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IFRS in Focus
IASB issues Exposure Draft on Lease Accounting

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Join Us!
Deloitte's IFRS Global Office will be holding a webcast on 8 September, 9:00-10:00am London time (GMT +1) to discuss important third quarter developments from the IASB including the proposals on revenue recognition and leases. For more information and to register, please click here.

For more information please see the following websites:

www.iasplus.com

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The Bottom Line

- The proposals would significantly affect the accounting for lease contracts for both lessees and lessors.
- Lessees would recognise assets and liabilities for all leases – operating leases and "lease classification" in the current IAS 17 lessee accounting model would no longer exist.
- For 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.
- Estimates of contingent rentals, residual value guarantees and term option penalties would be included as part of the lease liability using an expected outcome approach.
- Rentals during renewal periods would be included as part of the lease liability on the basis of the longest possible lease term that is more-likely-than-not to occur.
- A reassessment of the estimates of lease payments and renewal periods would be required if facts or circumstances indicate that there would be a significant change.
- Lessors would apply one of two models - the performance obligation approach or derecognition approach – depending on whether control and all but a trivial amount of the risks and benefits of the entire underlying asset are transferred to the lessee.
- The identification of non-lease components would become more important under the proposals.
- Extensive disclosures would be required for both lessees and lessors.
- The proposed transition requirements would not grandfather existing leases and would require adjustment of comparative periods.
- There is the potential for significant deferred tax consequences associated with the adoption of the proposals.
- The comment period ends on 15 December 2010, with a final standard expected to be published in June 2011.
- Lessees and lessors should begin to evaluate how the proposals would affect their financial statements, the future structuring of lease contracts, performance metrics used, debt covenants, accounting policies, and information systems.

The proposals

On 17 August 2010, the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) published a joint exposure draft ED 2010/9 Leases. The ED would eliminate the distinction between operating leases and finance leases and would introduce new accounting models for lessees and lessors. Lessees would no longer be permitted to treat leases as "off-balance sheet" financings but instead would be required to recognise an asset and liability for all leases within the scope of the proposals.

The Boards have been discussing lease accounting since 2006 when the project was added to the Memorandum of Understanding. Many believe that current lease accounting is too reliant on bright lines and subjective judgements that result in economically similar transaction being accounted for differently. The Boards published a Discussion Paper in March 2009 which focused on the lessee accounting and have since decided to address both lessee and lessor accounting.

Scope

Contracts specifically identified as not being within the scope of the ED are: (1) leases of intangible assets, (2) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, (3) leases of biological assets, and (4) leases between the date of inception[1] and date of commencement of a lease[2] if they meet the definition of an onerous contract under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Observation

It is common in some jurisdictions for leases of land to be for a very long period of time (e.g., 999 years). The Boards discussed whether long-term leases of land are better reflected as a purchase or sale. The Boards decided that a long-term lease of land that does not meet the criteria for a purchase or sale (discussed below) is no different from any other lease and therefore should be within the scope of the ED.

Investment properties

A lessee of investment property that elects to measure the property at fair value under IAS 40 *Investment Property* would measure the right-of-use asset in accordance with IAS 40 after initial recognition. Changes in the liability to make lease payments after initial recognition would be recognised in profit or loss in accordance with IAS 40. Also, a lessor that leases investment property to others would not apply the proposals if the lessor elects to measure the property at fair value in accordance with IAS 40. For lessors that use the fair value model, the ED proposes to amend IAS 40 to require income on investment property to be recognised on a straight-line basis over the lease term.

Purchases or sales

Contracts that represent the purchase or sale of the underlying asset would be scoped out of the proposed standard and accounted for under existing IFRSs. A contract would be considered a purchase or a sale if at the end of the term the contract transfers:

- control of the underlying asset; and
- all but a trivial amount of the risks and benefits associated with the entire underlying asset to another entity.

The ED indicates that a contract normally would meet both of these criteria when the contract automatically transfers title to the underlying asset at the end of the contract or includes a bargain purchase option where it is reasonably certain, at the inception of the lease, that the lessee will exercise the option. However, an entity would consider all relevant facts and circumstances and not base its conclusion solely on how the transaction is described in the contract. This determination is made at inception of the lease and is not subsequently reassessed.

Observation

The transfer of title of the underlying asset, in and of itself, would not be sufficient for an entity to conclude that the transaction should be considered a purchase or sale. All but a trivial amount of the risks and benefits must also be transferred to the lessee. Although the ED provides no specific guidance for determining what constitutes "trivial", such a low threshold suggests that if a lessor provides a warranty or guarantee to the lessee, or shares in future profits on the sale of the asset, the transaction may be considered a lease rather than a purchase or sale (regardless of whether title is transferred).

Lease contracts with an exercised purchase option

Lease contracts after a lessee has exercised a purchase option would not be within the scope of the ED because the Boards concluded that the exercise of the option terminates the lease and results in a purchase of the asset. Accordingly, such a contract would be accounted for by the lessee as a purchase and by the lessor as a sale under existing IFRSs only when the option is exercised. The exercise price would not be considered a lease payment but would be part of the cost of acquiring the underlying asset.

1 Date of inception of the lease is defined in the ED as "the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement".

2 Date of commencement of the lease is defined in the ED as "the date on which the lessor makes the underlying asset available for use by the lessee".

Short-term leases

The Boards provide some relief to both lessees and lessors for short-term leases (defined in the ED as "a lease that, at the date of commencement of the lease, has a maximum possible lease term, including options to renew or extend, of twelve months or less"). A lessee still would need to record a right-of-use asset and a corresponding liability but could elect, on a lease-by-lease basis, to measure the liability at the undiscounted amount of the lease payments and the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs.[3] A lessor could elect, on a lease-by-lease basis, not to recognise a lease receivable or a liability but continue to recognise the underlying asset and recognise lease payments in profit or loss over the lease term.

Contracts that contain both lease and service components

If a contract contains a lease, but also contains a service component, the ED would generally not apply to the "distinct" service components within the contract. A service component would be considered distinct if the entity or another entity either sells an identical or similar service separately or the entity could sell the service separately because the service has a distinct function and a distinct profit margin.

Lessees and lessors would allocate the payments required under the contract between the distinct service and lease components based on the guidance in paragraphs 50-52 of the Revenue Recognition ED, *Revenue from Contracts with Customers* (i.e., in proportion to the standalone selling price of each component). However, a lessee or lessor that applies the performance obligation approach would treat the entire contract as a lease if they are unable to allocate the payments between the distinct service and lease components.

If the service component is not distinct, lessees and lessors that apply the performance obligation approach would treat the entire contract as a lease. However, lessors that apply the derecognition approach would be required to allocate the payments between the service and lease components on a reasonable basis even if the service component is not distinct.

The determination of whether a service component is distinct is made at lease inception. If the payments required under the contract change after the commencement of the lease, an entity would determine the amount of the change attributable to the lease and service components. If such a determination is not possible, an allocation applying the same proportion as used at the date of commencement would be acceptable.

Lessee accounting

Overall model

The lessee accounting model is based on a right-of-use approach. Upon lease commencement, the lessee obtains a right to use an asset for a specified period and would recognise an asset reflecting that right and a liability for its obligation to pay rentals. The proposed model differs from the current lease accounting model where a lessee accounts for its right to use the leased asset either by recognising an asset and liability (i.e., capital/finance lease) or as an executory contract (i.e., operating lease) depending on the terms of the lease.

Initial measurement

As noted above, a lessee would recognise a right-to-use asset and an obligation to make lease payments during the lease term for all leases. Other than short-term leases, the initial measurement of the obligation to make lease payments would be at the present value of the lease payments, discounted using the lessee's incremental borrowing rate or the rate the lessor charges the lessee, if it can be readily determined. The right-of-use asset would be initially measured at the same amount as the obligation to make lease payments plus any initial direct costs. The two key components that a lessee must take into account when initially measuring the right-of-use asset and the lease liability are (1) the lease term and (2) the lease payments – both of these concepts are discussed in more detail below.

The ED does not address the effect of lease incentives (that is, payments a lessor makes to a lessee as an incentive for the lessee to enter into the lease) on the initial measurement of the right-of-use asset and lease liability.

3 Initial direct costs are defined as "recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made".

> **Observation**
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> The proposals could affect key performance metrics. An increase in assets and liabilities could result in lower asset turnover ratios, lower return on capital, and an increase in debt to equity ratios which could impact borrowing capacity or compliance with loan covenants.

Lease term

According to the ED, the lease term is defined as "the longest possible term that is more likely than not to occur". An entity would need to estimate the probability that each possible lease term would occur by taking into account explicit and implicit renewal options or early termination options included in the contract and by operation of the statutory law. The ED lists factors that a lessee would consider in assessing the probability of each possible lease term, including:

- contractual factors such as the level of lease payments (e.g., bargain renewal rates) and contingent payments (e.g., termination penalties, residual value guarantees, refurbishment costs);
- non-contractual factors such as the existence of significant leasehold improvements, costs of lost production, relocation costs, and tax consequences;
- business factors such as whether the underlying asset is crucial to the lessee's operations or is specialised in nature; and
- past experience or future intentions of the entity.

Observation

The current lease accounting model requires renewal options to be included in the accounting lease term if they are "reasonably certain" of being exercised. Current practice has generally interpreted "reasonably certain" as a high threshold. As a result, it is likely that the lease term under the proposed model would be longer, or at least as long, as the accounting lease term under IAS 17. In addition, lessees will need to consider carefully all renewal options – including "month-to-month" renewals where a lessee has the unilateral right to continue using the leased asset on a month-to-month basis at the end of the contractual lease term – as part of this analysis.

Example

The following example, adapted from the ED, illustrates how a lessee would determine the lease term under the proposed model.

A lessee enters into a non-cancellable 10 year lease with two 5 year options to renew. Based on contractual and non-contractual factors, the entity assigned the following probabilities to each of the potential lease terms:

40% probability of 10 year term

30% probability of 15 year term

30% probability of 20 year term

Analysis

There is a 30 percent probability of a 20-year lease term, a 60 percent probability of at least a 15-year lease term, and a 100 percent probability that the lease term will be 10 years. Therefore, the longest possible lease term more likely than not to occur is 15 years.

Lease payments

The proposals would require a lessee to determine the lease payments payable during the lease term using an expected outcome approach that is described in the ED as "the present value of the probability-weighted average of the cash flows for reasonable number of outcomes". The lease payments include estimates of contingent rentals, payments under residual value guarantees between the lessee and lessor and payments to the lessor under term option penalties. When determining the present value of the lease payments, a lessee would develop reasonably possible outcomes, estimate the amount and timing of cash flows for each outcome, calculate the present value of those cash flows and probability-weigh the cash flows for each outcome.

The ED includes other guidance for contingent rentals that depend on an index or a rate. A lessee would determine the expected lease payments that are based on an index or a rate using forward rates if they are readily available. If forward rates are not readily available, the lessee would use the prevailing rates.

Although purchase options are considered as part of the analysis to determine whether a lease contract represents the purchase or sale of the underlying asset (see Scope section above), under the proposed model, if a contract is determined to be within the scope of the lease accounting guidance, the purchase option would only be accounted for when it is exercised (i.e., the exercise price is not part of the lease payments).

Observation
The inclusion of contingent rentals using an expected outcome approach would represent a significant change from the current lease accounting model that generally excludes contingent rentals from minimum lease payments. The need to develop scenarios and probabilities based on information that could differ from lease to lease coupled with the need to reassess the estimate (discussed below) could make this requirement costly and time-consuming for many entities.

Subsequent measurement and reassessment
After the date of commencement of the lease, a lessee would measure the liability for lease payments at amortised cost and recognise interest expense using the effective interest method. The ED provides two approaches to measuring the right-of-use asset – at amortised cost or fair value in accordance with the revaluation model in IAS 16 *Property, Plant and Equipment*. A lessee that chooses to measure the right-of-use asset at amortised cost would amortise the asset on a systematic basis over the lease term or useful life, if shorter, in accordance with IAS 38 *Intangible Assets*.

Observation
Total lease related expense will be front-end loaded as compared to current operating lease treatment due to the recognition of interest expense using the effective interest method. However, because rental expense is not recorded under the new model – EBITDA (Earnings before Interest, Taxes, Depreciation and Amortisation) would be higher as compared to current operating lease accounting.

A lessee may choose to measure the right-of-use asset at fair value less any amortisation and impairment if it revalues (1) all owned assets in that class of property, plant and equipment and (2) all right-of-use assets relating to the class of property, plant and equipment to which the underlying asset belongs. A lessee would need to revalue the right-of-use asset regularly and recognise any gains and losses in the statement of comprehensive income in accordance with IAS 38.

The right-of use asset would be evaluated for impairment at each reporting date in accordance with IAS 36.

The ED requires a lessee to reassess the carrying amount of the liability "if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period." If there is an indication of a change to the lease term, the liability to make rental payments would be adjusted to reflect the change in the estimated lease term (with a corresponding adjustment to the right-of-use asset). Changes to the estimate of contingent rentals, term option penalties and residual value guarantees would be recognised in profit or loss to the extent those changes relate to the current or prior periods. Changes related to future periods would be recognised as an adjustment to the right-of-use asset.

A lessee would not change its discount rate unless the contingent rentals are contingent on reference interest rates in which case the lessee would need to revise the discount rate for changes in the reference interest rates and recognise changes in profit or loss.

Observation
The requirement for a lessee to evaluate regularly whether there are new facts or circumstances related to contingent rentals and lease term assumptions will be particularly challenging for entities that enter into a large number of leases and would represent a significant change from the current lease accounting model. Although lease accounting is performed on a lease by lease basis, entities with large portfolios of leases may need to develop robust accounting policies that are not only compliant with the ED's requirements but also allow for a practical application of those requirements (e.g., entities may need to develop typical indicators that would trigger a change in the accounting lease terms for a particular type of leased asset).

Significant system changes may be required to allow for the determination and tracking of the lease term and contingent rental assumptions.

The requirement to reassess estimates of lease term and contingent rentals could result in increased volatility in the statement of financial position and comprehensive income.

Lessor accounting

The ED proposes two accounting models for lessors – the performance obligation approach and the derecognition approach. The model to apply for a particular lease contract would be based on whether the lessor retains significant risks and benefits associated with the underlying asset. A lessor that retains exposure to significant risks or benefits associated with the underlying asset would apply the performance obligation approach; otherwise, the lessor would apply the derecognition approach. The determination on the appropriate model to apply would be made at inception of the lease and would not be reassessed.

The exposure to significant risks and benefits could occur either during the expected term of the lease contract (e.g., due to significant contingent rentals during the lease term, options to extend or terminate the lease, or material non-distinct services provided under the current lease) or after the lease term (e.g., when the lease term is not significant in relation to the useful life of the asset or a significant change in the value of the underlying asset is expected). The credit risk of the lessee would not be considered in this analysis.

In general, the two models are intended to follow the business model of a lessor. A lessor whose business model is primarily generating returns from the active management of the underlying assets (i.e., asset risk is the primary risk) would apply the performance obligation approach (e.g., a lessor that leases an asset to multiple parties over the asset's life or that sells the asset at the end of the lease term). Conversely, lessors whose business model is to lease an asset to a single party over the asset's life such that credit risk is the primary risk would apply the derecognition approach (e.g., manufacturer/dealer lessors that use leases as an alternative means of realising value from the goods they would otherwise sell). However, a careful analysis that considers all facts and circumstances would need to be performed to determine which model is most appropriate.

> **Observation**
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> Lessors that currently recognise up-front profit on lease contracts may not be able to do so under the proposed model. Lessors will need to determine the extent to which the lease contract exposes them to the risks and benefits associated with the underlying asset during and subsequent to the lease term. Significant judgement will be required as there are no bright lines for determining the appropriate model to use.

Performance obligation approach

Recognition

Under the performance obligation approach, the lessor has a performance obligation to permit use of the underlying asset during the lease term. Therefore, at the commencement of the lease, a lessor would recognise a lease liability equal to the present value of expected lease payments using the rate charged by the lessor. A lessor would recognise an asset for its right to receive lease payments equal to the sum of the present value of the lease payments, including initial direct costs incurred by the lessor, discounted using the rate charged by the lessor. A lessor would not derecognise the underlying asset.

Measurement

The initial measurement of the lease receivable at the date of inception of the lease would be based on the longest possible lease term that is more likely than not to occur determined using an expected outcome approach (like the approach used by the lessee as described above). Contingent rentals and residual value guarantees provided by the lessee are included in the measurement of the receivable, however, unlike lessee accounting, these amounts would be included only if they can be "measured reliably". An estimate of expected payments under term option penalties would also be included in the measurement of the receivable. A lessor would use the readily available forward rates or indices, or if not available, the prevailing rates or indices for contingent rentals that depend on an index or a rate.

Subsequent measurement

The lease payment receivable would be measured subsequently at amortised cost using the effective interest method. The liability would be amortised on the basis of the pattern of use of the underlying asset by the lessee (e.g., hours of use or units produced) or on a straight-line basis if the pattern of use cannot be determined reliably. The lessor would apply IAS 39 *Financial Instruments: Recognition and Measurement* at each reporting date to determine if the lease receivable is impaired.

Reassessment
A lessor would be required to reassess the carrying amount of the lease receivable if there is a change in facts or circumstances that indicates that there is a significant change to the reported amount of the lease receivable. When such a change exists, the estimated lease term, expected payments under contingent rentals and residual value guarantees that can be measured reliably and term option penalties would need to be reassessed. Changes to the lease term would result in an adjustment to the lease receivable and the lease liability. Changes in the estimated lease payments would be recognised in profit or loss to the extent the related lease liability has been satisfied; otherwise as an adjustment to the lease liability. The portion of the adjustment, if any, that would make the liability fall below zero would be included profit or loss.

A lessor would not change its discount rate due to changes in lease term or when amounts payable under contingent rentals vary, unless the contingent rentals are contingent on reference interest rates, in which case the lessor would revise the discount rate for changes in the reference interest rates.

Derecognition approach
Under the derecognition approach, the obligation to deliver the asset to the lessee is the performance obligation and it is satisfied at lease commencement. A lessor would recognise an asset for the right to receive rental payments, remove a portion of the carrying amount of the underlying asset from its statement of financial position and reclassify as a residual asset the portion of the carrying amount of the underlying asset that represents the lessor's rights in the underlying asset that it did not transfer. Additionally, at the date of commencement of the lease, a lessor would recognise lease income representing the present value of the lease payments and lease expense representing the cost of the portion of the asset derecognized. These amounts would be classified as revenue and cost of sales if generated in the course of the lessor's ordinary activities.

Observation
The amount of up-front profit on lease contracts under the derecognition approach may differ as compared to the current finance lease accounting model for lessors because of the differences in proposed treatment of contingent rentals, residual value guarantees and other elements of lease contracts

Measurement
The lease receivable would be measured at the present value of the lease payments discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor. The measurement of the lease term, contingent rentals, residual value guarantees and term option penalties would be identical to the performance obligation approach.

The portion of the underlying asset derecognised would be calculated at the date of inception of the lease as follows:

$$\frac{\text{Fair value of the right to receive lease payments}}{\text{Fair value of the underlying asset}} \times \text{Carrying amount of the underlying asset}$$

The remaining portion of the underlying asset that is not derecognised would be reclassified as the residual asset.

Subsequent measurement
The lessor would measure the lease receivable at amortised cost using the effective interest method. The residual asset would not be remeasured unless there is a change in lease term or the asset is impaired. The lessor would apply IAS 39 at each reporting date to determine if its right to receive lease payments is impaired, and IAS 36 to determine if the residual asset is impaired.

Reassessment
The expected lease payments (including the lease term, contingent rentals, term option penalties and residual value guarantees) would be reassessed at each reporting period if any new facts or circumstances indicate a significant change in the right to receive rental payments. If reassessment of the lease term results in a change in the residual asset, that change would be allocated to the rights derecognised and the residual asset and the carrying amount of the residual asset would be adjusted accordingly. Changes related to contingent rentals and residual value guarantees that can be measured reliably and term option penalties would be recognised in profit or loss.

Like under the performance obligation approach, the lessor would not change its discount rate due to changes in lease term or when amounts payable under contingent rentals vary, unless the contingent rentals are contingent on reference interest rates, in which case the lessor would revise the discount rate for changes in the reference interest rates.

Sale and leaseback transactions

An entity may enter into contracts to transfer an asset to another party and then lease that asset back. The contracts taken together would be considered a "sale and leaseback transaction" if they are "entered into at or near the same time, negotiated as a package with a single commercial objective or performed either concurrently or consecutively." According to the ED, if the transaction meets the criteria to be considered a sale and leaseback transaction and meets the conditions for a sale (i.e., control of the underlying asset has been transferred along with all but a trivial amount of the risks and benefits associated with the underlying asset), the transferor would account for the transaction as a sale in accordance with other applicable IFRSs and for the right-of-use asset and obligation to make lease payments in accordance with the proposed guidance for lessees. Likewise, a transferee would account for the transaction as a purchase in accordance with other applicable IFRSs and the lease in accordance with the performance obligation approach.

The ED lists conditions that would normally preclude purchase and sale accounting. If the transaction is not a sale or purchase, the transferor would account for the contract as a financing with the amount received recognised as a financial liability and the transferee would recognise the amount paid as a receivable in accordance with applicable IFRSs.

If the consideration for a purchase or sale and the lease payments are not at fair value, the transferor adjusts (1) the right-of-use asset to reflect current market rates and (2) the gain or loss by any difference between the present value of lease payments based on the terms specified in the lease and the present value of the lease payments based on current market rates. A transferee adjusts the carrying amount of the underlying asset and the lease liability it recognises under the performance obligation approach to reflect current market rates for the lease payments for that lease contract.

> Observation
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> The proposed sale and leaseback rules could represent a significant change to the current accounting under IAS 17. Under the ED, an entity that sells an asset and subsequently leases that asset back needs to consider carefully its continuing involvement with the underlying asset before recognising a sale. Many of the conditions listed in the ED that may preclude sale and leaseback accounting may not be considered under current practice.

Subleases

An entity may lease an asset from a lessor and then lease that same asset to a different party (commonly referred to as subleases). The same entity is both a lessee that leases an asset from a head lessor, and an intermediate lessor that subleases the same underlying asset to a sublessee. Under the ED, an intermediate lessor would account for its assets and liabilities arising from the head lease in accordance with the lessee model and would account for its assets and liabilities arising from the sublease in accordance with the lessor model. This could result in a different measurement of the head lease and a sublease because a reliability threshold would exist for measuring lease payments for lessors and would not for lessees.

Presentation

Lessee

A lessee would present right-of-use assets within property, plant and equipment or investment property but separate from other assets that the lessee owns and does not lease. The liabilities to make lease payments would be presented separately from other financial liabilities. The interest and amortisation expense would be presented separately from other amortisation and interest expense, either in profit or loss or disclosed in the notes. The cash payments would be classified as a separate financing activity in the statement of cash flows.

> **Observation**
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> Lease payments will be treated as financing cash outflows in the statement of cash flows. Operating lease rent payments are treated currently as an operating cash flow. Thus, for a lease currently classified as an operating lease, operating cash flows under the ED would be higher as compared to the current model.

Lessor – Performance obligation approach
A lessor would present the underlying asset, lease receivable, and lease liability on a gross basis in the statement of financial position, with a total of these items as a net lease asset or net lease liability. An intermediate lessor in a sublease would present the liability to make lease payments under a head lease separately from other assets and liabilities arising from the sublease and would present the right-of-use asset, lease receivable under sublease, and lease liability on a gross basis in the statement of financial position, with a total of these items as a net lease asset or net lease liability. A lessor would present in profit or loss the interest income on the lease receivable, lease income resulting from the satisfaction of the performance obligation and depreciation expense separately. Cash receipts would be presented separately from other cash flows from operating activities if the direct method is used while the changes in the lease receivable would be presented separately from other operating receivables if the indirect method is used.

Lessor – Derecognition approach
A lessor would present the lease receivable separately from other financial assets. The residual assets would be presented separately within property, plant and equipment. Lease receivables and residual assets that arise under subleases would be distinguished from other lease receivables and residual assets. The presentation in profit or loss will either be gross or net in a single line item, on the basis of the lessor's business model. If a lessor's business model is to use leasing arrangements for the purposes of providing finance, then the lessor would present income and expense net. However, manufacturers and dealers that utilise leasing as an alternative way to sell their products that would otherwise sell would present income and expenses gross as revenue and cost of sales. Also, a lessor would present interest income on its leased assets separately from other interest income.

A lessor would present cash flows received from lease payments differently depending on whether it applies the direct or indirect method of cash flows. Cash receipts would be presented separately from other cash flows from operating activities if the direct method is used while the changes in the lease receivable would be presented separately from other operating receivables if the indirect method is used.

Disclosure
The ED would significantly increase the required disclosures related to lease arrangements. An entity would be required to disclose quantitative and qualitative information that "identifies and explains the amounts recognised in the financial statements arising from leases" and "describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows". Disclosures would need to be disaggregated to a level so that the information provided is useful to the users of the financial statements.

Disclosures would include, among others, descriptions of the terms of contingent rentals, renewal options, and residual value guarantees as well as information about changes in assumptions and judgements relating to options, contingent rentals, residual value guarantees and discount rates. The ED would also require both lessees and lessors to provide a reconciliation between opening and closing balances of assets and liabilities related to lease arrangements.

Deferred tax considerations
There is the potential for significant deferred tax consequences associated with the adoption of the proposals for lessees. Lessees will need to consider carefully the tax law in their specific jurisdiction as well as any changes that are made by the taxing authority in response to these proposals. For example, the tax law may be modified to treat leases for tax purposes in accordance with the proposals (i.e., where tax law follows GAAP); tax law may be amended to a new methodology; or tax law may not be changed at all. A temporary difference may arise between the tax base and the carrying amount of the right-of-use asset and the lease liability upon initial recognition. IAS 12 *Income Taxes* generally requires deferred tax to be recognised on all temporary differences. However, there is an exception to this requirement for temporary differences that arise on initial recognition of an asset or liability (outside a business combination) that at the time of the transaction affects neither accounting profit nor taxable profit (tax loss) (referred to as the "initial recognition exemption"). A lessee that concludes there is a temporary difference will need to consider whether the initial recognition exemption applies. Because the proposals affect all outstanding leases as of the effective date, entities will need to be mindful of the deferred tax considerations that may arise upon initial application of the final Standard.

Transition
All outstanding leases at the date of initial application would be subject to the new lease accounting standard. The ED requires the lessee and lessor to apply the provisions of the new model using a simplified retrospective approach as of the beginning of the first comparative period presented in the first financial statements in which the entity applies the final Standard.

A lessee would recognise a liability "measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate on the date of initial application" and a corresponding right-of- use asset subject to any impairments. The right-of-use asset would be adjusted to reflect prepaid or accrued lease payments. No adjustment would be necessary for leases classified as finance leases under IAS 17 that do not have options, contingent rentals, term option penalties or residual value guarantees. Short-term leases would be recognised based on the previously discussed requirements of the ED.

For lease contracts under the performance obligation approach, a lessor would recognise a right to receive lease payments "measured at the present value of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease", subject to any impairments and the lessor would also recognise a corresponding lease liability. A lessor would also reinstate any previously derecognised underlying assets at depreciated cost, determined as if the asset had never been derecognised, subject to any impairment.

For lease contracts under the derecognition approach, the lessor would recognise a right to receive lease payments "measured at the present value of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease" subject to any impairment. A lessor would also recognise a residual asset measured at fair value at date of initial application.

Observation

The proposed transition requirements would not "grandfather" any existing leases. Although the effective date of the new leasing standard is not expected to be before 1 January 2013, lessors and lessees that enter into longer-term leases will need to consider the potential effect of the proposed rules to existing leases and how the proposed rules may change the structuring of future leases. Additionally, the effective date does not necessarily reflect when entities would need to be prepared to adopt the new rules because the transition requirements would require the new rules to be applied as of the beginning of the first comparative period presented in the financial statements. Therefore, it is important for entities to begin thinking today about how these proposals could affect their financial statements, and should consider the need to make changes to lease structures, performance metrics, debt covenants, and systems. Education of key stakeholders will also be necessary.

Effective date

The comment period ends on 15 December 2010, with a final standard expected to be published in June 2011. The ED does not specify an effective date. The Boards plan to consider the effective date after considering the comments they receive on the ED as well as their consideration of all other joint projects expected to be finalised in the coming year.

Examples

The following examples are 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.

Lessee accounting example

An entity enters into an arrangement to lease a retail outlet in an office building. The lease term is non-cancellable for 10 years, with two 5-year renewal options. The agreement is for annual lease payments of CU2 million per year plus additional contingent rentals of 2 percent of gross revenue per year. The entity's incremental borrowing rate is 8 percent. The agreement does not include a purchase option or a residual value guarantee.

Lease term

In the measurement of the right-of-use asset, the first step is determine the lease term. The entity developed the probabilities on the basis of contractual factors, the existence of leasehold improvements, and its past history of renewals. The lease term selected is 15 years because this is the longest possible lease term that is more likely than not to occur (illustrated as follows):

	Two 5-year renewals	One 5-year renewal	No renewal
Lease term	20 years	15 years	10 years
Probability	45%	35%	20%
Cumulative probability	45%	80%	100%

The next step is to estimate the lease payments over the 15-year lease term to determine the expected lease payments over the expected lease term. The scenarios below are based on the entity's forecasts and revenue projections for reasonably possible outcomes over the next 15 years.

Expected contingent rentals

	Outcome 1 constant revenue	Outcome 2 revenue growth 5%/yr	Outcome 3 revenue growth 8%/yr	Outcome 4 revenue decline 2%/yr	Total
Sales over 15 years Assuming CU10M in year 1	150,000,000	215,785,636	271,521,139	130,715,449	
Total Contingent rentals	3,000,000	4,315,713	5,430,423	2,614,309	
Present value	1,711,896	2,297,568	2,777,778	1,534,344	
Probability	40%	25%	25%	10%	
	684,758	574,391	694,444	153,434	**2,107,027**

The following are the total right-of-use asset and lease liability that would be recognised at the date of commencement of the lease. The amount is based on the lease term and contingent rentals (calculated above) and the annual lease payments.

Right-to-use asset/obligation

Contingent rentals	2,107,027
Annual Lease payments (PV of CU2M/year for 15 years)	17,118,957
Total right-of-use asset/obligation	**19,225,984**

At date of commencement of the lease, the entity would recognise a right-of-use asset and a lease liability of CU19.2M.

Journal entry at the end of year 1

At the end of year one, actual revenue was CU11,000,000 (i.e., CU1,000,000 above the lessee's estimate of year 1 revenue). If the entity makes its lease payment at 31 December, the entity would record the following entry (interim effects are ignored):

	Dr	Cr
Lease liability (effective Interest method)	661,921	
Interest expense (effective interest method)	1,538,079	
Amortisation expense (straight-line)	1,281,732	
Additional expense[1] (CU1,000,000 * 2%)	20,000	
Cash		2,220,000
Right-of-use asset		1,281,732

1 The ED does not specify whether the additional expense associated with the current period adjustment of contingent rentals would be classified as additional interest expense or additional amortisation expense.

Since the actual revenue was higher than initially estimated, the entity would recognise the additional contingent rental payment in connection with the current year directly in profit or loss. It would also need to reconsider its future estimates of revenue. If the estimate of future revenue and future contingent rentals are adjusted, the right-of-use asset and the lease liability would be adjusted.

The following table compares the profit or loss effect in the first year of this lease agreement under (1) the proposed right-of-use approach and (2) current operating lease accounting. Under the proposed approach, the expense is front-end loaded; therefore, the expense recognised in the early years of the lease would be higher than it would be under current operating lease accounting.

Income statement comparision: Year 1

	Proposed accounting	Current accounting
Amortisation expense	1,281,732	
Interest expense	1,538,079	
Contingent rentals[1]	20,000	220,000
Rent payment – expense		2,000,000
Total	2,839,811	2,220,000

1 The ED does not specify whether the additional expense associated with the current period adjustment of contingent rent would be classified as additional interest expense or additional amortisation expense.

Lessor accounting example

The following example is meant to compare the profit and loss effect under the performance obligation approach and current operating lease guidance. The example also illustrates the accounting entries under (1) the performance obligation approach, (2) the derecognition approach, and (3) current operating lease guidance. The example is not meant to illustrate how to distinguish whether a lessor should use the derecogniton approach or the performance obligation approach.

An equipment manufacturer offers a lease option to their customers. The lease term is non-cancellable for five years with no renewal options or residual value guarantees. The annual rental payment is CU7,800. The equipment's normal price is CU35,000, and it's cost is CU25,000. The estimated value at the end of the lease term is CU5,667. The discount rate the lessor is charging the lessee is 8 percent.

The comparsion of the annual impact on the lessor's profit or loss under the performance obligation approach and current operating lease guidance is as follows:

Profit or loss effect on lessor

	Performance obligation approach	Existing operating lease accounting
Lease inception	–	–
Year 1	4,853	3,933
Year 2	4,429	3,933
Year 3	3,970	3,933
Year 4	3,474	3,933
Year 5	2,939	3,933
Total	19,665	19,665

An illustration of the accounting entries under (1) the derecognition approach, (2) the performance obligation approach, and (3) current operating lease guidances is as follows:

	Derecognition	Performance obligation	Existing operating lease accounting
Journal entry at date of commencement of the lease:			
Lease receivable	31,143[1]	31,143	
Cost of sales	22,245[2]		
Underlying asset	(22,245)		
Revenue	(31,143)		
Lease liability		(31,143)	
Effect on Account Balances (Debit/Credit)			
Year 1			
Cash	7,800	7,800	7,800
Lease liability		6,229[3]	
Depreciation expense		3,867[4]	3,867
Accumulated deprecation		(3,867)	(3,867)
Interest revenue	(2,491)[5]	(2,491)	
Lease receivable	(5,309)	(5,309)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)
Year 2			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated deprecation		(3,867)	(3,867)
Interest revenue	(2,067)	(2,067)	
Lease receivable	(5,733)	(5,733)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)
Year 3			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated deprecation		(3,867)	(3,867)
Interest revenue	(1,608)	(1,608)	
Lease receivable	(6,192)	(6,192)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)

	Derecognition	Performance obligation	Existing operating lease accounting
Year 4			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated deprecation		(3,867)	(3,867)
Interest revenue	(1,113)	(1,113)	
Lease receivable	(6,687)	(6,687)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)
Year 5			
Cash	7,800	7,800	7,800
Lease liability		6,229	
Depreciation expense		3,867	3,867
Accumulated deprecation		(3,867)	(3,867)
Interest revenue	(578)	(578)	
Lease receivable	(7,222)	(7,222)	
Amortisation of lease liability		(6,229)	
Lease revenue			(7,800)

1 Lease receivable is the PV of annual lease payments (CU7,800) discounted at 8 percent.

2 Cost of sales is equal to the asset derecognised, which is an allocation of the carrying value measured as the fair value of receivables/normal sales price x cost) (CU31,143/CU35,000 X CU25,000).

3 The lease liability is amortised on a straight-line basis over 5 years (CU31,143/5 = CU6,229).

4 The underlying asset is depreciated so that at the end of five years the value is consistent with the residual value at the end of the lease term. Note that this amount will not necessarily equal the residual asset calculated under the derecognition approach.

5 The interest income is calculated using the effective interest method based on 8 percent.

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