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IFRS Project Insights
Leases

The IASB and FASB ('the Boards') published a Discussion Paper (DP) setting out a proposed lessee accounting model in March 2009.

The proposed accounting model has evolved since the issuance of the DP, although it has maintained the right of use model. The Boards finished re-deliberations in March 2015 and the final standard, which will be IFRS 16, is expected to be issued by the end of 2015. It will have an effective date of 1 January 2019. Entities will be able to apply IFRS 16 in earlier periods, provided that they are also applying IFRS 15 *Revenue from Contracts with Customers*.

The most significant developments to date in the project are: ***Updated***

(i) in August 2010, the IASB and FASB issued Exposure Draft ED/2010/09 *Leases* (ED) that proposed new accounting models for lessors and lessees. The comment period ended on 15 December 2010. Redeliberations on the proposals in the ED began in January 2011 and in July 2011 the Boards announced their intention to issue a revised ED;

(ii) in May 2013, a revised exposure draft was issued with a comment period that ended in September 2013 (**Appendix A** includes a summary of the 2013 ED);

(iii) in January 2014, the Boards started redeliberations to consider the feedback obtained from investors, analysts, preparers, accounting practitioners, as well as others, in comment letters, at public roundtable discussions, and at private outreach meetings, including fieldwork meetings;

(iv) in March 2014, the Boards made decisions on (i) the lessee accounting model; (ii) the lessor accounting model; (iii) small ticket leases and (iv) lease term and reassessment thereof by the lessee;

(v) in April 2014, the Boards made decisions on (i) lease modifications and contract combinations; (ii) variable lease payments; (iii) in substance fixed payments and (iv) discount rate;

(vi) in May 2014, the Boards made decisions on (i) the definition of a lease; (ii) separating lease and non-lease components and (iii) initial direct costs;

(vii) in June 2014, the Boards made decisions on (i) subleases; (ii) lessee balance sheet presentation and (iii) cash flow presentation;

(viii) in July 2014, the Boards made decisions on (i) sale and leaseback transactions and (ii) lessor disclosure requirements;

(ix) in October and December 2014, the Boards made decisions on guidance to identify a customer's right to direct the use of an asset;

(x) in November 2014, the IASB tentatively decided on consequential amendments to IAS 40 *Investment Property*;

(xi) in January 2015, the Boards made decisions on lessee's disclosure requirements;

(xii) in February and March 2015, the IASB tentatively decided on (i) transition requirements for lessees, lessors and first-time adopters; and (ii) additional guidance on the exception for leases of small assets and on subleases; and

(xiii) in March 2015, the IASB completed the redeliberations of the project and confirmed that all the due process steps were completed and no re-exposure was necessary.

(xiv) in October 2015, the IASB decided that the effective date of the lease standard would be 1 January 2019. The IASB also addressed some sweep issues identified by the staff during the drafting process related to (i) lease modifications treated as a separate new lease; (ii) reassessment of the discount rate for floating interest rate leases; (iii) costs associated with returning an underlying asset at the end of the lease; (iv) short-term leases and leases of low value in a business combination; and (v) interaction with disclosures requirements of IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations.*

This edition of Project Insights summarises the tentative decisions made to date by the IASB, and areas of divergence between the IASB and FASB.

Tentative decisions reached during redeliberations

Definition of a lease

The IASB tentatively decided to retain the principles in the 2013 ED regarding the definition of a lease.

The 2013 ED defined 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. At inception of a contract, an entity shall determine whether that contract is or contains a lease by assessing both of the following:

a) whether fulfilment of the contract depends on the use of an identified asset; and

b) whether the contract conveys the right to control the use of the 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.

This definition of a lease is consistent with existing guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease*. However, the IASB tentatively decided to add clarification guidance that would align the concept of control to IFRS 10 *Consolidated Financial Statements* and IFRS 15 *Revenue from Contracts with Customers*.

The guidance would clarify that:

a) fulfilment of the contract depends on the use of an identified asset when the supplier has no practical ability to substitute an alternative asset or the supplier would not benefit from substituting an alternative asset. A customer would presume that this is the case when it is impractical for the customer to determine otherwise; and

b in identifying whether a customer has the ability to direct the use of an identified asset, lease assessment should be performed on the basis of those decisions and benefits associated with the use of an underlying asset over the period of use.

Further, the IASB tentatively decided to clarify that a customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

Decisions that are relevant to determine whether the customer has the right to direct how and for what purpose the asset is used. In their analysis, the IASB considered that the decisions about how and for what purpose an asset is used are more important than other decisions to be made about use, including decisions about operations and maintenance. This is because decisions about how and for what purpose an asset is used generally have the most influence on the economic benefits that can be derived from use. Decisions regarding operations are generally about implementing the decisions about how and for what purpose an asset is used and are dependent upon (and subordinate to) those decisions. For example, a supplier's operational decisions would have no effect on the economic benefits derived from use of the asset if the customer decides not to operate the asset, and would always have proportionally less effect than the decisions about how and for what purpose the asset is used.

The IASB tentatively decided that if neither the customer nor the supplier controls how and for what purpose the asset is used throughout the period of use, the customer is considered to have the right to direct the use of the identified asset in either of the following circumstances:

a) the customer has the right to operate the asset or to direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions); or

b) the customer designed the asset, or caused the asset to be designed, in a way that predetermines during the period of use:

   i. how and for what purpose the asset will be used; or

   ii. how the asset will be operated.

In addition, the IASB decided that a supplier's protective rights over the identified asset typically define the scope of the customer's use of the asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset.

How should decisions be weighted when both the customer and the supplier have the ability to be involved in substantive decision-making about the use of the asset?
The leases Standard would require identification of which party has the ability to make the decisions that most significantly affect the economic benefits derived from the use of the asset. This assessment would be based on factors specific to the arrangement (consistent with the determination of which party has power over an investee under IFRS 10). In most cases, the decisions about 'how and for what purpose the asset is employed' during the period of use will be the decisions that most significantly affect the benefits derived from the use of the asset. For example, the decisions about the operations of a ship related to where and when the ship sails, and which goods it will transport are decisions that most significantly affect the benefits derived from the use of the asset.

Distinction between lease and service
The leases Standard would not include a definition of a service and, accordingly, this area will remain challenging. There are arrangements that involve significant use of an asset to provide a service.

The agenda paper discussed in May 2014 indicated that in order to differentiate a lease from a service, an entity would focus on the concept of control as defined in IFRS 10 and IFRS 15. If a supplier controls the use of the asset during the period of use, the contract is for services – the supplier uses the asset to deliver services to its customers. In contrast, if the customer controls the use of the asset during the period of use, the supplier does not have control over the asset. In that case, the customer has obtained the right to use the underlying asset and the contract contains a lease.

Lessee accounting model

The IASB tentatively agreed to adopt the right-of-use model that would require most leases (see below for exemptions) to be recognised on the balance sheet of lessees.

The IASB tentatively decided on a single model approach under which a lessee would account for most leases on balance sheet as financing the purchase of a right-of-use asset ("ROU asset"), thus eliminating the distinction between Type A and Type B leases included in the 2013 ED. Under the single model approach, the ROU asset is a non-financial asset, which would be accounted for consistently with other non-financial assets, e.g. amortised.

A corresponding liability would be recognised separately and accounted for at amortised cost, yielding an overall front-loaded expense profile, similar to existing finance leases. The ROU asset and lease liability would initially be measured at the present value of the lease payments.

IASB and FASB divergence
In bringing leases on-balance sheet for lessees, the FASB tentatively decided on a dual model approach similar to that proposed in the 2013 ED. Under this approach, a lessee would account for most existing capital/finance leases as Type A leases (with separate amortisation and interest) and most operating leases as Type B leases (with a single straight-line lease expense).

However, lease classification would be based on the existing principles of IAS 17, rather than whether the asset is property or not as proposed in the 2013 ED.

In addition, current bright lines existing under US GAAP would be eliminated (i.e. whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset).

Exemptions from the right-of-use model
In order to address the concerns received in response to the 2013 ED, the IASB decided to add some relief for preparers.

See further information in the sections on **Small-ticket leases** and **Short-term leases**.

Lessor accounting model

The IASB tentatively agreed that no significant changes are needed to the current lessor accounting model in IFRSs.

The IASB tentatively decided that a lessor should determine lease classification on the basis of whether the lease was effectively a financing or sale, or an operating lease, using guidance similar to the current requirements in IAS 17. Therefore, lease classification would focus on whether substantially all of the risks and rewards incidental to ownership of the underlying asset have been transferred to the lessee.

The IASB also decided to eliminate the receivable and residual approach originally proposed in the 2013 ED. Instead, a lessor would account for a lease as a sale or financing lease or an operating lease consistent with the current requirements in IAS 17.

Symmetry between lessee and lessor accounting

By retaining lease classification and accounting for lessors based on the existing guidance in IAS 17, the IASB decided against symmetry between the lessee and lessor accounting models based on cost-benefit considerations.

IASB and FASB divergence

The FASB tentatively decided on a similar approach to the one taken by the IASB. However, the FASB tentatively decided that a lessor would not be permitted to recognise a selling profit for any sales type lease that does not transfer control of the underlying asset to the lessee at lease inception (i.e. when the lessee has the ability to direct the use and obtain substantially all the remaining economic benefits of the underlying assets).

As a result, under US GAAP, if the lessor does not transfer control of the underlying asset, the selling profit would be deferred over the lease term, whereas under IFRS, all finance lease lessors would recognise any selling profit in accordance with existing guidance at lease commencement.

Small-ticket leases

The IASB tentatively decided to provide cost relief for small tickets held by a lessee as follows.

Portfolio exemption

An entity will be permitted to account for its leases at a portfolio level as an accounting policy choice. Accounting for leases at portfolio level would reduce the cost of applying the leases guidance for many entities with small-ticket leases. For example entities that lease IT equipment and cars as part of a master lease agreement would be able to apply this guidance. The IASB tentatively decided to include application guidance while the FASB tentatively decided to include that guidance in the basis for conclusions.

Impairment

If some, but not all, ROU assets within a lease portfolio are impaired, and the impairment is material to the entity, the entity would no longer be permitted to apply the leases guidance to that portfolio. Instead, the entity would need to split the original portfolio into smaller portfolios or apply the leases guidance at a contract level.

Small leases exemption

The IASB tentatively decided to permit an entity to exclude leases of small assets from the recognition and measurement requirements as an additional accounting policy choice. The exemption intents to capture leases such as those of small IT equipment and office furniture; however it would not function as guidance on how to apply materiality in the context of leases. The assessment of whether an asset would qualify for the exemption would be done on an absolute basis.

Materiality

The Boards tentatively decided not to include any explicit materiality guidance within the final leases Standard based on the fact that neither IFRS nor US GAAP provide materiality requirements at a standard level. Users would continue to use the guidance in IAS 8 to evaluate materiality for leases.

The IASB also tentatively decided that the final standard would include a requirement that the small asset exemption should apply only to leases of assets that are not dependent on, or highly interrelated with, other leases assets. Limiting the exemption for leases of small assets in this way would prevent large assets that are made up of small individual component leases being captured by the exemption.

In addition, the Basis for Conclusions of the final standard would include a discussion of the quantitative threshold that the IASB had in mind when deliberating the exemption.

Quantitative threshold

The agenda paper discussed by the IASB indicated a suggested threshold of $5,000 in terms of the value of the underlying asset when new. The agenda paper clarified that the threshold for a small leased asset exemption would differ from a capitalisation threshold in that it would be unrelated to materiality and the purpose of including this amount in the Basis for Conclusions would be to provide the context at the time the decision was made.

IASB and FASB divergence

The FASB tentatively decided not to move forward with an exemption for small leases.

Lease term

The IASB tentatively decided that:

(i) an entity should consider all relevant factors when assessing whether there is an economic incentive to exercise an option to extend, or not to terminate, a lease. An entity should include such an option in the lease term only if it is *reasonably certain* that the lessee would exercise the option having considered the relevant economic factors; and

(ii) purchase options should be treated similar to renewal and termination options.

Significant economic incentive
The assessment of whether the lessee has a significant economic incentive to exercise an option is based on facts and circumstances at lease commencement that are relevant to the decision the lessee will make to exercise or not to exercise an option, and is based on contract-based, asset-based, market-based and entity-based factors. The assessment is not based on the lessee's intention or past practice.

The term "significant" is effectively the same as the term "reasonably certain" which is used in existing IAS 17.

Reassessment of the lease term

The IASB tentatively decided that:

(i) a lessee should reassess the lease term only on occurrence of a significant triggering event that is within the control of the lessee and that would directly affect whether the lessee has a significant economic incentive to exercise an option. A significant change in market-based factors would not, in isolation, trigger reassessment; and

(ii) a lessor should not reassess the lease term.

Situations that would require reassessment
Reassessment would be required for actions taken by the lessee rather than for the mere passage of time or the occurrence of macroeconomic events.

An example that may trigger reassessment would be constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease, or to purchase the asset, becomes exercisable.

Short-term leases – *Updated*

The IASB tentatively decided that the final leases Standard would contain a scope exemption for recognition and measurement for short-term leases.

A short-term lease would have a lease term (see above) of 12 months or less.

A lessee would be permitted not to apply the recognition and measurement requirements to short-term leases as an accounting policy choice and instead recognise lease payments in profit or loss, typically on a straight-line basis.

An entity using this exemption would be required to disclose the short-term lease expense recognised in the current period as well as any qualitative information required for leases in general. Disclosure of the short-term lease commitments would be required if the short-term lease expense recognised does not reflect the short-term lease commitment.

The requirement in IFRS 3 *Business Combinations* which requires an acquirer to recognise assets and liabilities if the terms of an operating lease are favourable or unfavourable would not be retained. This decision was made to avoid a potential conflict with IFRS 3.

Lease modifications – Lessee accounting

The IASB tentatively decided to define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease. The modifications to be considered would only be those related to changes in scope of the lease and consideration paid by the lessee.

Lease modification vs lease reassessment
The definition of lease modification would differentiate between scenarios resulting in a lease reassessment (i.e. a change in lease term resulting from the exercise of an option to extend the lease when that option was included in the contract at inception) and those resulting in a lease modification (i.e. change in the lease term resulting from changes to the terms and conditions of the original lease).

Modifications resulting in a separate new lease – *Updated*

A lessee would account for a lease modification as a new lease, separately from the original lease, when the following occur:

(a) the modification increases the scope of the lease by adding the right to use one or more underlying asset; and

(b) the additional right of use is priced commensurate with its standalone price (in the context of that particular contract).

Modifications that do not result in a separate new lease – *Updated*

The IASB tentatively decided to distinguish lease modifications that do not result in a separate new lease when the modification:

(a) Extends the use of an underlying asset; or

(b) Reduces the scope of the lease; or

(c) Changes the consideration payable for the lease.

This approach focuses on the right of use of the asset and whether the modification affects that right of use or only the consideration paid for the right of use.

For a modification that either increases the scope of the original lease or changes the lease consideration, the lessee would use the updated lease payments and an updated discount rate to revise the lease liability and would recognise any difference as an adjustment to the ROU asset.

For a modification that reduces the scope of the original lease, the lessee would adjust the lease liability by using the revised lease payments and an updated discount rate, derecognise a proportionate amount of the ROU asset and recognise any difference as a gain/loss through earnings.

Discount rate
For modifications, the lessee would be required to use an updated discount rate in remeasuring the lease liability. The intention is to reflect the fact that in modifying the lease, the lessor's implicit rate, which is the discount rate that the lessee intents to approximate, changes.

Contract modification that reduces scope accompanied by significant change in discount rate
If a modification results in an insignificant reduction in scope but a significant change in the discount rate, the change in the lease liability would be separated into two components in order to determine the portion that impacts profit or loss: (1) the reduction in scope will have a corresponding impact in profit or loss and (2) the change in discount rate (i.e. any change other than scope) will have a corresponding impact on the ROU asset, without any impact on profit or loss.

Lease modifications – Lessor accounting

The IASB tentatively decided that a lessor would evaluate lease modifications in a manner consistent with contract modifications in IFRS 15 *Revenue from Contracts with Customers*.

Modifications resulting in a separate new lease

Consistent with the approach for lessees, a lessor would account for a lease modification as a new lease when:

(a) the lease modification grants the lessee an additional right of use not included in the original lease; and

(b) the additional right of use is priced commensurate with its standalone price (in the context of that particular contract).

Modifications that do not result in a separate new lease

The IASB tentatively decided that for operating leases, a lessor would account for a lease modification as a new lease from the effective date of the modification.

For finance leases, a lessor should apply the impairment and derecognition guidance in IFRS 9 to the lease receivable, including when assessing the effect of a lease modification.

This would mean no substantive change for IFRS lessors with respect to lease modifications.

Contract combinations

The IASB tentatively decided that an entity would combine two or more contracts entered into at, or near, the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if either of the following criteria is met:

(a) the contracts are negotiated as a package with a single commercial objective; or

(b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract.

Multiple contracts that form a single transaction
An entity may enter into multiple contracts in contemplation of one another, such that they, in substance, form a single arrangement. When the terms and conditions of a contract are negotiated in contemplation of another contract, they should be recognised as a single contract so that they reflect more accurately the economic impact of the transaction.

Variable lease payments

The IASB tentatively decided that the initial measurement of lease assets and lease liabilities would only include variable lease payments that depend on an index or a rate, measured using the index or rate at lease commencement.

Variable lease payments linked to usage or performance
Variable lease payments based on usage or performance of the asset would not be included in the initial measurement of the lease asset or lease liability but would be recognised in the income statement in the period in which they are incurred. This decision was primarily based on cost-benefit grounds.

Reassessment of variable lease payments

The IASB tentatively decided lessees would be required to reassess variable lease payments that depend on an index or a rate when there is a contractual change in the cash flows.

IASB and FASB divergence
The FASB tentatively decided not to require reassessment when the variable lease payment changes. Such changes would be recognised in profit or loss as they are incurred.

In relation to lessors, the IASB tentatively decided that a lessor should not be required to reassess variable lease payments that depend on an index or a rate.

In-substance fixed payments

The IASB tentatively decided that:

(a) variable lease payments that are in-substance fixed payments should be included in the definition of lease payments; and

(b) the Basis for Conclusions should note that variable lease payments that are in-substance fixed payments exist in practice.

IAS 17 *Leases* does not currently include guidance on when, if ever, variable lease payments that are in-substance fixed payments should be included within the definition of minimum lease payments although the IASB acknowledged that this concept was widely accepted. The IASB tentatively decided to include in-substance fixed payments because they do not create genuine variability, are unavoidable and indistinguishable from fixed payments and to avoid structuring opportunities.

Discount rate

The IASB tentatively agreed to:

- clarify what 'value' refers to in the definition of the lessee's incremental borrowing rate, but otherwise make no changes to the definition in the 2013 ED;
- describe the rate the lessor charges the lessee as the rate implicit in the lease, consistent with existing lessor guidance; and
- include initial direct costs of the lessor in the rate implicit in the lease.

Reassessment of the discount rate – *Updated*

Lessees would be required to reassess the discount rate only when a significant event or significant change in circumstances within the control of the lessee results in a change to the lease term or the assessment of purchase options, and for lease modifications that do not result in a separate new lease. However, the discount rate in a floating interest rate lease should be updated whenever the lease payments are updated.

The requirement to update the discount rate in a floating interest rate lease is consistent with IFRS 9 which indicates that the effective interest rate used to account for floating rate financial instruments for financial liabilities measured at amortised cost should be remeasured when future cash flows are re-estimated.

Lessors would not reassess the discount rate – this is consistent with the tentative decisions that lessors would not reassess the lease term or whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset.

Separating lease components

The IASB tentatively decided to retain the guidance in the 2013 ED on identifying separate lease components for both lessees and lessors.

The leases Standard would state that after determining that a contract contains a lease an entity shall identify each separate lease component within the contract. An entity shall consider the right to use an asset to be a separate lease component if both of the following criteria are met:

(a) the lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and

(b) the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

Separating lease and non-lease components

The IASB tentatively decided to:

- require lessors to separate lease and non-lease components and to allocate consideration in the contract to those components. A lessor should apply the guidance in IFRS 15 relating to the allocation of the transaction price to separate performance obligations when separating lease and non-lease components; and

- permit lessees an accounting policy choice either:

  – to separate lease components from non-lease components in a contract. The allocation should be based on stand-alone prices, if available, or otherwise on estimates, maximising the use of observable information; or

  – not to separate lease and non-lease components and instead recognise the entire contract as a lease.

Initial direct costs

The IASB tentatively decided that only incremental costs would qualify as initial direct costs. The final leases Standard would indicate that initial direct costs would only include incremental costs that an entity would not have incurred if the lease had not been obtained (for example sales commissions paid by a lessor).

The same definition would apply to both lessees and lessors.

Subleases

The IASB tentatively decided to require an intermediate lessor:

- to account for a head lease and sublease as two separate contracts unless the contracts meet the contract combination guidance (see above);

- to classify the sublease by reference to the ROU asset (i.e. the asset controlled by the intermediate lessor rather than the underlying asset controlled by the head lessor);

- not to offset lease assets and lease liabilities unless the offsetting requirements for financial instruments are met; and

- not to offset lease expense and lease income related to a head lease and a sublease, unless it recognises sublease income as revenue and acts as an agent in accordance with the 'principal-agent' guidance in IFRS 15.

The IASB also tentatively decided to allow an intermediate lessor to use the discount rate used for the head lease to account for a sublease classified as a finance lease if the rate implicit in the sublease could not be readily determined.

IASB and FASB divergence
The FASB tentatively decided that an intermediate lessor would classify a sublease by reference to the underlying asset rather than the ROU asset.

Balance sheet presentation – Lessee

The IASB tentatively decided to require a lessee to:

- present ROU assets either as a separate line item on the balance sheet or disclose them the notes.
  If a lessee does not present ROU assets as a separate line item, a lessee would (a) present ROU assets within the same line item where the corresponding underlying assets would be presented if they were owned and (b) disclose in the notes which line items on the balance sheet include ROU assets; and

- present lease liabilities either as a separate line item on the balance sheet or disclose them in the notes.

IASB and FASB divergence
The FASB tentatively decided that lease assets and lease liabilities should be presented separately for Type A and Type B leases, either on the face of the balance sheet or in the notes.

Cash flow presentation

The IASB tentatively decided to:

- require lessors to classify cash receipts from leases within operating activities; and

- require lessees to classify the principal portion of lease cash payments within financing activities and the interest portion paid for the lease liability in accordance with IAS 7 and to disclose lease payments separately from other cash flows.

IASB and FASB divergence
The FASB tentatively decided to require a lessee to classify:

(i) cash payments for the principal portion of the lease liability arising from Type A leases within financing activities;

(ii) cash payments for the interest portion of the lease liability arising from Type A leases within operating activities; and

(iii) cash payments arising from Type B leases within operating activities.

Sale and leaseback transactions

Determining whether a sale has occurred

The IASB tentatively decided that in determining whether a sale has occurred in a sale and leaseback transaction, the requirements for a sale in IFRS 15 would apply. The presence of the leaseback would not, in isolation, prevent the seller-lessee from concluding that it has sold the underlying asset to the buyer-lessor.

The final Standard would clarify that if the seller-lessee has a substantive repurchase option with respect to the underlying asset, the buyer-lessor would not obtain control of that asset and no sale would have occurred. In that case, the seller-lessee would account for the transaction as a financing arrangement. Conversely, a repurchase option that is not substantive would not preclude sale accounting.

In addition, the IASB tentatively decided not to include any additional application guidance in the final leases Standard regarding the determination of whether a sale has occurred.

IASB and FASB divergence
The FASB tentatively decided that if the leaseback is a Type A lease from the seller-lessee's perspective, no sale has occurred.

Accounting for the sale/purchase and leaseback

For sale and leaseback transactions in which a sale has occurred, the IASB tentatively decided that:

- a buyer-lessor would account for the purchase of the underlying asset consistently with the guidance that would apply to any other purchase of a non-financial asset (that is, without the presence of the leaseback);
- a seller-lessee would account for any loss on a completed sale in a sale and leaseback transaction consistent with the guidance that would apply to any other similar sale;
- a seller-lessee would only recognise the portion of the gain that relates to the residual asset but not the portion that relates to the ROU asset that has been retained (i.e. the seller-lessee has retained the right to use the underlying asset and has, in effect, sold its interest in the residual asset, rather than the entire underlying asset); and
- a seller-lessee and a buyer-lessor would account for the leaseback in the same manner as any other lease.

IASB and FASB divergence
The FASB tentatively decided that a seller-lessee would account for any gain on a completed sale in a sale and leaseback transaction consistently with the guidance that would apply to any other similar sale. Consequently, the gain would not be restricted to the residual asset sold by the seller-lessee.

Accounting for "off-market" terms

The IASB tentatively decided to retain the requirement in the 2013 ED to adjust the initial sale accounting if the consideration for the sale of the underlying asset is not fair value or the lease payments are not at market rates.

The IASB tentatively decided that an entity would determine any potential "off-market" adjustment on the basis of the difference between either (a) the sale price and the fair value of the underlying asset or (b) the present value of the contractual lease payments and the present value of fair market value lease payments, whichever is more readily determinable.

An entity would be required to maximise the use of observable prices and observable information in selecting the most appropriate benchmark to use in determining if the transaction is at-market or off-market and in calculating the adjustment for off-market terms.

The effects of any off-market term would be accounted as follows:

- any shortfall compared to fair value or market terms: as a prepayment of rent; and
- any excess over fair value or market terms: as additional financing provided by the buyer-lessor to the seller-lessee.

Accounting for "failed" sale and leaseback transactions

The IASB tentatively decided that both a seller-lessee and a buyer-lessor would account for a "failed" sale and leaseback transaction as a financing transaction. Consequently, the seller-lessee would not derecognise the underlying asset and instead would recognise any proceeds from the buyer-lessor as a financial liability.

Cost associated with returning an underlying asset at the end of a lease – *New*

The IASB tentatively decided that a lessee obligation to return an asset to the lessor in a specified condition at the end of the lease; to dismantle or remove the underlying asset or to restore the site on which the underlying asset had been located should be accounted for in accordance with IAS 37 – *Provisions, Contingent liabilities and Contingent assets*. Accordingly, a lessee would be required to:

(i) the initial estimate of the costs to be incurred should be included in the initial measurement of the right of use assets and the liability should be accounted for under IAS 37 (i.e. it should not be considered a lease liability)); and

(ii) the liabilities within the scope of IFRIC 1 – *Changes in Decommissioning, Restoration and Similar Liabilities* should be recognised by adjusting the right of use of the asset.

Consequential amendments to IAS 40 *Investment Property*

The IASB tentatively decided to confirm the proposed amendments to IAS 40 in the 2013 ED, i.e. right-of-use assets arising from property leases should be within the scope of IAS 40 if the property would otherwise meet the definition of investment property.

Lessee disclosure requirements

Overall disclosure objective

The IASB tentatively decided to retain the 2013 ED overall disclosure objectives requirements which aim to enable users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases.

IASB and FASB divergence

The FASB tentatively decided to retain the 2013 ED proposal requiring a lessee to disclose the following qualitative items:

- information about the nature of its leases (and subleases);
- information about leases that have not yet commenced but that create significant rights and obligations for the lessee;
- information about significant assumptions and judgements made in applying the requirements of the leases standards;
- the main terms and conditions of any sale and leaseback transactions; and
- whether an accounting policy election was made for the short-term lease exemption.

The IASB tentatively decided not to retain these requirements from the 2013 ED.

Quantitative disclosure requirements – *Updated*

The IASB tentatively decided that a lessee would be required to disclose:

a) lease expenses split by amortisation and interest expense. In addition, amortisation expense should be provided by class of asset;

b) short-term lease expense (for leases with a lease term of more than 30 days and less than one year) and small assets lease expense recognised in the reporting period. Additional disclosures should be provided if the short-term lease expense does not reflect a lessee's short-term lease commitments;

c) variable lease expense incurred in the period but not included in lease liabilities (or capitalised as part of an asset);

d) sublease income if the entity's main activity does not involve subleasing;

e) cash outflows for leases, and if an entity's subleasing income is material, the related cash inflows should be disclosed separately;

f) additions to ROU assets, including modifications to leases, extension options exercised but not previously included in the lease term and ROU assets arising from new leases;

g) gains or losses arising on sale and leaseback transaction should be disclosed separately gains or losses on disposals of other assets.

The IASB tentatively decided not to require a particular tabular format to present the quantitative information above, but that it should be presented in a single note.

In addition, a lessee would be required to disclose a maturity analysis of lease liabilities in accordance with IFRS 7 *Financial Instruments: Disclosures*. Judgement should be applied to determine the appropriate number of time bands.

The new lease standard will not require specific disclosures in respect of leases that are in scope of IFRS 5 beyond what is already required by IFRS 5.

IASB and FASB divergence
The FASB tentatively decided that a lessee should disclose:

- lease expenses separately for Type A and Type B leases;
- cash paid for amounts included in lease liabilities separately for Type A and Type B leases;
- a weighted average remaining lease term; and
- a maturity analysis of lease liabilities, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years, and reconciling the undiscounted cash flows to the discounted lease liabilities recognised in the statement of financial position.

Lessor disclosure requirements

The IASB tentatively decided that a lessor would be required to disclose:

- information about the nature of its leases, as well as information about significant assumptions and judgements made in applying the leases requirements;
- a table of lease income recognised in the reporting period;
- information about how it managed its risk associated with the residual value of its leased assets;
- a maturity analysis of the undiscounted future cash flows for Type A lease receivables that comprise the amounts receivable for each of the first five years following the reporting date and a total of the amounts for the remaining years thereafter, and a reconciliation of the undiscounted cash flows to the lease receivables recognised;
- a maturity analysis of the undiscounted lease payments to be received for Type B leases for each of the first five years following the reporting date and a total of the amounts for the remaining years thereafter; and
- a qualitative and quantitative explanation of the significant changes in the net investment in Type A leases during the reporting period.

The IASB tentatively decided that a lessor would be required to present assets under Type B leases as a class of property, plant and equipment separately from owned assets held and used by the lessor.

IASB and FASB divergence
The FASB tentatively decided that a lessor would be required to provide an explanation of the significant changes in the components (other than the lease receivable) of the net investment in Type A leases during the reporting period. The FASB will consider disclosures related to Type A lease receivables as part of its impairment project.

Transition Requirements

Leases previously classified as operating leases – Lessees

The IASB tentatively decided that a lessee can choose either a fully retrospective approach or a modified retrospective approach on transition. The IASB tentatively decided that the choice of whether to apply the new leases standard fully retrospectively should be applied consistently to a lessee's entire portfolio of former operating leases.

Under the fully retrospective approach, a lessee would transition all elements of its lease portfolio as if the requirements of the new leases standard had always been applied. This would include the restatement of comparative figures and disclosure about the effect of applying the new leases standard in accordance with IAS 8.

The modified retrospective approach would be similar to that permitted in IFRS 15 and IFRS 9, with additional disclosure requirements to mitigate the lack of comparability at transition. To apply the modified retrospective approach, the IASB tentatively decided that:

(i) a lessee should not restate comparative figures;

(ii) a lessee should recognise the cumulative effect of initially applying the new standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application;

(iii) a lessee should measure the lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application;

(iv) a lessee would be permitted a choice of two measurement approaches for the ROU asset at the date of initial application, chosen on a lease-by-lease basis:

- measure the ROU asset as if the new leases standard had always been applied, but using a discount rate based on the lessee's incremental borrowing rate as at the date of initial application; or
- measure the ROU asset at an amount equal to the lease liability, adjusted by the amount of any previously recognised prepaid or accrued lease payments;

(v) a lessee could apply a single discount rate to a portfolio of leases with reasonably similar characteristics;

(vi) a lessee should adjust the ROU asset by the amount of any previously recognised onerous lease provisions as an alternative to performing an impairment review;

(vii) a lessee could apply an explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application (as determined for the short-term lease exemption). A lessee could instead account for these leases in the same way as short-term leases, i.e. by continuing to apply operating lease accounting. A lessee would be required to disclose the cost associated with these leases within the short-term lease expense in the annual reporting period that includes the date of initial application;

(viii) a lessee would not need to include initial direct costs in the measurement of the ROU asset; and

(ix) a lessee could use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

Under the modified retrospective approach, a lessee would be required to disclose the following:

a. the weighted average incremental borrowing rate at the date of initial application;

b. an explanation of any differences between:

   i. the result of discounting the operating lease commitments reported under IAS 17 Leases at the end of the annual reporting period preceding the date of initial application; and

   ii. lease liabilities recognised on the balance sheet immediately after posting the cumulative catch-up adjustment on the date of initial application.

IAS 34 paragraph 16A requires that an entity should disclose a description of the nature and effect of changes in accounting policies. The IASB confirmed that an entity should consider, based on the specific impact of the new leases standard on its financial statements, whether it would be appropriate in the interim financial statements in the year of initial application to provide similar disclosures to those required in the annual financial statements.

Leases previously classified as operating leases – Lessors

The IASB tentatively decided that, with the exception of accounting for subleases, a lessor should continue to apply its current accounting for any leases that were ongoing at the date of initial application (i.e. those leases that were previously accounted for under IAS 17 and continue to be in place at the date of initial application).

Leases previously classified as operating leases – First-time adopters

The IASB tentatively decided that IFRS 1 should permit a first-time adopter to apply the modified retrospective approach.

However, for a first-time adopter, the following adjustments would be made to the modified retrospective approach:

(a) the date of initial application should be regarded as the date of transition to IFRSs in accordance with IFRS 1; and

(b) there would be no explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application.

Leases previously classified as finance lease

The IASB tentatively decided that an entity would not change its accounting for finance leases existing at the date of initial application.

Sale and leaseback transactions

The IASB tentatively decided that a seller-lessee should not perform a reassessment of historic sale and leaseback transactions to determine whether a sale occurred in accordance with IFRS 15.

For sale and leaseback transactions that had been classified as finance leases under IAS 17, a seller-lessee should not perform any retrospective accounting specific to the sale and leaseback arrangement. Instead, the seller-lessee should account for the leaseback in the same manner as any other finance lease that was ongoing at the date of initial application and should continue amortising any gain on sale in the same manner as under IAS 17.

For sale and leaseback transactions that had been classified as operating leases under IAS 17, a seller-lessee should not perform any retrospective accounting specific to the sale and leaseback arrangement. Instead, a seller-lessee should account for:

- the leaseback in the same manner as any other operating lease that was ongoing at the date of initial application;
- any deferred gains or losses that relate to off-market terms at the date of initial application as an adjustment to the leaseback ROU asset.

A seller-lessee would only be required to apply the partial gain recognition approach in the new leases standard to new sale and leaseback transactions entered into after the date of initial application.

Subleases

The IASB tentatively decided that an intermediate lessor would be required to:

(i) reassess each existing operating sublease at the date of initial application to determine whether it is classified as an operating lease or a finance lease under the requirements of the new leases standard (this assessment would be made with reference to the ROU asset associated with the head lease and not with reference to the underlying asset as would be the case under IAS 17);

(ii) base this reassessment on the remaining contractual terms of the head lease and the sublease (rather than performing a retrospective reassessment);

(iii) for those subleases that had been classified as operating leases under IAS 17 and would be classified as finance leases under the new leases standard, to account for the sublease as a new finance lease entered into on the date of initial application.

Definition of a lease

The IASB tentatively decided that the new leases standard should permit (but not require) an entity to grandfather the definition of a lease for all contracts that were ongoing at the date of initial application. Accordingly, an entity could continue to account for contracts that contain a lease under the existing requirements of IAS 17 and IFRIC 4 as containing a lease when applying the new leases standard; and an entity would not need to account for contracts that did not contain a lease under the existing requirements of IAS 17 and IFRIC 4 as a lease when applying the new leases standard.

The agenda paper discussed by the IASB indicated that the staff envisaged only very narrow differences in outcomes between the application of IFRIC 4 and the IASB tentative decisions on the definition of a lease. These differences would arise when a lessee takes all (or substantially all) of the output of the underlying asset during the lease term (and the contract is priced in a particular way) but does not have any decision-making rights over the use of that asset. Such a contract would be a lease under IFRIC 4 but a service under the new leases standard.

The IASB also tentatively decided that if an entity chooses to grandfather the definition of a lease, it should do so for all contracts that were ongoing at the date of initial application and disclose that fact.

IASB and FASB divergence
The IASB and FASB held separate discussions for transition requirements given that the Boards had previously tentatively decided on different accounting models for leases.

A summary of the FASB transition requirements can be found under: http://www.iasplus.com/en-us/publications/us/aje/2015/0226

Effective date – *New*

The IASB tentatively decided that entities would be required to apply the new lease standard for annual periods beginning on or after 1 January 2019 with earlier application permitted. However, entities that early adopt the new lease standard are also required to apply IFRS 15 *Revenue from Contracts with Customers* in the same reporting period.

Thinking ahead

- The concept of an operating lease for lessees would be eliminated, except for short-term leases, and therefore all leases would be recognised in the statement of financial position. An asset and a corresponding obligation would be recognised for the lessee's right to use the leased asset and obligation to pay rentals, respectively.

- Robust accounting policies may need to be developed because of the extent to which judgement could be involved. For example, a significant amount of judgement may be necessary to determine the lease term at lease inception.

- System modifications and enhancements may be necessary to track leases individually and/or at portfolio level and to perform the calculations necessary to determine the lease term and lease payments.

- Lessees should consider the effect the new leasing model will have on existing debt covenants.

- Lessees should consider whether performance metrics need to be modified and analysts educated on the effect of the new leases Standard.

- Lessees should consider whether the terms of new and existing lease contracts should be modified because of the proposed model.

Next steps – *Updated*

The IASB plans to issue the final Standard by the end of 2015.

Appendix A

Summary of the proposals in 2013 revised exposure draft

The following represents a summary of the proposals included in the 2013 ED.

Definition of lease

The 2013 ED defined 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 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 lease. 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.

Classification of leases

Under the proposals in the 2013 ED, 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.

Lessee accounting model

The 2013 ED proposed 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 ("ROU asset") and a lease liability in the statement of financial position for each lease. The ROU 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 ROU asset. The lessee's classification of the lease would determine the subsequent measurement of the ROU asset and accordingly, the pattern of expense recognition.

For Type A leases, the lessee would amortise the ROU 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 ROU 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.

Lessor accounting model

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 rate 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.

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.

Leases with variable lease terms

The 2013 ED proposed 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.

Leases with variable lease payments

The 2013 ED proposed 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 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 ROU 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.

Presentation

Lessees

Statement of financial position

A lessee would report a ROU asset and a lease liability for all leases that do not meet the definition of a short term lease. ROU 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. ROU 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.

Lessor

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 operating 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.

Disclosure requirements

The 2013 ED proposed 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.

Contract modifications

Modifications to the contractual terms and conditions that result in a significant change to the existing lease should be accounted for as a new contract with any differences recognised in profit or loss.

Discount rate

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.

Lessors should discount lease payments using the rate they charge in the lease.

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).

Impairment

Lessees and lessors would follow guidance in IAS 36 *Impairment of Assets* when evaluating the ROU asset and residual asset. The lease receivable would be assessed for impairment by lessors consistent with other financial assets under IAS 39 *Financial Instruments: Recognition and Measurement*.

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 ROU asset and to the amount recognised as the lessor's lease receivable.

Sale and leaseback

In determining whether the transferee has obtained control of the asset (indicating a sale transaction), entities would apply the requirements in the new 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 ROU asset.

Transition

The 2013 ED proposed 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 a 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.

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