recognising the right-of-use asset associated with the leaseback. In addition, consistent with the ED, the revised exposure draft is expected to propose that gains or losses not be deferred if the consideration is at fair value.

Observation

When applying the forthcoming revenue recognition standard to determine whether the underlying asset has been sold in a sale-and-leaseback transaction, an entity should evaluate the entire transaction. That is, the entity should consider if it will retain physical possession of the asset under the lease. However, the existence of the lease may not prevent the entity from accounting for the entire transaction as a sale and leaseback. The Boards concluded that the lease "does not transfer control of the underlying asset to the lessee; instead, it transfers the right to control the use of the underlying asset for the term of the lease." Therefore, provided that the seller/lessee does not have the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset, the transaction may qualify for sale-and-leaseback accounting rather than as a financing arrangement.

To address concerns related to sale-and-leaseback transactions that include a call or put option on the underlying asset, the revised exposure draft is expected to propose that if the seller/lessee can repurchase the asset, the entity would conclude that a sale has not occurred and the entire transaction would be treated as a financing arrangement.

Transition

The ED stated that all outstanding leases as of the date of initial application would be subject to the proposed lease accounting. The ED defined the date of initial application as "the beginning of the first comparative period presented in the first financial statements in which the entity applies this guidance" and required lessees and lessors to apply the provisions of the new model by using a simplified retrospective approach as of that date.

In redeliberating the proposals in the ED, the Boards made several proposals regarding transition requirements related to implementation of the proposed leases standard. The most significant proposal would give both lessors and lessees an option regarding how to apply the new standard to existing leases currently classified as an operating lease. Namely, the proposal would permit entities to apply either a full retrospective approach to implementation or a modified retrospective approach that would attempt to simulate the full retrospective approach without requiring the onerous application of full retrospective application.

The revised exposure draft is also expected to propose that lessees and lessors with existing capital/finance leases either carry forward the amounts recorded as of the date of initial application or apply a full retrospective approach.

For existing operating leases, the revised proposals are expected to permit lessees or lessors (for leases accounted for under the R&R model) to apply a modified retrospective transition approach under which the following transition reliefs would be available:

- Evaluation of initial direct costs for contracts that began before the effective date would not be required.
- The use of hindsight would be allowed when preparing comparative information including the determination of whether or not a contract is or contains a lease.

For lessees applying the modified retrospective approach, the revised exposure draft is expected to propose that, at the date of initial application, a lessee:

- Measure the lease liability as the present value of the remaining lease payments discounted using the lessee's incremental borrowing rate as of the effective date for each portfolio of leases with reasonably similar characteristics. The incremental borrowing rate for each portfolio of leases should take into consideration the lessee's total leverage, including leases in other portfolios.
- For leases accounted for under the I&A approach, measure the right-of-use asset as a proportionate amount of the liability to make lease payments at lease commencement relative to the remaining lease payments, with the difference recorded as retained earnings.
- For leases accounted for under the SLE approach, measure the right-of-use asset at an amount equal to the lease liability.
- At adoption, eliminate any prepaid or accrued rentals with an adjustment to the right-of-use asset.

Under the anticipated proposals, a cumulative-effect adjustment would be recognised in opening retained earnings at the date of initial application for the net change in recognised assets and liabilities.

For lessors applying the modified retrospective approach, the revised exposure draft is expected to propose that, at the date of initial application, a lessor derecognise the underlying asset and recognise a receivable for the estimated future lease payments, discounted at the rate the lessor charges the lessee, and a residual asset. The rate the lessor charges the lessee would be determined as of the lease commencement date. The residual asset would be determined as proposed under the R&R model using information as of the date of initial application. Any existing prepaid or accrued lease payment balance would result in an adjustment of the cost basis of the underlying asset that is derecognised at the date of initial application.

Under the anticipated proposals, a cumulative-effect adjustment would be recognised in opening retained earnings at the date of initial application for the net change in recognised assets and liabilities.

Observation

While the anticipated proposal to permit prospective application for capital/finance leases may provide relief, if the proposal is ultimately finalised, to lessees and lessors applying the proposed leases guidance, an initial measurement difference may exist for both lease assets and lease liabilities as a result of the proposal. For example, while current guidance in IAS 17 (IFRSs only) and Topic 840 Leases requires a lessor to include any residual value guaranteed by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging obligations under the guarantee within the minimum lease payments, the Boards' anticipated proposals would not permit the inclusion of residual value guarantees in the lessor's right to receive lease payments.

The Boards also discussed transition disclosures. As a result of these discussions, the revised exposure draft is expected to propose that transition disclosures be consistent with those required by IAS 8 *Accounting Policies, Changes in Estimates and Errors* (IFRSs only) or Topic 250 *Accounting Changes and Error Corrections* (US GAAP only) except that entities would not be required to disclose the effect of the change on any affected financial statement line item for the current period and any prior periods adjusted retrospectively.

The IASB also discussed how a first-time adopter of IFRSs would apply the proposed leases standard in its first IFRS financial statements. The IASB's revised exposure draft is expected to propose that a first-time adopter of IFRSs be permitted to apply to all of its lease contracts the transitional provisions and reliefs that are applicable to the operating leases of an existing IFRS preparer. Further, a first-time adopter would be permitted to initially measure a right-of-use asset at fair value in its opening IFRS statement of financial position and to use that amount as deemed cost.

Income and other taxes

The Boards did not address any income tax matters in either the ED or in their redeliberations. However, the proposals expected to be included in the revised exposure draft may significantly impact income taxes.

The classification of leases for tax reporting purposes is often based on economic factors established by case law and regulatory administrative rulings. Therefore, many leases may require an independent analysis of specific facts and circumstances to establish the appropriate classification. Because the proposals expected to be included in the revised exposure draft affect many outstanding leases as of the date of initial application, entities would need to be mindful of the significant deferred tax consequences that may arise upon initial application if these proposals are finalised.

Historically, the classification of leases for tax purposes may have followed the financial accounting treatment as either a capital/finance or an operating lease. Therefore, under current accounting guidance, an entity may have had operating leases for both financial reporting and tax purposes; in which case, there would be no existing temporary difference for those leases absent the existence of any unique tax rules applicable in a jurisdiction which differ from IFRSs.

Under the anticipated proposals, classification as operating leases would cease to exist (absent exceptions outlined above) and amounts recognised in the statement of financial position may differ. As a result, the deferred tax consequences of new and existing leases would also have to be addressed. For example, the right-of-use asset and lease liability for lessees would generally not be recognised for tax purposes. Therefore, new temporary differences may result. Even if tax laws are modified to conform to these changes, the timing would likely not coincide with the adoption of any revised standard.

Additional tax issues resulting from the proposals include:

- Whether an initial recognition exemption may be applied to the lease right-of-use asset and lease liability at inception, in which case no deferred taxes would be recorded.
- Whether existing lease assets recognised should be considered the "same asset".

Similarly, the anticipated proposals may provide for certain tax implications if the proposals are finalised including the following:

- The impact of proposals on EBITDA may result in a change in the cash tax depending on how tax law responds, if at all.
- The impact of proposals may result in increased volatility in the effective tax rate. For example, lease expense for financial reporting may be front loaded for a larger subset of leases under the Boards' proposed model, but tax deductions are often provided rateably over the life of the lease. Similarly, where the lease asset is impaired or adjusted, there will be a negative impact to the effective tax rate.
- Changes in debt-to-equity ratios as a result of recognition of additional lease liabilities in the statement of financial position for lessees may have a tax implication for thin capitalisation analyses in a variety of jurisdictions.

Further, the anticipated proposals may have potential consequences on other taxes. For example, many jurisdictions impose property taxes in addition to corporate income taxes. As property tax is often based on the value of property, plant and equipment, the relevant classification of the right-of-use asset as a component of property, plant and equipment or an intangible asset if the proposals are finalised may impact assessed tax levels. Additionally, US state apportionment factors may be impacted where allocation of income to states is based on factors which include a property factor.

Effective date and next steps

The Boards will not make a final decision on the effective date of the new standard until they complete their deliberations on a revised exposure draft. Although the Boards have not discussed a potential effective date for the final lease standard, they did discuss effective date pertaining to the revenue project and noted that such date would not be earlier than 1 January 2015. The lease project is more than one year behind the revenue project. Therefore, we would expect the effective date for the final lease standard to be no earlier than 1 January 2015.

At their July 2012 joint meeting, the Boards substantially completed their redeliberations of the leases project (absent certain FASB only deliberations to occur at a later date and any issues that are identified during the process of drafting the revised exposure draft) and instructed their respective staff to begin drafting the revised exposure draft. The Boards expect to issue the revised exposure draft in the first quarter of 2013 with a 120-day comment period.

Appendix A

Lessee accounting including reassessment of renewal options

The following example illustrates the application of the right-of-use model for a lessee on the lease commencement date and subsequently when there is a change in the lessee's expectations about whether there is a significant economic incentive to exercise a renewal option.

Fact Pattern	
Lease term	10 years
Annual lease payments in years 1–5	CU 2,000,000
Annual lease payments in years 6–10	CU 2,500,000
Renewal option years 11–15	CU 3,000,000
Concessions	None
Guaranteed residual value	None
Purchase option	None
Lessee's incremental borrowing rate at lease commencement*	7 percent
Lessee's incremental borrowing rate on reassessment date*	8 percent

* Incremental borrowing rate is used because the rate the lessor charges the lessee is not known in this example.

Assume that the lease is classified as an I&A lease in accordance with the 'Lessee accounting – Subsequent measurement' section above. The following table summarises the balances of the lessee's right-of-use asset and lease liability as well as amortisation and interest expenses throughout the lease term.

Lessee accounting for the initial lease term

Year	Base Rent Payments	Ending Right-of-Use Asset	Ending Lease Liability	Amortisation	Interest Expense at 7 percent	Principal Portion of Lease Payment	Lease Expense
0		CU 15,508,855	CU 15,508,855				
1	CU 2,000,000	13,957,970	14,594,475	CU 1,550,885	CU 1,085,620	CU 914,380	CU 2,636,505
2	2,000,000	12,407,084	13,616,088	1,550,886	1,021,613	978,387	2,572,499
3	2,000,000	10,856,199	12,569,214	1,550,885	953,126	1,046,874	2,504,011
4	2,000,000	9,305,313	11,449,059	1,550,886	879,845	1,120,155	2,430,731
5	2,000,000	7,754,428	10,250,493	1,550,885	801,434	1,198,566	2,352,319
6	2,500,000	6,203,542	8,468,028	1,550,886	717,535	1,782,465	2,268,421
7	2,500,000	4,652,657	6,560,790	1,550,885	592,762	1,907,238	2,143,647
8	2,500,000	3,101,771	4,520,045	1,550,886	459,255	2,040,745	2,010,141
9	2,500,000	1,550,886	2,336,448	1,550,885	316,403	2,183,597	1,867,288
10	2,500,000	–	–	1,550,886	163,552	2,336,448	1,714,438
	22,500,000			**15,508,855**	**6,991,145**	**15,508,855**	**22,500,000**

The lessee made significant leasehold improvements at the end of year 6 and therefore reassessed the lease term. As a result of the reassessment, the lessee determined that there is now a significant economic incentive to exercise the renewal option at the end of year 10. The calculation below illustrates the accounting for the extended lease term.

At the end of year 6:

- Carrying amount of lease asset: CU 6,203,542 (see table above).
- Carrying amount of lease liability: CU 8,468,028 (see table above).

New present value of lease liability, considering the revised lease term: CU 17,084,600.

(See table below. Note that the new present value of year 7 to year 15 payments is computed at the new incremental borrowing rate of 8 percent.)

The accounting entry on the reassessment date is as follows:

	Debit	Credit
Right-of-use asset	CU 8,616,572*	
Lease liability		CU 8,616,572
To record the impact of the reassessment of the renewal option (CU 17,084,600 – CU 8,468,028).		

* In a manner consistent with the ED, changes in lease payments that are due to a reassessment would result in a lessee's adjusting its obligation to make lease payments and the right-of-use asset would be adjusted to reflect any change in the liability to make lease payments. In other words, the lease asset and liability would generally be adjusted by the same amount when a renewal period is added to the measurement.

Lessee accounting after reassessment and inclusion of additional renewal option

Year	Base Rent Payments	Ending Right-of-Use Asset	Ending Lease Liability	Amortisation	Interest Expense at 7 percent	Principal Portion of Lease Payment	Lease Expense
		CU 14,820,114	CU 17,084,600				
7	CU 2,500,000	13,173,435	15,951,368	CU 1,646,679	CU 1,366,768	CU 1,133,232	CU 3,013,447
8	2,500,000	11,526,755	14,727,477	1,646,680	1,276,109	1,223,891	2,922,789
9	2,500,000	9,880,076	13,405,676	1,646,679	1,178,199	1,321,801	2,824,878
10	2,500,000	8,233,397	11,978,130	1,646,679	1,072,454	1,427,546	2,719,133
11	3,000,000	6,586,717	9,936,380	1,646,680	958,250	2,041,750	2,604,930
12	3,000,000	4,940,038	7,731,290	1,646,679	794,910	2,205,090	2,441,589
13	3,000,000	3,293,359	5,349,794	1,646,679	618,504	2,381,496	2,265,183
14	3,000,000	16,46,679	2,777,778	1,646,680	427,984	2,572,016	2,074,664
15	3,000,000	–	–	1,646,679	222,222	2,777,778	1,868,901
	25,000,000			**14,820,114**	**7,915,400**	**17,084,600**	**22,735,514**

Appendix B

Accounting for variable lease payments based on an index or rate

The following example as adapted from examples discussed during the Boards' July 2011 meeting illustrates the requirements to reassess variable lease payments that are based on an index. The Boards tentatively decided that entities should use the index that exists at the end of each reporting period, rather than a forward rate, to reassess variable payments related to an index. Therefore, at the end of each reporting period, entities would remeasure the lease liability using the index at the end of the reporting period. This example illustrates the impact that the reassessment would have throughout the entire lease term on the basis of the actual indices.

A lessee enters into a 5-year lease of a building with a base payment of CU 100,000 per year (paid annually in arrears) in which the base payment will be adjusted each year by the change in an inflation rate. Variable lease payments are calculated as the spot inflation rate / 100. The lessee's incremental borrowing rate is 6 percent and the inflation rate at lease commencement is 104.06. The lessee would initially measure the lease liability at CU 438,339 calculated as the present value of CU 104,060 per year for 5 years discounted at 6 percent.

Assume that the lease is classified as an I&A lease in accordance with the 'Lessee accounting – Subsequent measurement' section above. The following table summarises the balances of the lessee's right-of-use asset and lease liability as well as amortisation, interest and variable lease expenses throughout the lease term, including the effects of reassessment of the lease payments due to changes in the inflation rate.

Year	Base Lease Payments	Inflation Rate	Actual Payments	Ending Right-of-Use Asset	Ending Lease Liability	Amortisation	Interest Expense	Variable Lease Expense	Total Expense	PV of Additional Variable Lease Expense[1]
0		104.06		CU 438,339	CU 438,339					
1	CU 100,000	104.23	CU 104,230	351,260	361,168	CU 87,668	CU 26,300	CU 170	CU 114,138	CU 589
2	100,000	104.50	104,500	264,167	279,330	87,815	21,670	270	109,755	722
3	100,000	104.86	104,860	176,771	192,250	88,056	16,760	360	105,176	660
4	100,000	106.88	106,880	90,291	100,830	88,386	11,535	2,020	101,940	1,906
5	100,000	107.53	107,530	–	–	90,291	6,050	650	96,991	–
	500,000		**528,000**			**442,215**	**82,315**	**3,470**	**528,000**	

1 This amount represents the present value of the additional variable lease expense relating to future periods that will increase the lease liability and right-of-use asset as a result of reassessment. While the Boards tentatively decided that lessees would be required to separate lease payment variability as a result of a change in an index and rate between changes related to the current reporting period and changes related to future reporting periods, the staffs intend to develop further guidance on methods to be used in allocating changes in rates or indices to reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or was consumed. The above presentation reflects one possibility discussed during the Boards' July 2011 meeting.

Appendix C

Lessee accounting example

The following lessee accounting model example as adapted from examples discussed during the Boards' June 2012 meeting is intended to illustrate the application of the proposals using very simple fact patterns. The calculations below may be considerably more complex in practice depending on facts and circumstances.

Fact Pattern	
Lease term	5 years
Annual lease payments	CU 60
Contingent rentals	None
Residual value guarantees	None
Term option penalties	None
Rate implicit rate in the lease	6 percent
Present value of annual lease payments at lease commencement	CU 253

Assume that the above fact pattern corresponds to a lease of equipment in which the equipment has a useful life of 5 years and the fair value of the equipment is CU 260. The new lease classification test would require this lease to be classified as an I&A lease. This is because the underlying asset is not real estate, the lease term is for more than an insignificant part of the economic life of the asset and the present value of the lease payments is not insignificant compared to the fair value of the asset. The following table summarises the balances of the lessee's right-of-use asset and lease liability as well as amortisation and interest expenses throughout the lease term as a result of this classification.

Year	Base Rent Payments	Ending Right-of-Use Asset	Ending Lease Liability	Amortisation	Interest Expense at 6 percent
0		CU 253	CU 253		
1	CU 60	202	208	CU 51	CU 15
2	60	152	160	50	12
3	60	101	110	51	10
4	60	51	57	50	7
5	60	–	–	51	3
	300			**253**	**47**

Now assume that the above fact pattern corresponds to a lease of a building which has a remaining useful life of 50 years at commencement of the lease and the fair value of the building at commencement of the lease is CU 25,000. The new lease classification test would require this lease to be classified as a SLE lease. This is because the asset is real estate, the lease term is for less than a major part of the economic life of the asset and the present value of the lease payments does not amount to substantially all of the fair value of the asset. The following table summarises the balances of the lessee's right-of-use asset and lease liability as well as total lease expenses throughout the lease term as a result of this classification.

Year	Base Rent Payments	Ending Right-of-Use Asset[1]	Ending Lease Liability[2]	Total Lease Expense[3]
0		CU 253	CU 253	
1	CU 60	208	208	CU 60
2	60	160	160	60
3	60	110	110	60
4	60	57	57	60
5	60	–	–	60
	300			**300**

1 The right-of-use asset will be adjusted each period by the difference between the amount of straight-line lease expense less interest arising on the lease liability for the period.
2 The lease liability would be measured at amortised cost using the effective interest rate method.
3 Total lease expense will be recognised on a straight-line basis over the lease term (CU 300/5 years).

Appendix D

Lessor accounting example

The following lessor accounting model example as adapted from examples discussed during the Boards' October 2011 meeting is intended to illustrate the application of the proposals using very simple fact patterns. The calculations below may be considerably more complex in practice depending on facts and circumstances.

Fact Pattern	
Lease term	3 years
Annual lease payments	CU 30
Contingent rentals	None
Residual value guarantees	None
Term option penalties	None
Estimated useful life of underlying asset	6 years
Rate implicit rate in the lease	8.38 percent
Present value of annual lease payments at lease commencement	CU 77
Estimated fair value of residual asset at end of lease term	CU 55
Estimated present value of residual asset at lease commencement	CU 43
Carrying value of underlying asset	CU 100
Fair value of equipment at lease commencement	CU 120

Assume that the lease is classified under the R&R model in accordance with the 'Lessor accounting' section above.

Year	Lease Receivable	Gross Residual Asset[1]	Deferred Profit	Net Residual Asset[2]	Gain on Sales[4]	Interest on Receivable	Unwinding Interest for Residual Asset	Total Lease Income
0	CU 77	CU 43	CU7	CU36	CU13			CU13
1	53	47	7	40	–	CU 6	CU 4	10
2	28	51	7	44	–	4	4	8
3	–	55	7	48	–	3	4	7
					13	**13**	**12**	**38**

1 The gross residual asset is measured at the present value of the estimated residual value at the end of the lease term (CU 55), discounted using the rate that the lessor charges the lessee (8.38 percent), and subsequently accreted using the rate implicit in the lease.

2 Deferred profit is measured as the difference between the gross residual asset (CU 43) and the allocation of the carrying amount of the underlying asset leased [CU 100 – (CU 100 x (CU 77/CU 120))], or the portion of total underlying asset profit retained by the lessor [(CU 120 – CU 100) x (1-(CU 77/CU 120))]. The lessor would not recognise any of the deferred profit in profit or loss until the residual asset is sold or re-leased.

3 The gross residual asset and deferred profit are presented as a net residual asset.

4 Profit recognised at lease commencement represents the difference between the lease receivable (CU 77) and the portion of the carrying amount of the underlying asset derecognised (CU 100 less CU 36).

Now assume that the same lease is classified under the operating lease model in accordance with the 'Lessor accounting' section above.

Year	Underlying Net Asset	Gross Lease Income	Depreciation	Lease Income, Net
0	CU 100			
1	85	CU 30	CU 15	CU 15
2	70	30	15	15
3	55	30	15	15
		90	**45**	**45**

As noted above, total profit recognised over the lease term (CU 38) under the R&R approach is less than the total profit recognised under operating lease model (CU 45) because any profit on the residual asset (CU 7) is not recognised under the R&R approach until the leased asset is sold or re-leased at the end of the lease term.

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