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IFRS Project Insights

Leases

2 November 2011

The IASB and FASB are working on a joint project to improve the accounting for leases. In March 2009, the IASB and FASB published a Discussion Paper (DP) setting out a proposed lessee accounting model. The proposed accounting model has evolved since the issuance of the DP. On 17 August 2010, the IASB and FASB issued Exposure Draft ED/2010/09 *Leases* (ED) that proposes new accounting models for lessors and lessees. The comment period ended on 15 December 2010. In January 2011, the Boards began their redeliberations of the proposals in the ED.

At the July 2011 Board meeting, the Boards noted that decisions taken to date during the redeliberations were sufficiently different from those published in the ED to warrant re-exposure of the revised proposals. The Boards intend to complete their deliberations, including consideration of the comment period, during the fourth quarter of 2011 with a view to publish a revised exposure draft during March or April of 2012.

Tentative Decisions Reached during Redeliberations

Right-of-use model

The Boards tentatively decided to confirm the right-of-use model for lease arrangements for lessees except for short-term leases. Therefore, a lessee would recognise a right-of-use asset representing its right to use an underlying asset during the lease term and a liability to make lease payments.

Scope

The Boards tentatively decided that the leases standard is not required to be applied to all leases of intangible assets except for right-of-use assets in a sublease. The Boards requested the staff bring back the question of whether intangibles under Subtopic 350-40 *Internal-Use Software* (US GAAP only) should be in the scope of the leases standard.

The Boards tentatively decided that leases of inventory should be in the scope of the leases standard (consistent with IAS 17 *Leases* (IFRSs) but inconsistent with Topic 840 *Leases* (US GAAP only) which currently scopes out leases of inventory).

The Boards tentatively decided that an entity is not required to apply the leases standard to leases:

- for rights to explore for or use natural resources such as minerals, oil, natural gas and similar non-regenerative resources,
- for biological assets, including timber (US GAAP only), and
- service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements* (IFRSs only).

Definition of a lease

The Boards tentatively decided that a contract would be considered a lease if fulfilment of the contract depends on the use of a specified asset and the contract conveys the right to control the use of a specified asset for a period of time.

A “specified asset” would be an identifiable asset that is explicitly or implicitly identified in the contract. An asset would be implicitly identified if it would not be practical and economically feasible for the owner to substitute alternative assets in place of the underlying asset during the lease term. Conversely, a contract would not be a lease if it would be practical and economically feasible for the owner of the asset to substitute the underlying asset and substitution could occur at any time without the customer’s consent.

A contract would convey the right to control the use of the underlying asset if the customer has the ability to direct the use, and receive the benefit from use, of a specified asset throughout the lease term. The ability to direct the use of a specified asset would include determining how, when, and in what manner the specified asset is used or determining how the specified asset is used in conjunction with other assets or resources to deliver the benefit from its use to the customer. If a customer can specify the output or benefit from use of the asset, but is unable to make decisions about the input or process that result in that output, the ability to specify the output would not, in and of itself, be determinative that the customer has the ability to direct the use of the asset. A customer's ability to receive the benefit from use of a specified asset refers to its present right to obtain substantially all of the potential economic benefits from use of that asset throughout the lease term. The economic benefits would include those that arise directly from the use of the asset (e.g., renewable energy credits or secondary physical output), and would exclude income tax benefits.

In circumstances in which the supplier directs the use of the asset used to perform services requested by the customer, the Boards tentatively decided that customers and suppliers would be required to assess whether the use of the asset is an inseparable part of the services requested by the customer (if inseparable, the entire contract would be accounted for as a service contract because the customer has not obtained the right to control the use of the asset) or a separable part of the services provided. The Boards directed the staffs to research and perform outreach activities to understand any potential problems with this tentative decision.

The Boards tentatively decided that the underlying asset can be a physically distinct portion of a larger asset (e.g., a floor of a building) if that portion is explicitly or implicitly specified. A capacity portion of a larger asset that is not physically distinct (e.g., 50 per cent capacity of a pipeline) is not a specified asset.

Short-term leases

Definition of short-term lease

The Boards tentatively decided that the definition of *short-term lease* should be "a lease that, at the date of commencement of the lease, has a maximum possible lease term, including any options to renew or extend, of 12 months or less". Therefore, in determining whether a lease that includes a renewal option is short-term, a lessee and lessor would not evaluate whether there is a significant economic incentive for the lessee to exercise the option because it is assumed the renewal option would be exercised.

Accounting for short-term leases

The Boards tentatively decided that the proposed guidance in the ED for the accounting for short-term leases by lessors would be retained and the requirements for lessees would be amended such that short-term leases would not be recognised on a lessee's statement of financial position (i.e., consistent with the current requirements for operating leases).

Presentation in profit or loss

The Boards tentatively decided that both lessees and lessors would present the expense or income from short-term leases as lease expense or lease income which is consistent with current operating lease treatment.

Pattern of profit or loss recognition

The Boards tentatively decided that lease payments on short-term leases would be recognised on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

Applying short-term lease guidance

The Boards tentatively decided that an entity would apply the short-term lease guidance as an accounting policy election by asset class.

Purchase/sale scope exclusion

The Boards tentatively decided to eliminate the in-substance purchase/sale scope exclusion that was included in the ED from the new leases standard. Therefore, a contract that meets the definition of a lease and includes a bargain purchase option or automatically transfers title to the lessee by the end of the lease term would be treated as a lease. The ED would have treated these types of contracts as purchases/sales outside the scope of the new leases standard.

Purchase options

The Boards tentatively decided that a purchase option should be included in the lessee's liability to make lease payments and the lessor's receivable if the purchase option provides a significant economic incentive for the lessee to exercise the purchase option (e.g., a bargain purchase option). If so, the lessee's right-of-use asset would be amortised over the economic life of the underlying asset rather than the lease term. Other purchase options would be excluded from the lessee's liability and lessor's receivable.

The Boards tentatively decided that purchase options should be reassessed only when there is a significant change in relevant facts and circumstances such that the lessee would then either have, or no longer have, a significant economic incentive to exercise the option to purchase the underlying asset.

Lease term

"Lease term" should be defined for the lessee and lessor as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.

Assessment and reassessment of lease term

The Boards tentatively decided that in determining whether there is a significant economic incentive, lessees and lessors should consider contract-based factors, asset-based factors and entity-specific factors for both the initial and subsequent evaluation. Market-based factors such as fluctuations in the market rental or asset values would be considered by the lessee and lessor for purposes of the initial evaluation only.

Contract-based factors are terms that are written into the lease contract that could create a significant economic incentive to exercise an option at the date of commencement, or subsequently if there is a change in the lease contract. Examples of contract-based factors include the requirement of the lessee to pay a substantial penalty for terminating the lease earlier than the contractual lease term, the obligation of the lessee to incur material costs to restore the asset prior to returning it to the lessor and the existence of a bargain renewal or purchase option.

Asset-based factors relate to the characteristics of the underlying leased asset that exist either at lease commencement or subsequently that could create a significant economic incentive to exercise an option. Examples of asset-based factors include the existence of significant leasehold improvements installed by the lessee during the lease term that will have significant value at the time when the option becomes exercisable and the importance of the location of the asset.

Entity-specific factors would include historical practice of the entity, management intent and common industry practice.

The Boards tentatively decided that a lessee would adjust its obligation to make lease payments and its right-of-use asset when there are changes in lease payments due to a reassessment and a lessor that applies the derecognition approach would adjust the lease receivable and the carrying amount of the residual asset.

Term option penalty

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

Variable lease payments

The Boards tentatively decided that variable lease payments should not be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable unless the variable lease payments are (1) structured in such a way that they are in-substance fixed lease payments (commonly referred to as 'disguised minimum lease payments'), (2) the portion of a residual value guarantee expected to be paid by a lessee or (3) based on an index or rate derived payment.

The final standard is expected to provide more clarity around the definition of disguised minimum lease payments.

Residual value guarantees provided by the lessee (excluding unrelated third party guarantees) would be included in the measurement of a lessee's liability to make lease payments at the amount that represents the difference between the residual value and the level of the guarantee. The Boards directed the staffs to research distinguishing characteristics between residual value guarantees and variable lease payments (e.g., contingent rent) for discussion at a future meeting.

For those variable lease payments which depend on a rate or index, the rate or indices existing at lease commencement would be used in measuring the right-of-use asset and lease liability.

The tentative decision to recognise variable lease payments in limited circumstances is a practical expedient and reverses the Boards' previous tentative decision to include variable lease payments that are 'reasonably certain' to be paid by the lessee.

Subsequent measurement of residual value guarantees

Amounts expected to be payable under residual value guarantees (excluding unrelated third party guarantees) included in the measurement of the lessee's right-of-use asset would be amortised on a systematic basis (i.e., to reflect the pattern in which the economic benefits of the right-of-use asset are consumed or otherwise used up) from the date of commencement of the lease to the end of the lease term or over the useful life of the underlying asset, if shorter. If a pattern cannot be readily determined, a straight-line amortisation method would be used.

The Boards tentatively decided that lessees should reassess amounts expected to be payable under residual value guarantees when events or circumstances indicate that there is a significant change in the amounts expected to be payable under residual value guarantees, and an entity would be required to consider all relevant factors in the determination of a significant change. Changes to the lessee's liability to make lease payments arising from current or prior periods would be recognised in profit or loss, while changes relating to future periods would be recognised as an adjustment to the right-of-use asset. The allocation for changes in estimates of residual value guarantees would reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or was consumed; however, if the pattern cannot be reliably determined, an entity would allocate changes in estimates of residual value guarantees to future periods.

Subsequent measurement of payments dependent on a rate or index

Lessees and lessors would reassess variable lease payments that depend on an index or rate in measuring the lessee's liability to make lease payments and the lessor's right to receive lease payments each reporting period.

At its July 2011 Board meeting, the Boards tentatively decided that changes to the lessee's liability to make lease payments arising from current periods would be recognised in profit or loss, while changes relating to future periods would be recognised as an adjustment to the right-of-use asset. The Boards directed the staffs to perform further research in allocating changes in rates or indices to reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or was consumed. However, in a subsequent Board meeting, the Boards tentatively decided that a lessor should recognise immediately in profit or loss changes in the lease receivables due to reassessments of variable lease payments that depend on an index or a rate. It is unclear whether the Boards will redeliberate their previous tentative decision relating to recognising changes in the lessee's liability to make lease payments.

Lessee accounting

Recognition

The Boards tentatively decided there should be one type of lease for lessee accounting consistent with the ED. The lessee would recognise a right-of-use asset and a liability to make lease payments at the present value of the lease payments. The right-of-use asset would be amortised / depreciated using a systematic and rational method and the liability to make lease payments would be amortised using the effective interest method. Therefore, the expense recognition pattern would be on an accelerated basis for all leases.

Subsequent measurement

In considering subsequent measurement issues in the lessee accounting model, the Boards tentatively decided:

- to confirm changes in the liability to make lease payments as a result of foreign exchange differences would be recognised in profit or loss.
- to confirm the right-of-use asset would be evaluated for impairment in accordance with IAS 36 *Impairment of Assets* (IFRSs only) or Topic 350 *Intangibles – Goodwill and Other* (US GAAP only). See divergence matters between IFRSs and US GAAP as a result of this tentative decision in the 'Lease inception versus commencement' section below.
- to permit revaluation of the right-of-use asset in accordance with the principles of IAS 38 *Intangible Assets* if a revaluation policy is applied to owned assets of the same class consistent with the proposed guidance in the ED (IFRSs only). For preparers following US GAAP, revaluation of the right-of-use asset is not permitted.

Lessor accounting

Recognition and measurement

The Boards tentatively decided there should be one type of lease for lessor accounting (the 'receivable and residual approach'), except for short-term leases, as defined above, or leases of investment property measured at fair value. Under the receivable and residual approach, the lessor would:

- initially measure the lease receivable at the present value of lease payments discounted using the rate charged in the lease and subsequently amortised using the effective interest method;
- initially measure the residual asset on an allocated cost basis based on the proportion of the underlying asset's fair value that is subject to the lease and subsequently accreted using the rate charged in the lease;
- recognise profit at lease commencement for any difference between the previous carrying amount of the underlying asset and the sum of the lease receivable and the residual asset recognised, subject to the profit being reasonably assured; and
- recognise interest income on the receivable and residual asset over the lease term.

In leases where profit on the right-of-use asset transferred is not reasonably assured, a lessor would initially measure the residual asset as the difference between the carrying amount of the underlying asset and the lease receivable. The lessor would subsequently accrete the residual asset using a constant rate of return to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation.

If the right to receive lease payments is greater than the carrying amount of the underlying asset at lease commencement, the lessor would recognise, at a minimum, the difference between those two amounts as profit at that date.

In a subsequent meeting held in October 2011, the Boards discussed lessor accounting and considered different variations to the 'receivable and residual' approach. The Boards tentatively decided on an approach which would defer the recognition of profit embedded in the residual asset until the lessor either sells or re-leases the underlying asset. The residual asset would be accreted during the lease term using using the rate the lessor charges the lessee to the expected fair value of the underlying asset at the end of the lease term. The residual asset would be presented net of any deferred profit embedded in the residual asset in the statement of financial position (i.e., the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset). The Boards reversed their previous tentative decision and tentatively decided that there would be no requirement for profit on the right-of-use asset to be reasonably assured before it is recognised.

The Boards tentatively decided to include a scope exception to the lessor accounting model for lessors that hold underlying assets that meet the definition of investment property under current IFRSs or future U.S. GAAP. If the scope exception is met, the lessor would apply current operating lease accounting rather than the proposed lessor approach. The Boards are expected to discuss whether this scope exception should be optional or mandatory at a future meeting. The Boards may also discuss a similar scope exception for lessees at a future meeting.

Lessor accounting – variable lease payments and measurement of the residual asset

The Boards tentatively decided that when the rate the lessor charges the lessee reflects an observable expectation of variable lease payments, the lessor would adjust the residual asset based on its expectation of variable lease payments and recognise an expense as variable lease payments are received. Any difference between actual and expected variable lease payments would not result in a further adjustment to the residual asset. However, when the rate the lessor charges the lessee does not reflect an expectation of variable lease payments, the lessor would not make any adjustments to the residual asset with respect to variable lease payments. The Boards indicated that they expect adjustments to residual assets with respect to variable lease payments to occur infrequently.

Application of financial asset guidance to lease receivables

The lease receivable would be subsequently measured using the effective interest method and assessed for impairment in accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Classification and Measurement* (IFRSs only) and Topic 310 *Receivables* (US GAAP only).

Fair value requirement for lease receivables and transfers of lease receivables

The Boards discussed the transfer of the lease receivable that gives rise to derecognition. The Boards tentatively decided that a lessor:

- should not measure a lease receivable at fair value, even if part or all of that receivable is held for the purpose of sale;
- should apply existing derecognition requirements (in IFRS 9 (IFRSs only) or Topic 860 *Transfers and Servicing* (U.S. GAAP only)) to lease receivables, but the allocation of the carrying amount should be done on the basis of the fair value of the lease receivable excluding option elements and variable lease payments that are not transferred; and
- should apply the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* (IFRSs only) and Topic 860 (U.S. GAAP only) for transferred lease receivables.

Subsequent measurement

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

Residual value guarantees

The lessor would not recognise residual value guarantees before they are due from the guarantor. However, the lessor would consider the existence of any residual value guarantees when considering if the residual asset is impaired.

Sublease transactions

The Boards tentatively decided:

- a head lease and corresponding sublease would be accounted for as separate transactions; and
- lease assets and lease liabilities in a sublease would be accounted for consistently with lease assets and lease liabilities recognised in accordance with all other lease arrangements.

Lease inception versus commencement

The Boards tentatively decided that a lessee and lessor would recognise and initially measure lease assets and liabilities (and derecognise any corresponding assets and liabilities for lessors) at the date of commencement of the lease. This is a change from the ED which would have required measurement at lease inception and recognition at lease commencement.

The Boards tentatively decided that the incremental borrowing rate would be determined at the lease commencement date.

The Boards tentatively decided that costs incurred prior to the lease commencement date should be accounted for outside the scope of the leases standard (e.g., construction costs incurred by the lessee before lease commencement). The final standard will provide guidance on what other standards would apply.

The Boards tentatively decided that lease payments made prior to the lease commencement date would be recognised as a prepayment and the prepayment would be added to the right-of-use asset at the lease commencement date. The final standard will provide further application guidance.

Lease contracts are explicitly within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (IFRSs only), and thus, would require assessment as to whether the leases are onerous between the inception and commencement date of the lease. Under US GAAP, there is no general requirement to recognise a loss for onerous contracts (i.e., executory contracts that are anticipated to result in a loss), and therefore, there would be no requirement to determine whether a lease contract is in a loss position between lease inception and lease commencement. This could result in the right-of-use asset being carried at two different amounts at commencement under IFRSs and US GAAP.

Initial direct costs

The Boards tentatively decided that initial direct costs should be defined as "costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made". This definition is consistent with the ED except for the removal of "recoverable" from the definition which is implicit in the definition.

The Boards tentatively decided to retain the guidance in the ED that lessees and lessors should capitalise initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively.

Lease incentives

The Boards tentatively decided that any upfront cash payments received from the lessor would be considered to relate to the right to use the asset and therefore included in the initial measurement of the right-of-use asset (receipts from the lessor would reduce the right-of-use asset initially measured).

Determination of the discount rate in a lease

Lessee

The Boards tentatively decided that a lessee should establish its discount rate using either:

- Its incremental borrowing rate; or
- The rate that the lessor charges the lessee (the rate implicit in the lease), if readily determinable.

If both rates are available, the lessee would be required to use the rate the lessor charges the lessee. However, a lessee would not be expected to use extreme measures to determine the implicit rate.

Lessor

The Boards tentatively decided that the lessor should use the rate that the lessor charges the lessee, which could be the lessee's incremental borrowing rate, the rate implicit in the lease, or, for property leases, the yield on the property. When more than one indicator of the rate the lessor charges in the lease is available, the rate implicit in the lease should be used.

Reassessment of discount rate

The Boards tentatively decided that the discount rate should not be reassessed on a periodic basis when there is no change in lease payments. The discount rate would be reassessed when there is a change in lease payments due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease or to purchase the underlying asset. The discount rate would also be reassessed when there is a change in lease payments due to the exercise of an option that the lessee did not have a significant economic incentive to exercise. If reassessment is necessary, the discount rate would be revised using the spot rate at the reassessment date and applied to the remaining lease payments, including the remaining payments on the initial lease plus the payments due to the extension period or upon exercise of the purchase option.

Separation of components in contracts that contain a lease

The Boards tentatively decided that in multiple element contracts that include both lease components as well as non-lease components, lessees and lessors would identify and separately account for the non-lease components in the contract. The distinct versus non-distinct guidance included in the ED would not be carried forward to the final standard.

Allocation of payments between components in contracts that contain a lease

Lessor

The Boards tentatively decided that in contracts that contain lease components and non-lease components, lessors would be required to allocate payments required by a contract between lease components and non-lease components consistent with the allocation method in the revenue recognition project.

Lessee

The Boards tentatively decided that in contracts containing lease components and non-lease components, lessees would be required to allocate between lease components and non-lease components based on their relative standalone purchase prices. Observable lessor-specific standalone purchase price provide the best basis for determining lessee's purchase price, followed by observable purchase prices that other marketplace participants would charge for similar components.

The Boards tentatively decided that if the purchase price of one component in a contract that contains a lease is observable, a lessee can use the residual method to allocate the price to the component for which there are no observable purchase prices.

The Boards tentatively decided that lessees would treat the entire contract as a lease when there are no observable prices for any of the components.

Sale and leaseback transactions

The Boards tentatively decided that a transaction would be accounted for as a sale and leaseback transaction when the sale occurs. An entity would apply the control criteria in the new revenue recognition standard to determine whether a sale has occurred. The transaction would be accounted for as a financing if a sale does not occur.

The Boards tentatively decided that when consideration is at fair value, gains or losses arising from the transaction would not be deferred. However, when consideration is not a fair value, the assets and liabilities, gains and losses recognised should be adjusted to reflect current market rentals.

The Boards tentatively decided that the seller/lessee would apply the "whole asset" approach when a sale occurs. For example, if an entity sells a 5-story building and leases back a single floor in that building and the transaction meets the requirements for sale accounting, the lessee would derecognise the entire building and account for the leaseback under the new leases standard.

The Boards tentatively decided not to prescribe a particular type of lessee accounting model for entities that are participating in a sale and leaseback transaction.

Contract modifications or change in circumstances after the date of inception of the lease

The Boards tentatively decided that the final leases standard would include guidance for accounting for modifications to the contractual terms of a contract or changes in circumstances after the date of inception of the lease. The guidance would clarify that:

- a substantive change to the existing contract would result in the accounting for the modified lease as a new lease;
- a change in circumstances that would affect the assessment of whether a contract is, or contains, a lease would result in a reassessment by the lessee and the lessor as to whether the contract is, or contains, a lease and may result in the lessee and lessor applying or ceasing to apply the leases standard; and
- a change in circumstances that would affect whether a lease transfers substantially all of the risks and rewards incidental to ownership of the underlying asset (i.e., the "classification" of the lease) should not result in a reassessment by the lessee or lessor.

Embedded derivatives

The Boards tentatively decided that lessors and lessees would be required to account for any embedded derivatives within a lease contract in accordance with current accounting guidance.

Transition

Lessee accounting

The Boards tentatively decided that for capital / finance leases existing at the beginning of the earliest comparative period presented, a lessee would not be required to make any adjustments to the carrying amount of the lease assets and lease liabilities under IAS 17 (IFRSs only) or Topic 840 (U.S. GAAP only). However, the entity would reclassify the lease assets and lease liabilities as right-of-use assets and liabilities to make lease payments.

For operating leases existing at the beginning of the earliest comparative period presented, the Boards tentatively decided to allow lessees the option of applying either a full-retrospective approach or a modified retrospective approach with transition reliefs. Lessees would be required to apply the transition approach consistently to all lease arrangements.

Under the modified retrospective approach, the Boards tentatively decided that a lessee should:

- recognise liabilities to make lease payments at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate as of the effective date for each portfolio of leases with reasonably similar characteristics. The incremental borrowing rate for each portfolio of leases should take into consideration the lessee's total leverage, including leases in other portfolios.
- recognise right-of-use assets on the basis of the proportion of the liability to make lease payments at lease commencement relative to the remaining lease payments.
- record to retained earnings any difference between the liabilities to make lease payments and the right-of-use assets at transition.
- adjust the right-of-use asset recognised at the beginning of the earliest comparative period presented by the amount of any recognised prepaid or accrued lease payments when the lease payments are uneven over the lease term.

The Boards tentatively decided to provide the following transitional reliefs under the modified retrospective approach in the year of application:

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

If an entity elects any of the available reliefs, the entity should disclose which reliefs it elected.

The full-retrospective approach would not allow for transitional reliefs. Application would be consistent with requirements outlined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (IFRSs only) or Topic 250 *Accounting Changes and Error Corrections* (U.S. GAAP only).

The Boards discussed transition disclosures and tentatively decided that such disclosures should be consistent with those required by IAS 8 (IFRSs only) or Topic 250 (U.S. GAAP only) except that entities would not be required to disclose the effect of the change on any affected financial statement line item for the current period and any prior periods adjusted retrospectively.

Lessor accounting

The Boards tentatively decided that for finance / sales-type leases existing at the beginning of the earliest comparative period presented, lessors would not be required to make adjustments to the carrying amount of the assets associated with those leases.

For operating leases existing at the beginning of the earliest comparative period presented, the Boards tentatively decided to permit lessors the option of applying either a full-retrospective approach or a modified retrospective approach. Lessors would be required to apply the selected transition approach consistently to all lease arrangements.

Under the modified retrospective approach, the Boards tentatively decided that a lessee should:

- recognise a right to receive lease payments, measured at the present value of the remaining lease payments and discounted using the rate charged in the lease that was determined at the date of commencement of the lease, subject to any adjustments that are required to reflect impairment.

- recognise a residual asset that is consistent with the initial measurement of the residual asset under the receivable and residual approach using information available at the beginning of the earliest comparative period presented.
- derecognise the underlying asset.
- adjust the cost basis in the underlying asset that is derecognised at the beginning of the earliest comparative period presented by the amount of any recognised prepaid or accrued lease payments when the lease payments are uneven over the lease term.

Transitional reliefs under the modified retrospective approach would be consistent with those for lessee accounting. If an entity elects any of the available reliefs, the entity should disclose which reliefs it elected.

The full-retrospective approach would not allow for transitional reliefs. Application would be consistent with requirements outlined in IAS 8 (IFRSs only) or Topic 250 (U.S. GAAP only) except that entities would not be required to disclose the effect of the change on any affected financial statement line item for the current period and any prior periods adjusted retrospectively.

Sale and leaseback transactions

The Boards tentatively decided that transition requirements for sale and leaseback transactions would be aligned with decisions reached in transitioning for lessees and lessors. That is, for capital / finance leases existing at the beginning of the earliest comparative period presented, prospective application of the new lease requirements would be permitted. However, for operating leases existing at the beginning of the earliest comparative period presented, entities would be permitted to apply either a full-retrospective approach or a modified retrospective approach.

Other considerations

The Boards tentatively decided that no transition guidance would be provided in the final leases standard for short-term leases, investment property measured at fair value, subleases, useful lives of leasehold improvements, build-to-suit leases and in-substance purchases and sales. The Boards will consider transition guidance related to secured borrowings at a future meeting.

The FASB tentatively decided that the transition exception in Topic 840-10-25 (formerly Emerging Issues Task Force (EITF) Issue 01-8 *Determining Whether an Arrangement Contains a Lease*) would not be retained in the final leases standard.

Presentation and disclosure

Lessee accounting

Statement of cash flows

The statement of cash flows will present:

- the allocation of principal and interest of cash paid for lease payments in accordance with current applicable IFRS or US GAAP requirements.
- the cash paid for variable lease payments excluded from the measurement of the right-of-use asset and the liability to make lease payments as an operating cash flow.
- the acquisition of a right-of-use asset in exchange for a lease liability as a non-cash disclosure.
- the cash outflows for short-term leases not included in the liability to make lease payments as an operating cash flow.

Statement of financial position

The Boards tentatively decided that lease assets and lease liabilities would be separately presented either in the statement of financial position or notes to the financial statements. If not presented on the face of the statement of financial position, the amounts disclosed in the notes would indicate presentation of each balance within the statement of financial position.

The right-of-use asset would be classified in a consistent manner to the classification had the entity owned the asset.

The Boards will not clarify in the final standard whether the right-of-use asset recognised by the lessee represents a tangible or intangible asset.

Disclosure

The Boards considered lessee disclosure requirements outlined in the ED and tentatively decided to:

- Retain the requirements in the ED to reconcile the beginning and ending balances of right-of-use assets by underlying asset type and the liability to make lease payments. There would be no requirement to disaggregate the reconciliation of the lease liability by underlying asset type.
- Include a requirement to disclose a maturity analysis of undiscounted amounts to be paid that are included in the liability to make lease payments.
- Include a requirement to disclose time bands for the maturity analysis of liabilities to make lease payments for a minimum annual disclosure of the first five years and the total of the amounts for the remaining years.
- Disclose separately the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations for the lessee.
- Disclose separately the future contractual commitments associated with services and other non-lease components that are separated from a lease contract (US GAAP only). The IASB was not supportive of this disclosure requirement.
- Retain the disclosure requirements in paragraphs 73(a)(ii) – 73(a)(iii) of the ED (i.e., disclosing the basis and terms on which contingent rentals are determined and the existence and terms of options, including renewal and termination). The staffs intend to provide aggregation guidance and / or illustrations of the proposed disclosures to a future meeting.
- Remove the requirements in the ED to disclose (a) the existence and principal terms of any options for the lessee to purchase the underlying asset and (b) initial direct costs incurred on a lease.
- Include a requirement to separately present or disclose interest expense and interest paid related to leases.
- Retain the requirements in the ED to separately present interest and amortisation (i.e., not combined and presented as lease expense).
- Include a requirement for tabular disclosure of lease expenses disaggregated by (a) amortisation expense, (b) interest expense, (c) expense relating to variable lease payments not included in the liability to make lease payments and (d) expense for those leases for which the short-term practical expedient is elected, to be followed by the principal and interest paid on the liability to make lease payments.
- Include a requirement to disclose qualitative information indicating whether any circumstances or expectations about short-term lease arrangements are present that would result in a material change to the expense in the next reporting period as compared with the current reporting period.

A lessee would not be required to disclose:

- discount rates used to calculate the liability to make lease payments.
- the fair value of the liability to make lease payments.
- the existence and principal terms of any options for the lessee to purchase the underlying asset or initial direct costs incurred on a lease.
- information about arrangements that are no longer determined to contain a lease.

The Boards also tentatively decided that arrangements that are no longer determined to contain a lease (as a result of consequential amendments to non-lease guidance) would be outside the scope of the leases standard.

Lessor accounting

Statement of cash flows

The Boards tentatively decided that all cash receipts from lease payments would be classified as operating activities in the statement of cash flows, except those cash flows relating to securitised receivables. Existing guidance would be applied in classifying cash flows from securitised receivables.

Statement of financial position

The Boards tentatively decided that lease receivables and residual assets would be presented under a single caption as 'investment in leased assets' in the statement of financial position. Lease receivables and residual assets would be separately presented either in the statement of financial position or notes to the financial statements. However, lessors would be required to apply the guidance provided in IAS 1 *Presentation of Financial Statements* (IFRSs only) and Securities and Exchange Commission (SEC) regulations (US GAAP only), in conjunction with management judgement, in determining whether disaggregation of lease receivables and residual assets is required in the statement of financial position.

Statement of comprehensive income

The Boards discussed the presentation of amounts recognised by the lessor in the statement of comprehensive income. The Boards tentatively decided that:

- accretion of the residual asset should be presented as interest income.
- a lessor should present lease income and lease expense in profit or loss either in separate line items or net in a single line item so that it provides information that reflects the lessor's business model. For example, if a lessor's business model uses leases as an alternative means of realising value from the goods it would otherwise sell, the lessor should present lease income and lease expense in separate line items. However, if a lessor's business model uses leases for the purposes of providing finance, the lessor would present lease income and lease expense net in a single line item.
- a lessor's income and expense from lease transactions may be presented separately from other income and expense on the statement of comprehensive income or disclosed in the notes to the financial statements. If disclosed, the notes should reference the line items in which the income and expenses are presented.
- the statement of comprehensive income should present the amortisation of the initial direct costs recognised in the lessor's receivable as an offset to interest income on the receivable.

Disclosure

The Boards tentatively decided a lessor should disclose:

- lease income generated from the entity's leasing activities in a tabular form and disaggregated by, for example, (a) profit recognised at lease commencement, (b) interest income on the lease receivable, (c) accretion of the residual asset, (d) variable lease income for amounts not initially recorded in the lease receivable and (e) short-term lease income.
- fixed-price purchase options which exist on underlying leases.
- the basis and terms on which contingent rentals are determined and the existence and terms of options, including renewal and termination options.
- a reconciliation between the beginning and ending balances of the lease receivable and residual asset.
- a maturity analysis of undiscounted cash flows that are included in the lease receivable, with reconciliation to the amounts reported in the statement of financial position for the lease receivable. Time bands for the maturity analysis should, at a minimum, include each of the first five years following the reporting date and the total of the amounts for the remaining years.
- how it manages its exposure to the underlying asset, including:
    - its risk management strategy;
    - the carrying amount of the residual asset that is covered by residual value guarantees and the unguaranteed portion of the carrying amount of the residual asset; and
    - whether the lessor has any other means of reducing its exposure to residual asset risk (e.g., buyback agreements with the manufacturer from whom the lessor purchased the underlying asset or options to put the underlying asset to the manufacturer).

However, disclosure would not be required for:

- initial direct costs incurred in the reporting period and included in the lease receivable.
- the fair value of the lease receivable or the residual asset.
- the range or the weighted average of discount rates used to calculate the lease receivable.

Convergence

The IASB and FASB have thus far reached the same tentative decisions on the leases project except for the following items as outlined above:

- the reversal of impairment losses.
- permitting revaluation in the subsequent measurement of a right-of-use asset.
- treatment of onerous lease contracts between inception and commencement date.
- separate disclosure of contractually obligated cash commitments under executed leases not yet commenced.

Next steps

The Boards are expected to complete their redeliberations during the fourth quarter of 2011 and have tentatively decided to re-expose their proposals with a view to publish a revised exposure draft during March or April of 2012. A final standard is expected to be published in 2013.

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 for both lessees and lessors 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 individual leases and to perform the calculations necessary to determine the lease term and contingent rentals. These amounts would also need to be reassessed after lease inception.
- Entities should consider the effect the new leasing model will have on existing debt covenants.
- Entities should consider whether performance metrics need to be modified and analysts educated on the effect of the new leasing standard.
- Entities should consider whether the terms of new and existing lease contracts should be modified because of the proposed model. The proposed transition requirements would not grandfather existing leases.