

New on the Horizon: Leases

International Financial Reporting Standards
September 2010

Foreword

In Exposure Draft ED/2010/9 *Leases* (the ED) the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) propose a new approach to lease accounting for lessees and lessors.

The proposals are a response to long-standing criticism that current lease accounting is too permissive of off-balance sheet accounting by lessees and dominated by a plethora of rules. In their recently revised work plan update, the IASB and the FASB identified leasing as one of the five high priority issues for significantly improving current accounting and convergence.

The ED addresses the core concern about lessee accounting by abolishing the current distinction between operating and finance leases. Instead, a lessee would apply a right-of-use model under which it would recognise an asset for its right to use the underlying asset and a liability for its obligation to make lease payments. Lessees with operating leases coming onto the statement of financial position in this way would experience an increase in assets and liabilities and often would see a front-loading of expenses in the statement of comprehensive income. These changes particularly would affect entities with significant operating leases of large, expensive assets such as aircraft. Others who would be affected include those with leased assets in the mining, construction and transport sectors as well as entities with leased buildings, including head offices and retail premises.

Lessors also would be impacted by the proposed changes with two very different models proposed. The performance obligation approach would be applied if the lessor retains significant risks and benefits associated with the underlying asset; otherwise the derecognition approach would be applied. Under the performance obligation approach, the lessor would continue to recognise the underlying asset, recognise an asset for the lease payments and recognise a liability for permitting use of the leased asset. Under the derecognition approach, the lessor would derecognise the leased asset and recognise an asset for the lease payments and a residual value asset for its interest in the leased asset at the lease end. Lessors who currently treat leases as investment property at fair value will be relieved that they are exempt from the new proposals.

Some may see the changes as a step forward for lessee accounting, allowing a clearer picture of an entity's assets and payment obligations. From a financial statement user's perspective, many analysts already make changes to incorporate operating leases in their assessments and these proposals are likely to assist them. Others may see the changes as adding complexity.

One thing is certain: there will be considerable accounting changes for every entity that has lease arrangements. An adequate transition time will be crucial once this standard is finalised.

We hope that this publication will assist you in gaining a greater understanding of the proposals in ED/2010/9. We encourage you to join in the debate and to provide the IASB with your comments by the deadline of 15 December 2010.

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

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Content

Our *New on the Horizon* publications generally are prepared upon the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of *New on the Horizon* considers the proposed requirements of ED/2010/9 *Leases*, which was published by the IASB and the FASB on 17 August 2010.

The text of this publication is referenced to the ED by way of references in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

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A more detailed discussion of the general accounting issues that arise from the application of IFRSs can be found in our publication *Insights into IFRS*.

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- Newsletters, which highlight recent developments
- IFRS Practice Issue publications, which discuss specific requirements and pronouncements
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1. Executive summary

1.1 Proposed accounting models at a glance

	Lessee	Lessor: performance obligation approach	Lessor: derecognition approach
Assets and liabilities arising from lease contracts	<p>“Right-of-use” asset</p> <p>Obligation to make lease payments (lease liability)</p>	<p>Right to receive lease payments (lease asset) + Underlying asset</p> <p>Obligation to permit the lessee to use the underlying asset (performance obligation)</p>	<p>Right to receive lease payments (lease asset) + Residual asset</p>
Income and expense arising from lease contract	<p>Amortisation/impairment/revaluation of right-of-use asset</p> <p>Interest expense on lease liability</p> <p>Gain/loss on reassessment of lease payments</p>	<p>Interest income on lease asset</p> <p>Lease income on satisfaction of performance obligation</p> <p>Gain/loss on reassessment of lease payments</p> <p>Depreciation of underlying asset</p> <p>Impairment losses</p>	<p>Profit/loss on commencement</p> <p>Interest income on lease asset</p> <p>Gain/loss on reassessment of lease payments</p> <p>Impairment losses</p>
Initial measurement: lease liability/asset	Present value of lease payments	Present value of lease payments plus lessor’s initial direct costs	Present value of lease payments plus lessor’s initial direct costs
Components of lease payments	<p>Fixed rentals</p> <p>Contingent rentals</p> <p>Lessee residual value guarantees</p> <p>Term option penalties</p>	<p>Fixed rentals</p> <p>Contingent rentals*</p> <p>Lessee residual value guarantees*</p> <p>Term option penalties</p> <p>* that lessor can measure reliably</p>	<p>Fixed rentals</p> <p>Contingent rentals*</p> <p>Lessee residual value guarantees*</p> <p>Term option penalties</p> <p>* that lessor can measure reliably</p>
Discount rate	Lessee’s incremental borrowing rate, or rate lessor charges lessee if readily determinable	Rate lessor charges lessee	Rate lessor charges lessee

	Lessee	Lessor: performance obligation approach	Lessor: derecognition approach
Initial measurement: right-of use asset/ performance obligation/residual asset	Lease liability plus lessee's initial direct costs	Present value of lease payments	Allocation of carrying amount of underlying asset
Gain/loss on initial recognition of lease contract	Only if onerous contract prior to commencement	Only if onerous contract prior to commencement	Yes
Subsequent measurement: lease liability/asset	Amortised cost Reassess lease payments if facts and circumstances indicate significant change in lease liability	Amortised cost Reassess lease payments if facts and circumstances indicate significant change in lease asset	Amortised cost Reassess lease payments if facts and circumstances indicate significant change in lease asset
Subsequent measurement: right-of use asset/ performance obligation/residual asset	Cost or valuation, less amortisation and impairments	Outstanding obligation, amortised based on pattern of use by lessee or straight line	Cost less impairment

1.2 Summary of key impacts for lessees

Proposal	Observation
Single model for lessee accounting, replacing current distinction between operating and finance leases.	<ul style="list-style-type: none"> • All leases within scope will be on-balance sheet for lessees. • Lessees with significant operating leases will see an increase in assets and liabilities. • Key ratios and covenants may be affected.
New measurement basis for lease liability.	<ul style="list-style-type: none"> • Lease liability will be different from finance lease liability calculated under IAS 17: <ul style="list-style-type: none"> – proposals regarding lease term and contingent rentals will tend to increase lease payments compared to IAS 17; and – proposals regarding purchase options and residual value guarantees will tend to decrease lease payments compared to IAS 17. • Increased use of judgement and estimates, on inception and throughout term of lease. • Increased volatility in reported assets and liabilities as lease liabilities reassessed throughout term of lease.
Recognition and measurement of right-of-use asset.	<ul style="list-style-type: none"> • Front-loading of expenses in profit or loss due to amortisation of asset and interest charge on liability. • Increase in EBITDA (earnings before interest, depreciation and amortisation) and similar measures, since operating lease expense is included in EBITDA whereas amortisation excluded.
Withdrawal of existing guidance.	<ul style="list-style-type: none"> • No specific guidance proposed regarding: <ul style="list-style-type: none"> – lease incentives; – renegotiation of leases; and – derecognition of lease assets and liabilities.

1.3 Summary of key impacts for lessors

Proposal	Observation
Two approaches to lessor accounting, replacing the current distinction between operating and finance leases.	<ul style="list-style-type: none"> ● Complex proposals with continuation of alternative approaches, and alternative presentation approaches within derecognition approach. ● Continued reliance on judgemental assessment of transfer of risks and benefits to determine accounting treatment of each lease contract.
New measurement basis for lease asset, with significant differences from the IAS 17 finance lease model.	<ul style="list-style-type: none"> ● Lease asset will be different from the finance lease receivable calculated under IAS 17: <ul style="list-style-type: none"> – proposals regarding lease term and contingent rentals will tend to increase lease payments compared to IAS 17; and – proposals regarding purchase options and residual value guarantees will tend to decrease lease payments compared to IAS 17. ● Increased use of judgement and estimates, on inception and throughout lease term. ● Increased volatility in reported assets and income as lease assets reassessed throughout lease term.
Performance obligation approach.	<ul style="list-style-type: none"> ● Front-loading of income in profit or loss, due to amortisation of performance obligation and interest income on lease asset. ● No gain recognised on commencement.
Derecognition approach.	<ul style="list-style-type: none"> ● Potential for recognition of gain/loss on commencement of lease, but deferral of income relating to residual asset until underlying is sold or re-let.
Withdrawal of existing guidance.	<ul style="list-style-type: none"> ● No specific guidance proposed regarding: <ul style="list-style-type: none"> – lease incentives; – renegotiation of leases; or – derecognition of lease assets and liabilities.

2. Introduction and background

The objective of the IASB's¹ and the FASB's² (together, the Boards) joint project on leases is to develop a converged standard on lease accounting by lessees and lessors that would improve the financial reporting of lease contracts. The project is included in the Memorandum of Understanding issued by the Boards in 2006 and updated in 2008 and 2010.

The Boards published Discussion Paper *Leases: Preliminary Views* (the DP) in March 2009. The DP presented the Boards' preliminary views on lessee accounting and a high level overview of possible approaches to lessor accounting. The DP highlighted additional issues to be addressed to develop an operational standard.

Since publishing the DP, the Boards have developed the lessee model more fully, developed detailed proposals for lessor accounting, and have received extensive input from constituents through comments letters on the DP, field work and other consultations.

With ED/2010/9 *Leases* (the ED or the Leases ED), the Boards have now published a proposed new standard on accounting by lessees and lessors, including application guidance that would form an integral part of the new standard. The new standard would replace IAS 17 *Leases*, IFRIC 4 *Determining whether an Arrangement contains a Lease*, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

The comment deadline for the ED is 15 December 2010. The Boards plan to undertake further outreach and to hold public round-table meetings, and to issue the new standard by June 2011. The Boards plan an additional consultation on the effective date of this and other new standards.

1 IASB: International Accounting Standards Board

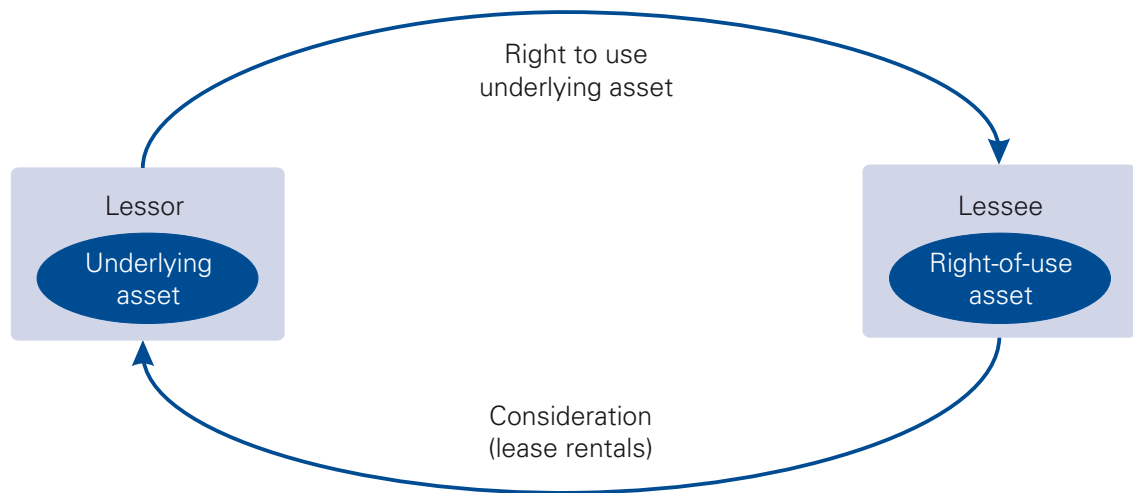
2 FASB: US Financial Accounting Standards Board

3. Scope

3.1 Identification of a lease

ED App A

The ED defines a *lease* as a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration. The lessor/lessee relationship can be illustrated as follows:



ED B1

The ED retains the principal requirements of IFRIC 4 regarding the identification of lease transactions. That is, a contract is or contains a lease if both of the following conditions are met:

- the contract conveys the right to use a specified asset; and
- the contract conveys the right to control the use of the underlying asset.

Observations

The proposed definition of a lease is similar to that in IAS 17 and is likely to be equivalent for most practical purposes. The ED also retains the current principles in IFRIC 4 regarding the identification of a lease, though not all of the supporting material included in the illustrative examples and basis for conclusions of IFRIC 4 is brought forward in the ED, and there are subtle changes that may affect the analysis in some cases. It should be noted, however, that the ED's proposals on when and how to separate a contract that contains a lease component and service component differ significantly from the requirements in IFRIC 4 (see 3.2.5).

Although the proposals regarding the definition and identification of a lease generally are consistent with current literature and practice, questions around scope are likely to be a key focus when implementing the proposals, particularly for lessees. This will be the case as long as there are different accounting requirements for leases and service contracts, as for lessees the assessment of whether an arrangement is a lease or an executory contract will determine whether it is "on" or "off" balance sheet.

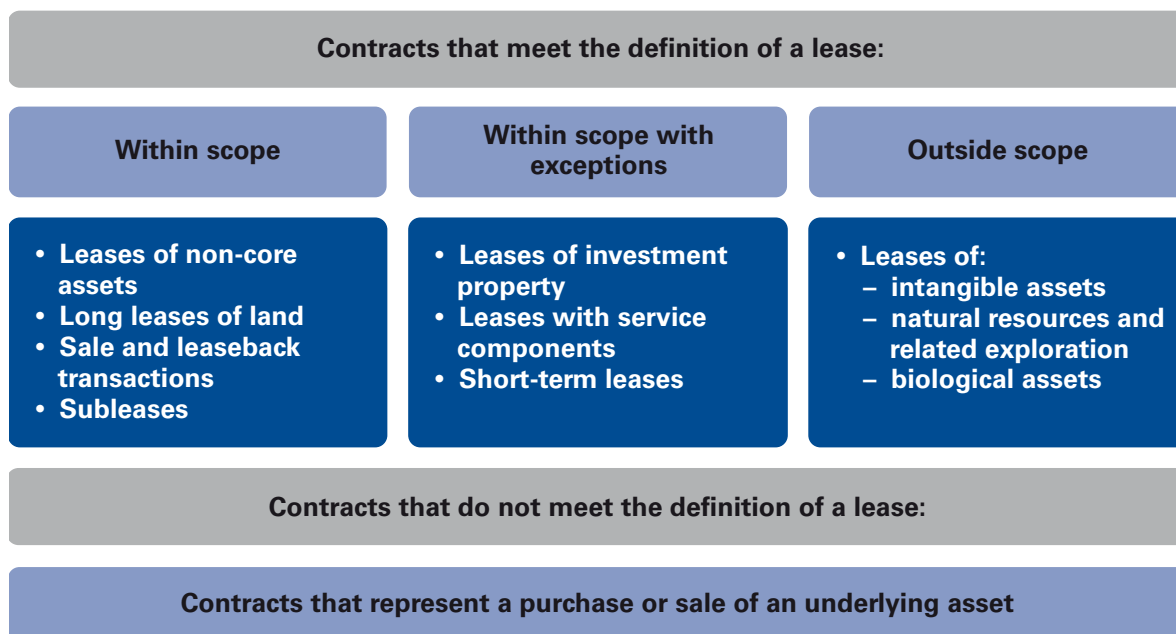
Although the guidance in IFRIC 4 that is brought forward in the ED is not industry specific, it has its origins in US GAAP literature developed largely in the context of the power and utilities industry. It will be important that constituents consider carefully whether that guidance is robust and operational in other contexts.

3.2 Scope exceptions

3.2.1 Overview

ED 5-9

The ED proposes a number of scope exclusions and comments on agreements that will be within the scope. Some leases are excluded from the scope of the proposals; other leases are subject to specific exceptions regarding measurement.



Observations

The ED proposes a number of potentially significant scope exemptions. However, the inclusion of long leases of land and leases of non-core assets (i.e. assets that are not essential to an entity's operations) within the scope of the proposals may attract comment.

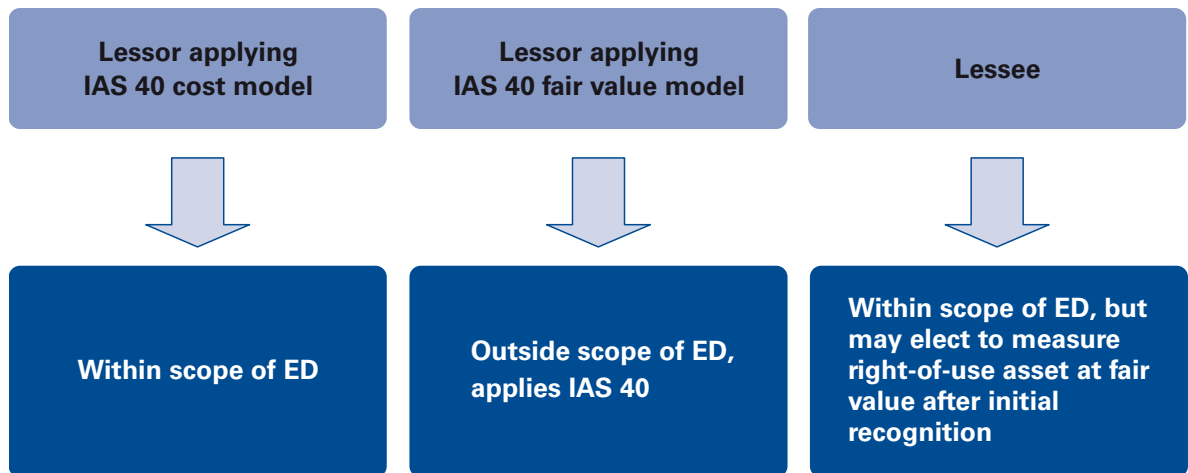
Amendments to the IAS 17 guidance on the classification of long leases of land as finance leases or operating leases became effective from 1 January 2010. While it acknowledged previously that in some cases the lessee in a long lease of land will be in a position economically similar to an entity that had purchased the land, the IASB now argues in the ED that there is no conceptual basis for treating long leases of land differently from other leases, and that a long lease of land is not, as a matter of fact, a purchase.

The ED includes leases of non-core assets in scope, noting that IFRSs generally do not distinguish between core and non-core assets.

3.2.2 Investment property

ED 7

Leases of investment property generally are within the scope of the ED, subject to the following exceptions:



ED 7(b)

The requirements for a *lessor* of investment property depend on how the lessor measures investment property under IAS 40 *Investment Property*. A lessor that applies the IAS 40 fair value model would be outside the scope of the ED and would continue to apply IAS 40 to its investment property. In particular, the lessor would account for lease payments receivable as rental income on a straight-line basis. Conversely, a lessor that applies the IAS 40 cost model would be within the scope of the proposals.

ED 7(a)

A lessee that uses the fair value model for investment property would be permitted but not required to measure its right-of-use asset under the IAS 40 fair value model after initial recognition, with changes in the liability to make lease payments recognised in profit or loss.

Observations

The IASB has concluded that lessors who measure investment property at fair value should be outside the scope of the proposals. This follows representations from investment property analysts and industry bodies that the fair value model provides useful information and that rental income is a key metric in the sector. This proposal is likely to be welcomed by many in the real estate sector.

The IASB proposes to amend IAS 40 to address the accounting for rental income. This will be necessary to provide guidance to lessors following the withdrawal of IAS 17 and SIC-15. It will be important that the amendments to IAS 40 address topics such as lease incentives, which currently are not mentioned in the ED.

3.2.3 In-substance purchases and sales

ED 8, B9

The ED proposes that a contract that represents the sale and purchase of an underlying would not be a lease and so would not be within the scope of the proposals.

ED 8(a)

A transaction would be an in-substance purchase/sale if the seller/lessor transfers control of the underlying asset and all but a "trivial" amount of the risks and benefits to another entity.

ED B10

The ED proposes that an entity consider all relevant facts and circumstances in order to determine whether an agreement is a lease or an in-substance purchase/sale, but states that the following generally would be considered to be purchases/sales of the underlying asset:

- transactions in which title to the underlying asset transfers automatically at the end of the lease term; and
- transactions in which a bargain purchase option is attached to the underlying asset.

ED 8(b) A contract that is a lease initially ceases to be a lease and becomes a purchase/sale if the lessee exercises a purchase option.

Observations

Leases classified currently as finance leases that are in-substance purchases/sales would be excluded from the leases standard: the lessor would recognise a sale of the leased asset with an associated financial asset; and the purchaser would recognise a purchase of the leased asset with an associated financial liability. The resulting financial asset/liability would be subject to the measurement and other requirements of the financial instruments standards rather than those in the leases standard, which are different. In some jurisdictions, the taxation treatment of a transaction may depend on whether such a transaction is classified as a lease or a purchase/sale.

There is tension between the objective to have a single lease accounting model and the decision to exclude in-substance purchases/sales. Similar to the manner in which operating and finance leases are distinguished currently, it would be necessary to make a binary distinction between two different types of lease transactions.

This tension is evident particularly on the lessor side, as the determination of the accounting approach that a lessor applies to lease contracts itself depends on a further assessment of the extent to which the lessor transfers/retains exposure to risks and benefits associated with the underlying asset. This matter is discussed further in section 5.1.

3.2.4 Short-term leases

ED 64, 65

The ED defines a *short-term lease* as a lease for which the longest possible lease term is not more than 12 months. Short-term leases are within the scope of the proposals but lessees and lessors may elect to apply the following simplified requirements to such leases:

- a *lessee* would be permitted initially to measure the lease liability at the undiscounted amount of the lease payments and the right-of-use asset at the amount of the lease liability plus initial direct costs; and
- a *lessor* would be permitted not to recognise additional assets and liabilities arising from the lease contract and not to derecognise any portion of the underlying asset.

Lessees and lessors would instead recognise lease payments in profit or loss over the lease term, i.e. similar to the accounting model for lessors in operating leases under current IAS 17, lessees and lessors would elect whether to apply these simplified requirements on a lease-by-lease basis.

Illustrative example – Short-term lease

Lessee B enters into two contracts with Lessor M to lease cars; the lease term in each case is 12 months and the contracts do not contain renewal options. Lessee C enters into a contract with Lessor M to lease a car; the lease term is 9 months and C has the option to renew the lease for another 6 months.

Both of B's leases qualify as short-term leases because the longest possible lease term under the contracts in each case is not more than 12 months. B and M can elect to apply the simplified requirements for short-term leases to either or both of these leases.

C's lease does not qualify as a short-term lease because the longest possible lease term is 15 months, even if C considers that the chance of it exercising the renewal option is remote. C and M may not apply the simplified requirements to this lease.

Observations

The proposed lease accounting models discussed in sections 4 and 5 may be burdensome to apply to multiple short-term low-value lease arrangements, and the simplified requirements are likely to provide welcome relief, particularly to lessors.

The simplified requirements may have less impact for lessees, since the only difference compared to the proposed right-of-use model discussed in section 4 is the effect of discounting, which normally would not be expected to be significant over a less than 12-month period.

The overall materiality requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* will continue to apply. Some lessees may conclude that the outstanding portion of very short-term leases at the reporting date, e.g. hotel rooms and hire cars, is not material; so in practice this exemption may be more relevant to lessors than to lessees.

3.2.5 Agreements containing service and lease components

ED 6, B5

If a contract contains service and lease components, then the lessee and lessor would assess whether the service component is "distinct" and whether it is practicable to allocate the payments between the service and lease components. The following table summarises the proposed guidance:

	Lessee	Lessor: performance obligation approach	Lessor: derecognition approach
Service component is distinct and payments can be allocated	<ul style="list-style-type: none"> Account for the lease component in accordance with the ED. Account for the service component in accordance with ED/2010/6 <i>Revenue from Contracts with Customers</i> (the Revenue ED)/other applicable IFRSs. 		
Service component is distinct but payments cannot be allocated	<ul style="list-style-type: none"> Account for the whole contract as a lease. 		<ul style="list-style-type: none"> Account for lease components in accordance with the ED. Account for the service component in accordance with the Revenue ED.
Service component is not distinct	<ul style="list-style-type: none"> Account for the whole contract as a lease. 		<ul style="list-style-type: none"> Allocate the payments between the lease and service components on a reasonable basis and account for the components separately.

ED B6

The determination of whether the lease and service components are distinct is made at the date of inception of the lease.

Observations

In practice, many agreements contain service and lease components. Under current IFRSs, the service components typically are treated as executory contracts. When an arrangement contains a lease and a service component, IFRIC 4 requires an entity to separate the payments between the two components on the basis of their relative fair values, which is the general approach proposed in the Revenue ED for allocating the transaction price to separate performance obligations.

The ED's proposals would constitute a change in current practice for lessors under the derecognition approach, since they always would be required to account for the lease and service components separately, regardless of whether the service component is distinct.

3.2.6 Other specific scope exclusions

ED 5

The ED proposes scope exclusions for the following leases:

- leases of intangible assets, except leases of right-of-use assets in a sublease (see section 6.2);
- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and
- leases of biological assets.

ED 5

In addition, the ED proposes that a lease that is assessed to be onerous between the dates of inception and commencement would be within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Observations

IAS 17 includes scope exclusions covering similar types of assets. However, the IAS 17 scope exclusions list individual assets whereas the ED proposes scope exclusions for classes of assets, as noted above.

The decision to exclude leases of intangible assets appears to be for expediency in completing the project to the proposed timeline. The IASB notes that there is little conceptual basis to this exemption and it is possible that the IASB will return to leases of intangible assets at a later date.

The scope exception for leases to explore for or use minerals etc. reflects current diversity in the accounting for such assets, and the IASB's current active project on Extractive Industries.

The rationale for exempting leases of biological assets is that the fair value model under IAS 41 *Agriculture* provides relevant information to financial statement users. The IASB uses a similar argument in conjunction with the exemption for lessors of investment property measured at fair value. However, the ED does not seek to address whether there is a general, conceptual case for exempting from the proposals leases of assets measured at fair value through profit or loss.

4. Accounting model for lessees

4.1 The right-of-use model

ED 10

The ED proposes that lessees account for all lease contracts within scope under the right-of-use model. Under this model, the lessee recognises an asset for its right to use the underlying asset and a liability for its obligation to make lease payments.

Observations

The ED's focus on the right-of-use model is consistent with the DP, and with various joint projects with other standard setters in which the IASB participated previously. Headlines to the effect that "all leases will become finance leases" or "changes to lease accounting mean that debt will soar" have been commonplace for some years. The ED represents a significant step towards the on-balance sheet treatment of leases by lessees.

In practice, many analysts routinely adjust lessees' reported financial figures to reflect commitments under leases classified currently as operating leases, based on amounts disclosed in accordance with IAS 17 and IFRS 7 *Financial Instruments: Disclosures*. One key area of focus following publication of the ED is likely to be the extent to which the lease balances that would be recognised under the ED's proposals provide useful incremental information to users.

The proposed requirement to recognise additional assets, liabilities and financial expense is likely to affect key performance ratios, such as tangible asset ratios and debt/equity ratios, and consequently the ability to satisfy debt covenants. Entities currently renegotiating debt arrangements may wish to consider whether flexibility in determining appropriate debt covenants can be obtained to minimise the impact of the new leases standard when it becomes effective. The recognition of additional assets and liabilities also may affect the results of impairment tests of cash-generating units that include the leases.

Tax considerations often are a major factor when an entity is assessing whether to lease or buy an asset, and when a lessor is pricing a lease contract. However, like IAS 17, the ED addresses lessee and lessor accounting on a pre-tax basis. The income tax accounting for lease contracts would remain within the scope of IAS 12 *Income Taxes*. At present, depending on the treatment allowed by the tax authorities, complexities can arise in accounting for income taxes by lessees on finance leases in particular, for example concerning the applicability of the initial recognition exemption and whether the finance lease asset and liability should be considered to be linked for the purposes of the income tax analysis. These issues are discussed in our publication *Insights into IFRSs* (see 3.13.130). Similar issues are likely to be encountered under the proposals in the ED, as the lessee always would recognise an asset and liability.

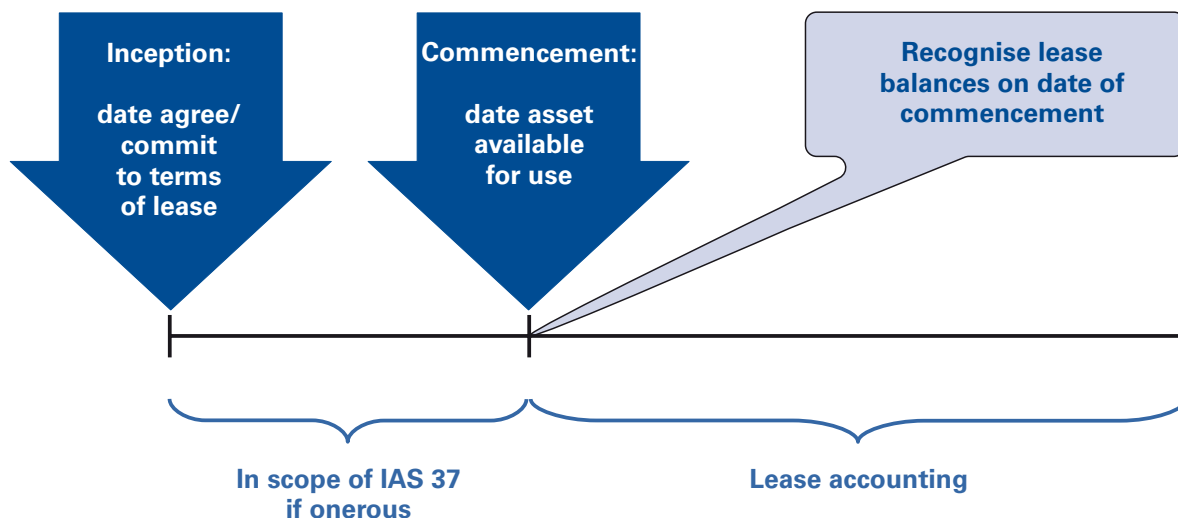
4.2 Timing of initial recognition

ED 10, App A

The ED proposes that a lessee generally would not recognise a lease contract between the dates of inception and commencement of a lease, where:

- *inception* is the earlier of the date of the lease agreement and the date the parties commit to the lease; and
- *commencement* is the date that the lessor makes the underlying asset available for use by the lessee.

ED 5(d) However, if a lease contract is onerous, then the lessee applies the guidance on onerous contracts in IAS 37.



Observations

The proposal that a lessee generally would not recognise a lease contract between the dates of inception and commencement is consistent with the current requirement of IAS 17 that lessees and lessors recognise lease balances on commencement of a lease.

In effect, the ED proposes that a lease contract be recognised only once the lessor has performed by delivering the underlying leased asset to the lessee. It is interesting to compare this approach with the proposal in the Revenue ED that an entity recognise a net contract asset or liability when *either* it performs by delivering a good or service *or* the customer performs by paying consideration. In contrast, the ED does not seem to envisage that a lessee or lessor recognises a lease contract if the lessee performs by making an advance payment to the lessor prior to commencement of the lease.

In practice, there are many arrangements in which substantial payments are made prior to commencement of the lease, particularly when the underlying asset is being constructed specifically for the lessee. However, the ED does not discuss the presentation of such items between the dates of inception and commencement.

In addition, the ED does not discuss how payments between the lessee and the lessor that are made at or before commencement of the lease may affect the measurement of balances recognised by the lessee and lessor on commencement of the lease.

For example, if a lessee makes a lease payment of 100 to the lessor between inception and commencement, then on commencement one might expect the lessee to exclude the payment of 100 from its liability to make lease payments (see section 4.3) but to include the payment of 100 in the initial carrying amount of its right-of-use asset (see section 4.4). Similarly, on commencement one might expect the lessor to exclude the payment of 100 from its right to receive lease payments but to include the payment of 100 in the initial measurement of its performance obligation (see section 5.2) or in its allocation of the carrying amount of the underlying asset between the amount to be derecognised and the amount to be reclassified as a residual asset (see section 5.3). However, this is not stated explicitly in the ED.

4.3 Initial measurement of the liability

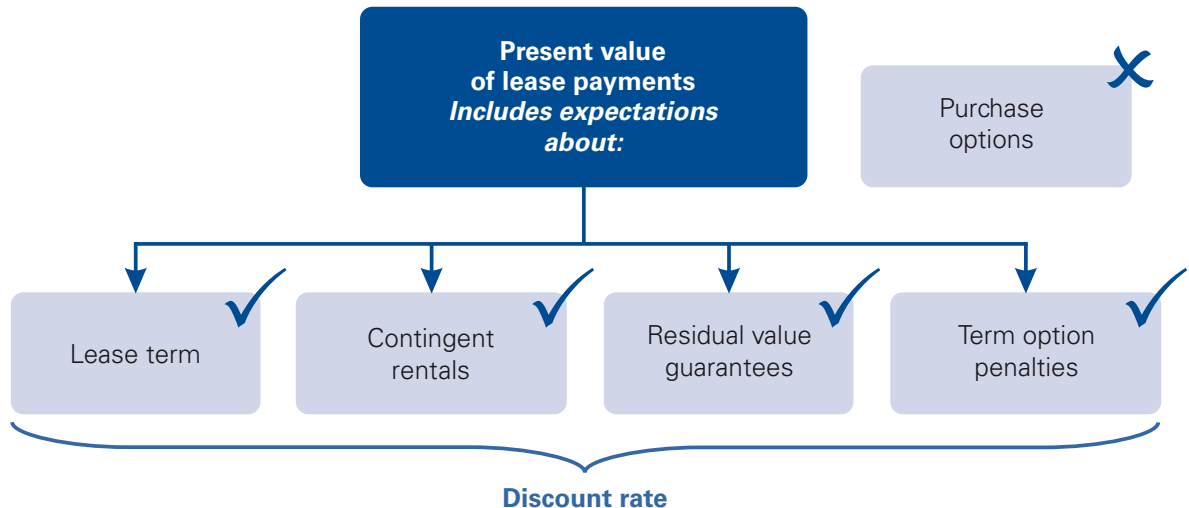
4.3.1 A single liability

ED 12(a)

The ED proposes that the lessee measure its lease liability at the present value of the lease payments.

ED App A

The ED proposes that the lessee recognise the obligation to make lease payments as a single liability (the lease liability). That is, uncertainty in the number and amount of lease payments because of options to extend the lease term (see 4.3.3), contingent rentals (see 4.3.4) and term option penalties and residual value guarantees (see 4.3.5) would not result in the recognition of separate financial instruments by the lessee, but would be reflected in the measurement of the liability as follows:



ED 15, BC63,
64

In contrast, amounts payable by a lessee under a purchase option would not be included in the lease liability; the IASB considers purchase options as not being part of an obligation to make lease payments but rather as terminating the lease contract and purchasing the underlying asset. Therefore, the ED proposes that purchase options be recognised when they are exercised.

Observations

The lessee's lease liability is a financial liability. However, this liability would be measured in accordance with the requirements of the ED, and not the requirements of the financial instruments standards.

The IASB's rationale for excluding purchase options from lease accounting is that exercise of a purchase option terminates a lease and creates a sale and purchase agreement. This is different from the approach under IAS 17, in which the existence of a bargain option may indicate that the lease is a finance lease. The proposal to require different accounting approaches to renewal options and purchase options, which may be economically similar in practice, could create structuring opportunities.

The ED does not provide explicit guidance on the topic of lease incentives, that is, incentives to encourage a lessee to enter into a lease. Lease incentives are common in practice, and may be monetary or non-monetary. One practical issue in implementing the proposals in the ED may be the identification of lease incentives that would be included in the lease payments.

4.3.2 Determining the discount rate

ED 12(a), App A

The ED proposes that the lessee's lease liability be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate. The ED defines the *lessee's incremental borrowing rate* as the rate of interest that, at the date of inception of the lease, the

lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset.

ED 12(a) The rate the lessor charges the lessee could be used as an alternative if it is readily determinable (see section 5.2).

Observations

Permitting the liability to be discounted at the interest rate the lessor charges the lessee enables the specific circumstances of a lease, including the structured financing of the arrangement or tax benefits inherent within the return agreed between the lessee and the lessor, to be reflected. However, it may be difficult for a lessee to determine the rate the lessor is charging the lessee, in particular for leases in which the underlying asset has a significant residual value at the end of the lease term; generally this is the case for leases classified currently as operating leases.

4.3.3 Determining the lease term

ED 13, App A The potential lease payments that would be included in the lessee's lease liability are those that arise during the lease term. The ED proposes that the *lease term* be the longest possible term that is more likely than not to occur.

ED B18 In determining the lease term, the ED proposes that a lessee consider the following factors:

Type of factor	Examples
Contractual factors	<ul style="list-style-type: none"> • The amount of lease payments in any secondary period. • The existence and amount of any contingent payments. • The existence and terms of renewal options. • The costs associated with an obligation to return the leased asset in a specified condition or to a specified location.
Non-contractual factors	<ul style="list-style-type: none"> • Statutory law and local regulations. • Financial consequences of a decision to extend or terminate a lease. • The existence of significant leasehold improvements that would be lost if the lease were terminated or not extended. • Non-contractual relocation costs. • Costs associated with lost production. • Tax consequences of terminating or not extending the lease. • Costs associated with sourcing an alternative item.
Business factors	<ul style="list-style-type: none"> • Nature of the leased asset (specialised/non-specialised; the extent to which the asset is crucial to the lessee's operations). • Location of the asset.
Factors specific to the lessee	<ul style="list-style-type: none"> • Lessee's intentions. • Lessee's past practice.

Illustrative example – Lease term

Lessee X has entered into a non-cancellable lease contract with Lessor L to lease a building. The lease term is four years, and X has the option to extend the lease either by another two years or by another four years.

At inception of the lease, X's expectations about exercising the option to extend the lease term are as follows:

- Lease term of 4 years, i.e. option to extend not exercised: 40 percent chance.
- Exercise of the option to extend by two years: 30 percent chance.
- Exercise of the option to extend by four years: 30 percent chance.

This results in a 30 percent chance of a lease term of at least 8 years, a 60 percent chance of a lease term of at least 6 years, and a 100 percent chance of a lease term of at least 4 years. In this example, the longest possible lease term that is more likely than not to occur is 6 years. Therefore, for the purpose of calculating the present value of the obligation to make lease payments, X uses a lease term of 6 years.

Observations

Under IAS 17, the lease term is the non-cancellable contracted period plus any additional periods for which the lessee has the right to extend the lease and for which, at inception of the lease, it is reasonably certain that the lessee will exercise its option. It is likely that the proposals in the ED will result in lease terms, on average, being longer than under IAS 17. That is, the lease liability will include lease payments for a longer period than under current finance lease accounting.

The IASB's intention is to establish the lessee's reasonable expectation of what the actual lease term will be. Another possible approach that the Board considered was using a term based on a probability-weighted outcome of all possible lease terms; however, this approach was rejected because it may lead to a recognised lease term that is not possible to occur in practice.

We expect that determining the longest possible lease term that is more likely than not to occur will require a significant amount of judgement and that the determination may have a significant impact on the amount of the lease liability in some cases.

4.3.4 Contingent rentals

ED 14(a)

The ED proposes that a lessee include contingent rentals in its lease payments when determining its lease liability.

ED 14(a), B21

The amount to be included would be determined based on a *probability-weighted* estimate of contingent rentals payable, using a reasonable number of outcomes for which a probability distribution is estimated. Not every possible outcome would need to be considered.

ED 14(a)

If lease payments are contingent on changes in an index or rate, such as the consumer price index or the central bank rate, then the ED proposes that a lessee measure the lease liability using the forward rate if it is readily available. If not, then the rate at inception of the lease would be used.

Illustrative example – Contingent rentals

Lessee Y has entered into a lease contract with Lessor L to lease a machine. The lease term, determined in accordance with the principles in 4.3.3, is 6 years and the base annual payments are 100. Payments are due at the end of the year; Y's discount rate is 5 percent.

In addition to the base lease payments, the contract stipulates that Y pays contingent rentals based on the number of products that are manufactured annually by the machine. The contingent rental is 0.02 per product manufactured.

At inception of the lease, Y's expectations about the number of products that the machine will manufacture annually are as follows:

- Less than 3,500 products: 2 percent chance;
- 3,500 products: 10 percent chance;
- 3,800 products: 24 percent chance;
- 4,100 products: 50 percent chance;
- 4,400 products: 12 percent chance;
- More than 4,400 products: 2 percent chance.

Y calculates the probability-weighted outcome of each reasonably possible outcome, meaning that the scenarios with a 2 percent chance are not considered. The probability-weighted outcome is $((3,500 \times 10\%) + (3,800 \times 24\%) + (4,100 \times 50\%) + (4,400 \times 12\%)) / 96\% = 4,000$ products. The estimated contingent rental therefore is 80 $(4,000 \times 0.02)$.

The present value of the lease payments is 914, based on a discount rate of 5 percent and annual lease payments of 180 $(100 + 80)$ for 6 years.

Observations

The ED's proposal for contingent rentals is different from current practice under IAS 17, in which lessees generally recognise contingent rentals as they are incurred.

The ED's proposal is likely to prove controversial. Consider, for example, a retailer that leases a retail outlet and pays to the lessor a fixed monetary amount plus a percentage of revenue generated at the retail outlet. The ED's proposals would require the retailer to prepare a probability-weighted estimate of the contingent rentals payable, based on its estimate of the revenues arising. The retailer would then include this amount in its lease liability.

The IASB believes that such an obligation meets the definition of a financial liability because it is unconditional; only the amount that will be paid is uncertain. However, some respondents to the DP noted that if rentals depend on sales or on the number of products manufactured using a leased machine, then often there would be no unconditional obligation and therefore no liability under IAS 37 as the lessee could avoid having to pay rentals by choosing not to make sales or not to operate the machine.

4.3.5 Residual value guarantees and term option penalties

ED 14(b), (c),
B21

The ED proposes that amounts payable by the lessee under residual value guarantees and term option penalties be included in the lease liability in the same manner as contingent rentals. That is, the lessee would determine the probability-weighted expected amount payable.

Illustrative example – Residual value guarantee

Lessee Z has entered into a lease contract with Lessor L to lease a car. The lease term is five years and the annual payments at the beginning of the year are 100. In addition, Z and L agree on a residual value guarantee; if the fair value of the car at the end of the lease term is below 400, then Z will pay to L an amount equal to the difference between 400 and the fair value of the car. Payments are due at the start of the year; Z's discount rate is 5.06 percent.

At inception of the lease, Z's expectations about the amount payable at the end of the lease term in respect of the residual value guarantee are as follows:

- amount of 200 payable under residual value guarantee: 40 percent chance;
- amount of 100 payable under residual value guarantee: 30 percent chance; and
- amount of 0 payable under residual value guarantee: 30 percent chance.

In this example, the probability-weighted amount payable under the residual value guarantee is 110 ((200 x 40%) + (100 x 30%) + (0 x 30%)).

The present value of Z's lease payments is 540, based on a discount rate of 5.06 percent, annual lease payments of 100 for 5 years, and an amount of 110 payable at the end of the lease term.

Observations

Amounts payable under residual value guarantees are included in a lessee's minimum lease payments under IAS 17. However, the amount to be included under IAS 17 is the maximum exposure under the guarantee, not the expected amount payable. It appears that amounts relating to residual value guarantees included in lease payments under the ED would, on average, be lower than amounts relating to residual value guarantees included in minimum lease payments under IAS 17.

The value of a residual value guarantee could be seen as being linked to the value of the underlying asset rather than the right-of-use asset. However, the IASB believes that residual value guarantees are expected to be closely related to other lease terms and therefore inclusion of residual value guarantees within lease payments (and thus the right-of-use asset) is proposed.

4.4 Initial measurement of the right-of-use asset

ED 12(b), AppA The ED proposes that the lessee initially measure its right-of-use asset at cost, which equals the lease liability, calculated in accordance with section 4.3, plus any initial direct costs. *Initial direct costs* are defined as recoverable costs directly attributable to negotiating and arranging a lease that would not have been incurred had the lease not been made.

ED B14, 15 The proposals include guidance that would assist a lessee in determining whether costs are incremental costs and whether they are directly attributable to negotiating and arranging a lease. That additional guidance includes the following types of costs as examples:

Typically initial direct costs?	
<ul style="list-style-type: none"> • Commissions • Legal fees • Costs in respect of evaluating and recording guarantees, collateral and other security arrangements • Costs associated with negotiating lease terms • Costs of preparing and processing lease documents • Costs of closing the transaction 	<ul style="list-style-type: none"> • General overheads • Advertising costs • Costs associated with soliciting potential leases • Costs of servicing existing leases • Costs related to other ancillary activities

Observations

Broadly, the proposed initial measurement of a lessee's right-of-use asset (a non-financial asset) is consistent with most other non-financial assets that are measured initially at cost, such as assets measured in accordance with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

Conversely, the Revenue ED requires entities to expense the costs of obtaining a contract.

4.5

Subsequent measurement of the liability

4.5.1

Measurement basis

ED 16(a), 19

The ED proposes that subsequent to initial recognition the lessee measures its lease liability at amortised cost using the effective interest method. The discount rate used for initial recognition of the liability would not be revised subsequent to initial recognition. The lessee would not be permitted to measure its lease liability at fair value.

Illustrative example – Liability measured subsequently at amortised cost

Lessee D has entered into a lease contract with Lessor L to lease a building. The longest lease term that is more likely than not to occur is determined to be 7 years. The annual lease payments are 450 and are due at the end of the year. D's discount rate is 5.04 percent.

The initial recognition of the obligation to make lease payments is 2,600. At the end of the first year, D pays the first annual lease payment of 450 to L: 131 ($2,600 \times 5.04\%$) is interest; and 319 ($450 - 131$) is principal, which decreases the liability by 319.

The carrying amount of the liability at the start of the second year is 2,281 ($2,600 - 319$).

Observations

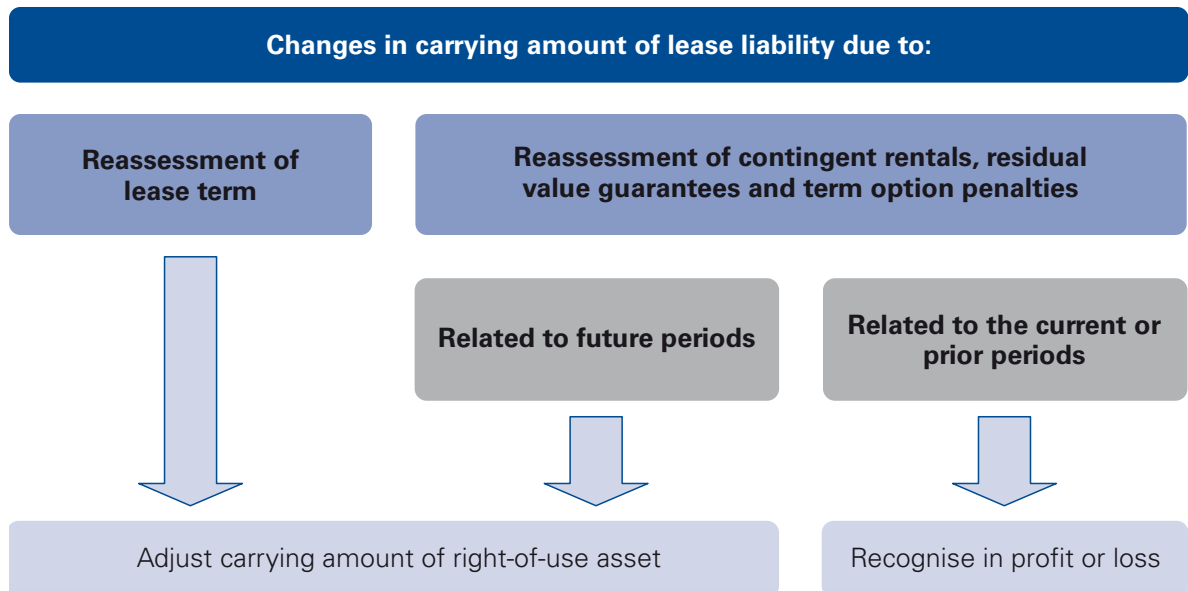
The ED proposes a cost model for the lessee's lease liability, consistent with the measurement basis of a lessee's IAS 17 finance lease liability.

One key argument that the IASB cites to support the prohibition on the lessee measuring its lease liability at fair value after initial measurement is that this would be inconsistent with the subsequent measurement of many non-derivative financial instruments. However, as the IASB has rejected a components approach to accounting for the lessee's liability, there will be many cases in which a lessee's lease liability will contain features that would be identified as embedded derivatives under IAS 39 *Financial Instruments: Recognition and Measurement*.

4.5.2 Changes in lease payments

ED 17, 18

The ED proposes that an entity assess whether facts and circumstances indicate that there has been a significant change since the previous reporting period. If this is the case, then the lessee would reassess the lease payments and compute a new carrying amount for its lease liability. Changes in the carrying amount of the lease liability would be recognised as follows:



ED 19

There is no change to the discount rate when the lease payments are reassessed in this way. However, if contingent rentals are based on a reference interest rate, then the lessee reassesses the contingent rentals for changes in that reference interest rate and recognises the resulting change in the carrying amount of the lease liability in profit or loss.

Illustrative example – Change in contingent rental

Assume the same facts as in the illustrative example in 4.5.1 except that the annual lease payments are contingent on D's sales and are expected to be 450 in each of the next 7 years. The carrying amount of the obligation to make lease payments is 2,600. Initially D records the following entry, assuming that initial direct costs are zero:

	<i>Debit</i>	<i>Credit</i>
Right-of-use asset	2,600	
Obligation to make lease payments		2,600
<i>To recognise right-of-use asset and obligation to make lease payments</i>		

In the first year D's actual sales are such that the lease payment due to L at the end of the year is 500. D records the following entries in relation to the lease payment:

	<i>Debit</i>	<i>Credit</i>
Interest costs (2,600 × 5.04%)	131	
Obligation to make lease payments		131
<i>To recognise interest on obligation to make lease payments</i>		

	<i>Debit</i>	<i>Credit</i>
Obligation to make lease payments	500	
Cash		500
<i>To recognise first annual lease payment</i>		

D revises its expectations about the annual lease payments for the next 6 years and now expects to pay 520 each year. The present value of the obligation to make lease payments at the start of the second year, based on a remaining lease term of 6 years, the same discount rate of 5.04 percent, and expected annual lease payments of 520, is 2,636. The liability at the start of the second year is 2,231 (2,600 + 131 - 500); therefore, 405 needs to be added to the liability. Of this amount, 50 (500 - 450) relates to prior periods, and the remainder relates to future periods. Accordingly, D records the following entry:

	<i>Debit</i>	<i>Credit</i>
Right-of-use asset	355	
Profit or loss	50	
Obligation to make lease payments		405
<i>To recognise change in obligation to make lease payments</i>		

The 355 added to the right-of-use asset also can be calculated as the present value of 6 (remaining lease term in years) payments of 70 (revised annual payment of 520 less original estimate of 450), discounted using a rate of 5.04 percent.

Observations

Under IAS 17, estimates made on inception of a lease generally are not revisited during the lease term, and estimated cash flows are adjusted only if there is a change to the terms of the lease. In contrast, the ED's approach would result in greater volatility in the liabilities recognised by lessees since a reassessment of future lease payments would be required when any new facts or circumstances indicate that there is a significant change in the lease liability.

The approach for recognising changes in the lease liability resulting from a reassessment of amounts payable under contingent rentals and residual value guarantees is not consistent with the approach to changes in decommissioning liabilities under IFRIC 1 *Changes in Decommissioning, Restoration and Similar Liabilities*. In general, IFRIC 1 requires changes in decommissioning liabilities to be recognised against the carrying amount of the related asset.

Identifying whether a change in the amounts payable under contingent rentals and residual value guarantees relates to prior or future periods may not always be straightforward, particularly for lessees that have entered into a large number of leases.

A change in the lease liability that relates to a reassessment of the amount payable under a residual value guarantee would be recognised against the carrying amount of the right-of-use asset to the extent that the change relates to future periods. However, this may appear to be counter intuitive in certain circumstances. An increase in the amount payable under a residual value guarantee typically occurs when there is a decrease in the value of the underlying asset; this may be seen as indicating a decrease in the value of the right to use that asset rather than as an increase in that value. It also could be argued that a decrease in the residual value of the underlying asset, which results in an increase in the right-of-use asset, in some cases could give rise to an immediate impairment of that right-of-use asset.

4.6 Subsequent measurement of the right-of-use asset

ED 16(b), 21

The ED proposes that subsequent to initial recognition the lessee measure the right-of-use asset based on amortised cost. Alternatively, the lessee may measure the right-of-use asset under the revaluation model if it also applies the revaluation model to the class of assets that it owns and to which the leased asset would belong if it were accounted for under IAS 16.

ED 20

The right-of-use asset would be amortised on a systematic basis over the shorter of the lease term and the useful life of the underlying asset. The related expense would be presented as amortisation expense (see section 4.7).

ED 24

The ED does not propose a new impairment model for the right-of-use asset; instead, the asset would be subject to the requirements of IAS 36 *Impairment of Assets*.

Observations

Although the right-of-use asset is an intangible asset, the ED proposes that a lessee be permitted to apply a revaluation model if it meets the conditions to apply the revaluation model to property, plant and equipment. In particular, the ED does not impose the requirement in IAS 38 that fair value be determined by reference to an active market. Consequently, a lessee may apply a revaluation model to right-of-use assets in circumstances in which it would be limited to the cost model for other forms of intangible assets.

The ED does not include specific guidance on other aspects of accounting for the right-of-use asset. For example, the ED does not discuss whether a lessee should identify components of an intangible asset and amortise those separately, as would be required for an item of property, plant and equipment within the scope of IAS 16. Also, the ED states that the lessee would present amortisation of the right-of-use asset in the statement of comprehensive income (see section 4.7), but does not discuss whether such amortisation could be capitalised in the carrying amount of another asset.

4.7 Presentation

ED 25-27

The ED proposes that a lessee present the items arising from lease contracts within the scope of the new standard as follows:

Statement of financial position	Statement of comprehensive income	Statement of cash flows
<ul style="list-style-type: none"> • Present obligation to make lease payments separately from other financial liabilities. • Present right-of-use asset within property, plant and equipment or investment property, separately from other assets that the lessee owns. 	<ul style="list-style-type: none"> • Present amortisation and interest expense separately from other amortisation and interest expense; this presentation also would be permitted in the notes only. 	<ul style="list-style-type: none"> • Classify cash repayments of principal and interest as financing activities, separately from other financing cash flows.

Observations

IAS 17 does not contain any presentation requirements; for example, there is no requirement for a lessee in a finance lease to present the assets and liabilities arising from lease contracts separately from other assets and liabilities in its statement of financial position. For many entities, the ED's proposals would increase the number of line items in their statement of financial position.

The ED's proposal that a lessee present the asset and liability arising from a lease contract contrasts with the ED's proposal that a lessor following the performance obligation approach present the assets and liabilities arising from a lease together, totalling to a net lease contract asset or liability (see section 5.2).

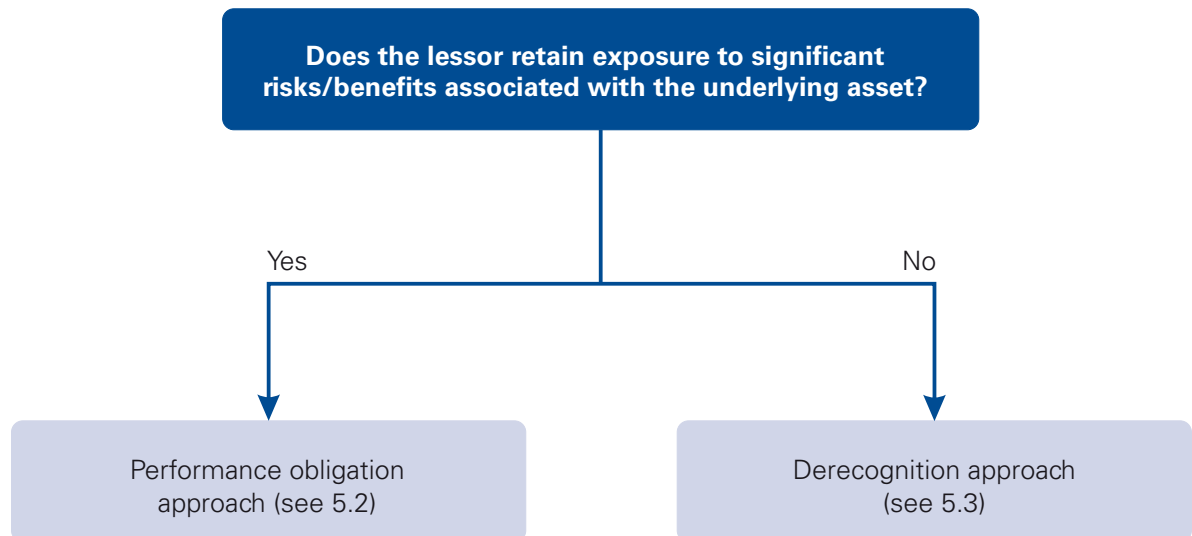
The ED's proposal regarding presentation in the statement of cash flows is more prescriptive than current requirements and may represent a change in practice for many entities.

5. Accounting model for lessors

5.1 The performance obligation and derecognition approaches

ED 28, 29

The ED proposes two accounting models for lessors: the performance obligation approach and the derecognition approach, as shown below:



ED 29

The lessor's exposure to significant risks or benefits associated with the underlying asset is assessed on a lease-by-lease basis. The assessment would be performed at inception of the lease and would not be revisited subsequently.

ED 28, B22-B27 A lessor considers whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the current lease, or subsequent to the term of the current lease, for example by leasing the underlying asset multiple times or selling the underlying asset. The ED identifies the following indicators that may be relevant to this assessment, but notes that the existence of one or more indicators is not conclusive:

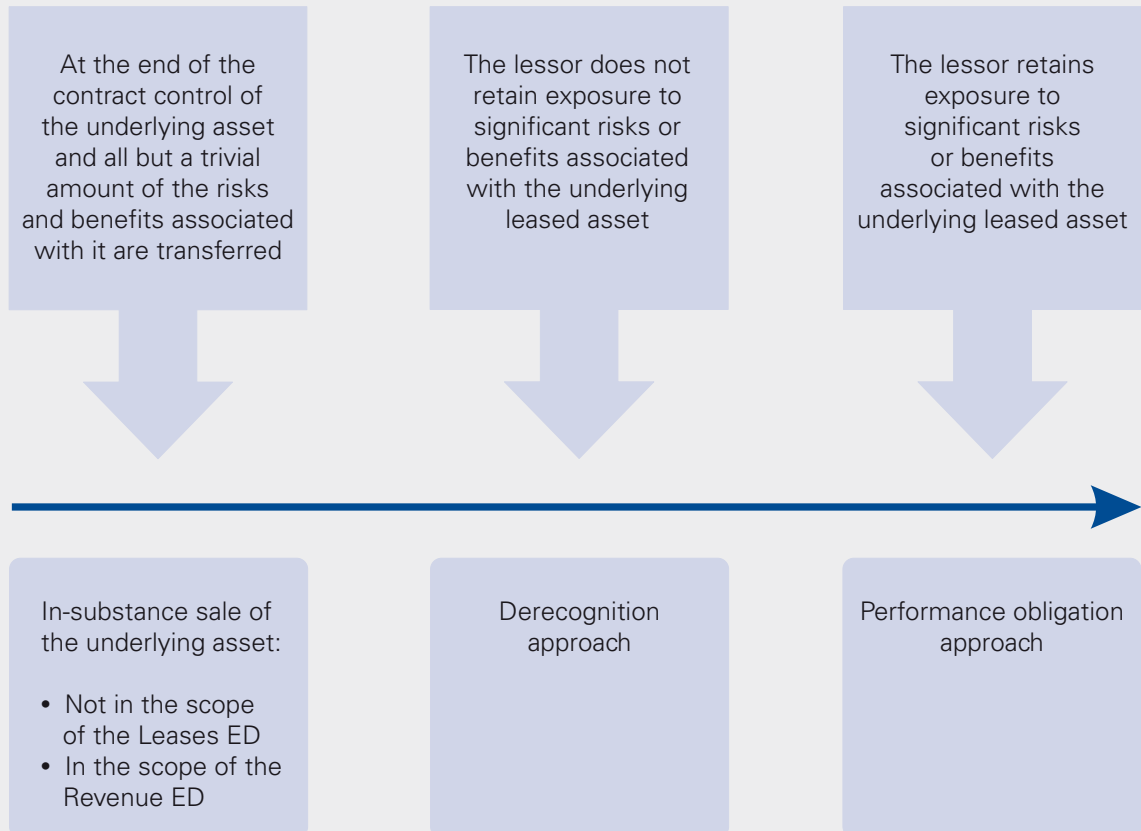
During the expected term of the current lease	Subsequent to the term of the current lease
<ul style="list-style-type: none"> • Significant contingent rentals that are based on the use or performance of the underlying asset. • Options to extend or terminate the lease. • Material non-distinct services provided under the current lease contract. <p><i>Note:</i> the credit risk of the lessee is ignored.</p>	<ul style="list-style-type: none"> • Whether the lease term is short in relation to the remaining useful life of the underlying asset. • Whether a significant change in the value of the underlying asset at the end of the lease term is expected, considering: <ul style="list-style-type: none"> – the present value of the underlying asset at the end of the lease term; and – any residual value guarantee.

Observations

The IASB argues that it has proposed a single model for lessor accounting, the right-of-use model, and that the performance obligation approach and the derecognition approach are different approaches to application. However, the approaches appear to be significantly different conceptually, and give significantly different accounting results.

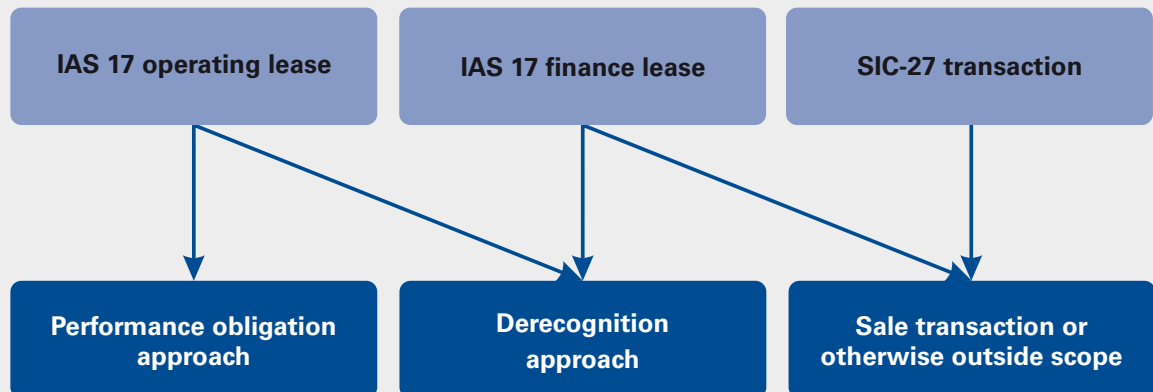
Many lessors will find that their current lease contracts may be accounted for in one of three different ways under the ED: under the performance obligation approach; under the derecognition approach; or as a sale of the underlying asset.

In effect, a lessor would consider its exposure to risks or benefits associated with the underlying asset in two different instances. Firstly, the lessor would assess whether the contract is a lease or an in-substance sale of the underlying item; if the contract is an in-substance sale, then it is excluded from the scope of the guidance (see 3.2.3). Secondly, if the contract is a lease, then the lessor would consider which approach to apply to the lease.



To an extent, current lessor accounting requirements also feature a three-way model, in that SIC-27 states that certain contracts in the legal form of a lease may not have the substance of leases. At a very high level, the boundary tests to distinguish operating leases, finance leases and SIC-27 transactions under IAS 17 have some similarities to the boundary tests when assessing whether a lessor should apply the performance obligation approach, the derecognition approach or sale accounting. However, there is not a one-to-one relationship between the categories.

The most common mapping when moving from IAS 17 to the ED is illustrated below, but other outcomes are possible.



The IASB considers that the lessor's business model will be indicative of the appropriate approach. When the lessor's business model is primarily the provision of finance and credit risk is the principal business risk, the derecognition approach is likely to be appropriate. Conversely, when the lessor's business model is primarily to generate return from the active management of the underlying asset and asset risk is the principal business risk, the performance obligation approach is likely to be appropriate. However, as the assessment is to be made on a lease-by-lease basis, a lessor cannot assume that all its lease contracts necessarily would be accounted for under the same approach.

The performance obligation approach views the underlying asset as the lessor's economic resource and therefore considers the lease contract as creating an asset and liability to be recognised in addition to the underlying asset.

The derecognition approach views the lessor as having transferred economic benefits associated with the underlying asset to the lessee at commencement of the lease. The derecognition approach appears to be closer in spirit to the Boards' proposals on other projects regarding revenue recognition and the derecognition of financial instruments. It also appears to be more consistent with the proposed approach for lessees in that delivery of the leased asset is seen as satisfying a performance obligation, giving rise to the recognition of revenue.

5.2 Accounting under the performance obligation approach

5.2.1 Initial recognition and measurement

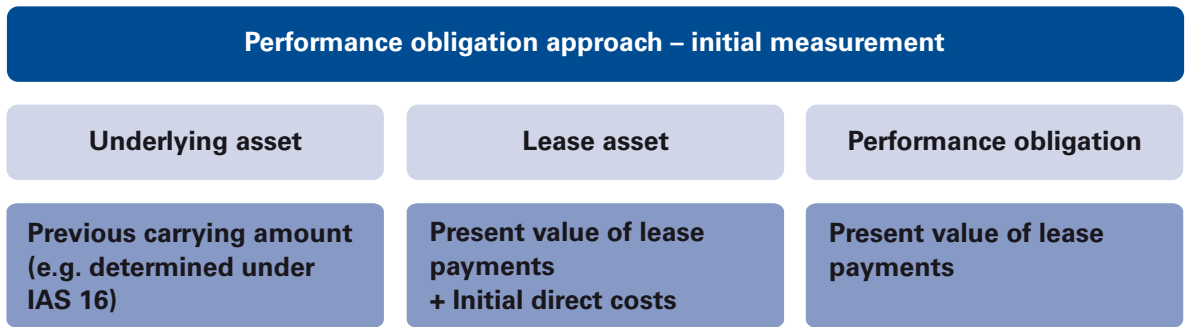
ED 30

The ED proposes that a lessor recognise at commencement of a lease:

- an asset representing its right to receive lease payments (the lease asset); and
- a liability representing its obligation to permit the lessee to use the underlying asset (the performance obligation).

In addition, the lessor would continue to recognise the underlying asset.

The lessor would not recognise a gain on commencement of a lease, assuming that the lessor has a single performance obligation being its obligation to grant the lessee the right to use the asset for the lease term.



ED 33-36 The ED proposes that the lessor initially measure its lease asset at inception of the lease at the present value of the lease payments, plus any initial direct costs.

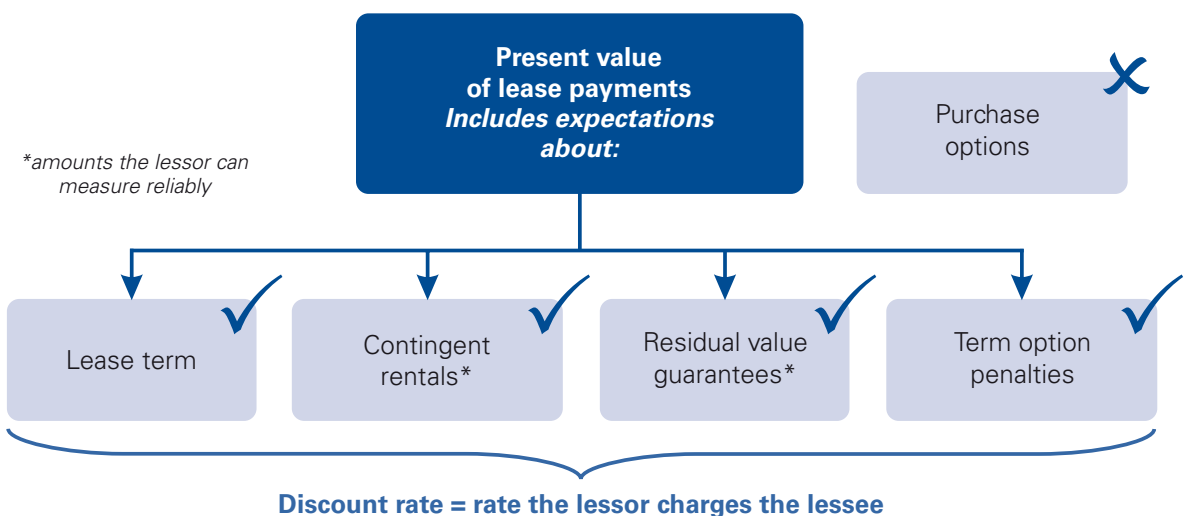
ED 33(a), 35(a) Generally, the lessor would measure the present value of the lease payments in a similar manner to a lessee, except that:

- the discount rate would be the rate that the lessor charges the lessee; and
- contingent rentals and amounts receivable under residual value guarantees would be included only if the lessor can measure the amounts reliably.

ED 33(a), App A, B11-13 The discount rate used to determine the present value of lease payments for the lessor (the rate that the lessor charges the lessee) would take into account the nature of the transaction as well as specific terms of the lease, such as:

- lease payments;
- the lease term;
- contingent rentals;
- the value of the underlying asset at the end of the lease term; and
- security attached to the underlying asset during the lease term.

ED BC126 Contingent rentals and amounts receivable under residual value guarantees would be included in the assessment of lease payments only if the lessor can measure the amounts reliably; this is because it may be difficult for a lessor to estimate contingent rentals that depend on the actions of the lessee.



ED 33(b) The lessor would measure its performance obligation at the amount of the present value of the future lease payments.

Observations

While the lease asset meets the definition of a financial asset, the Boards concluded, based on special features unique to lease contracts, that a lessor should not account for the lease asset in the same way as other financial assets.

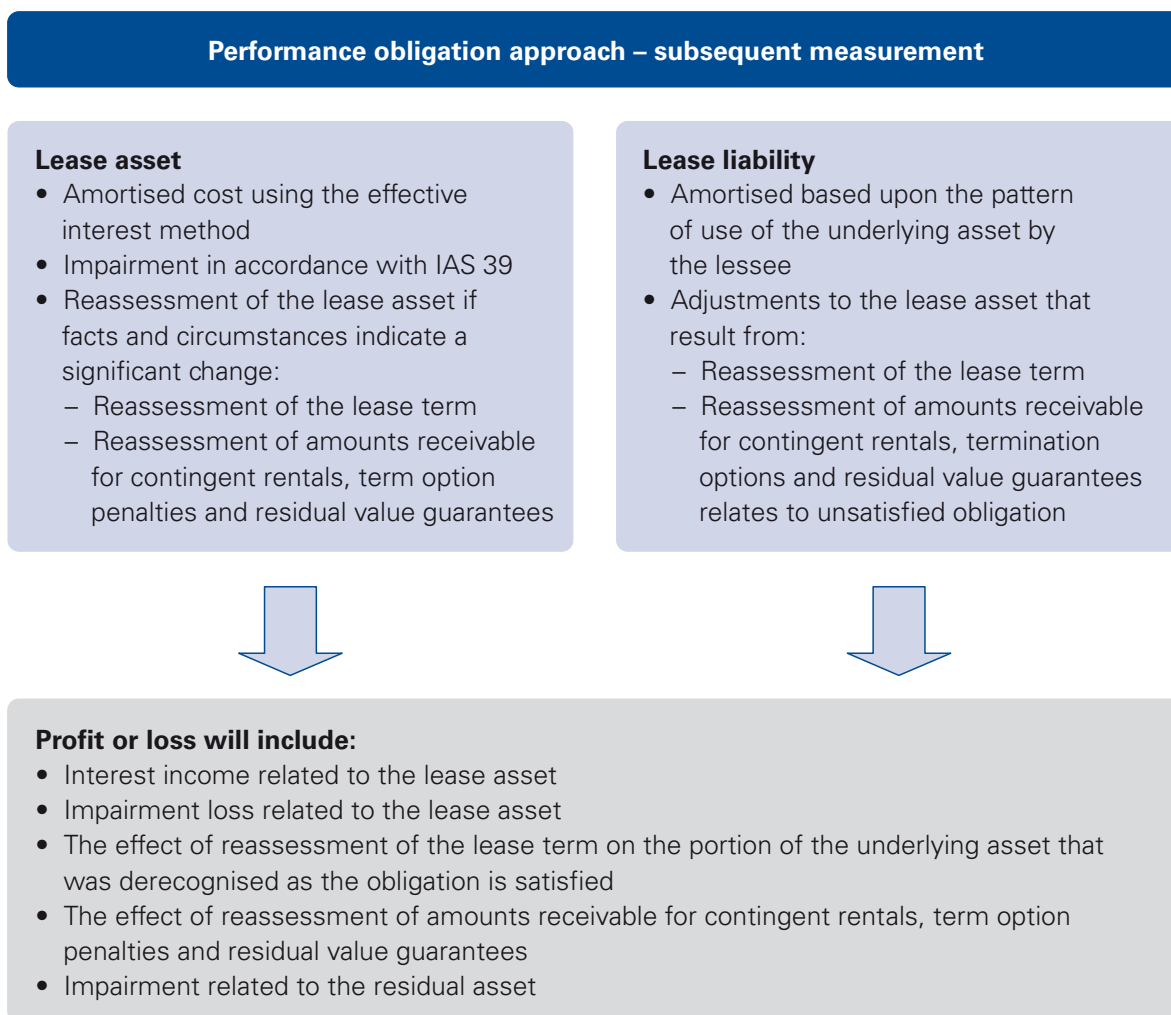
Conceptually, the lessor's lease asset is the counterpart of the lessee's lease liability, though there are a number of measurement differences. Generally, the lessee's lease liability will reconcile to the lessor's lease asset on initial recognition as follows:

Lessee's liability: obligation to pay lease payments	XXX
Discount rate: different calculations	+ / -
Lease payments: lease term; differences resulting from different information and expectations	+ / -
Lease payments: contingent rentals, amounts receivable under termination options and residual value guarantees if they can be measured reliably; differences resulting from different information and expectations	+ / -
Lease payments: contingent rentals, amounts receivable under termination options and residual value guarantees if they cannot be measured reliably	-
Lessor's initial direct costs	+
Lessor's lease asset: lease payments receivable	XXX

The proposal that a lessor recognise contingent rentals etc. in its lease asset only if the lessor can measure them reliably is similar to the proposal in the Revenue ED that a seller include variable consideration in the transaction price only if it can estimate it reasonably. It is not clear whether the IASB intends that "measure reliably" and "estimate reasonably" should result in significantly different recognition thresholds.

The proposals that lessors and lessees apply a different recognition threshold to contingent rentals etc., and may use different discount rates on occasion, reflect the information asymmetry between lessors and lessees in many leases. It means that the amounts recognised by a lessor and a lessee may be significantly different in some cases.

5.2.2 Subsequent measurement

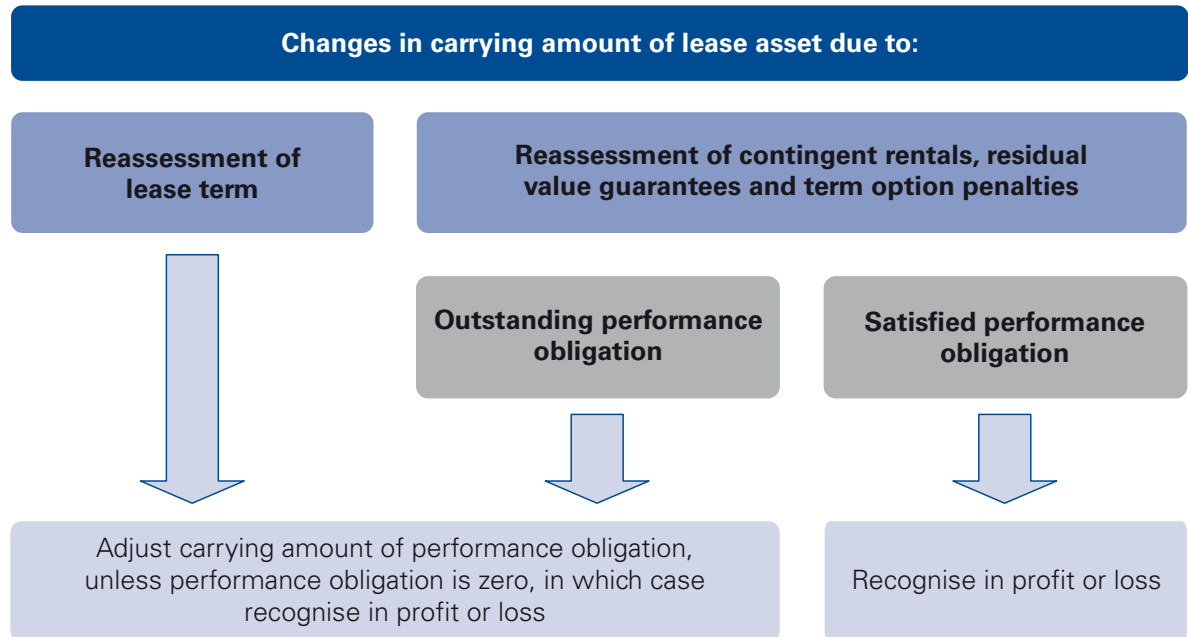


ED 37, 41 The ED proposes that from commencement of the lease the lessor measure its lease asset at amortised cost using the effective interest method and recognise any impairment losses in accordance with IAS 39.

ED 37, 38 The performance obligation would be amortised subsequently based on the pattern of use of the underlying asset by the lessee (e.g. straight-line method, output methods such as based on units produced, or input methods). If the lessor cannot determine this pattern on a systematic and rational manner, then it would use the straight-line method.

ED 39 The lessor would reassess its lease asset in a manner similar to that in which a lessee would reassess its liability, except that the lessee would adjust its right-of-use asset whereas the lessor would adjust its lease liability. However, the carrying amount of the performance obligation could not be reduced below zero, so any further debits would be recognised in profit or loss.

Changes in the carrying amount of the lease asset would be recognised as follows:



Observations

The proposals on subsequent measurement of the lessor's lease asset are, broadly, a corollary to the proposals on subsequent measurement of the lessee's lease liability. However, they are significantly different from the current requirements on subsequent measurement of finance lease receivables under IAS 17. In contrast to IAS 17, lessors would be required to consider whether it is necessary to reassess the lease payments each reporting period, which may result in increased volatility in reported lease balances.

The proposals on subsequent measurement may be complex to apply in practice. For example, a single lease asset may require adjustment due to changes in the expected lease term, contingent rentals and residual value guarantees while being amortised at the effective interest rate and subject to impairment testing. It would then be necessary to allocate changes in the carrying amount of the lease asset between the performance obligation and profit or loss.

Many of these complexities would not arise if the lessor were permitted to measure the lease asset at fair value. However, the IASB argues that an option to measure lease assets at fair value could impair comparability. That is, the IASB appears to value comparability between balances arising from similar lease contracts over comparability with those arising from other, similar contracts. For example, entities generally would have the option to measure at fair value receivables arising from contracts for the sale of an asset, including those currently accounted for as leases under IAS 17.

The measurement of the lessor's performance obligation can be compared to the proposals included in the Revenue ED, as illustrated in the following table:

	Revenue ED	Leases ED
Initial recognition	An entity measures the liability at the amount of customer consideration on initial recognition.	A lessor measures its performance obligation at the present value of the lease payments, i.e. the consideration receivable from the lessee.
Subsequent measurement	An entity remeasures the liability (performance obligation) in subsequent periods to reflect the extent to which it has satisfied that obligation.	The lessor remeasures its performance obligation to reflect the pattern of use of the underlying asset by the lessee.
Changes in uncertain consideration	Changes in variable consideration treated as changes in the original transaction price and allocated between all performance obligations, including satisfied performance obligations.	Changes in variable lease payments due to the reassessment of contingent rentals, residual value guarantees and term option penalties allocated between the satisfied and outstanding portions of the performance obligation.

The amortisation proposals in the ED appear to focus on how the lessee uses the underlying asset, rather than how the lessor satisfies its performance obligation to the lessee. While this outcome is likely to be welcomed by lessors, it is difficult to reconcile this with the proposals in the Revenue ED, which focus on the satisfaction of the performance obligation by the seller.

The ED proposes that a lessor apply IAS 39 in order to determine whether its lease asset is impaired. Also, the lessor would continue to recognise the underlying asset which, in the absence of specific other guidance, appears to remain subject to impairment testing under IAS 36. The ED does not discuss whether the amount subject to impairment testing in either case would be reduced by the unamortised portion of the lease obligation, or whether an impairment charge related to the lease asset identified under IAS 39 would reduce the carrying amount of the underlying asset that is subject to impairment testing under IAS 36. In the absence of further proposed guidance, it is not clear what steps a lessor using the performance obligation approach would take to avoid the "double-counting" of impairment losses.

5.2.3 Presentation

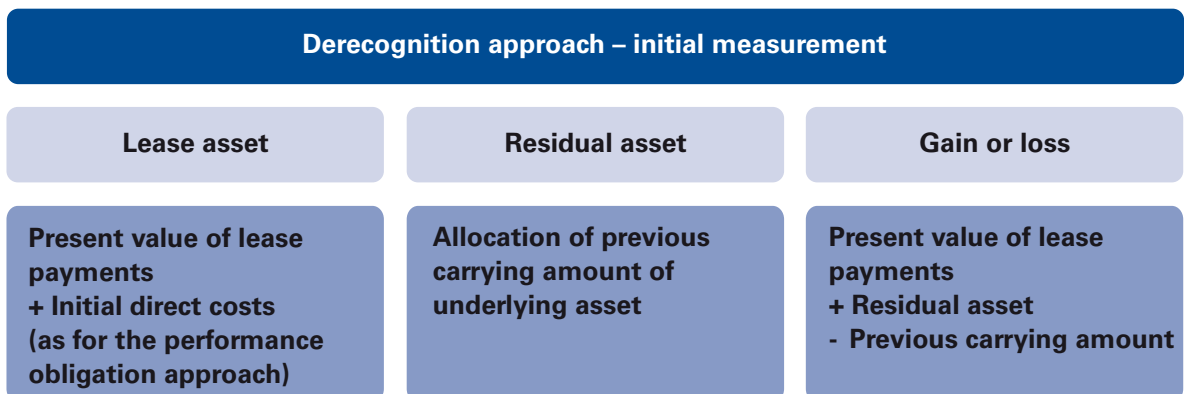
ED 42-45

The ED proposes that a lessor present the following with respect to lease contracts under the performance obligation approach:

Statement of financial position	Statement of comprehensive income	Statement of cash flows
<ul style="list-style-type: none"> Present a net total of the following as a net lease asset or a net lease liability: <ul style="list-style-type: none"> underlying asset right to receive lease payments (lease asset) liability to permit the lessee to use the underlying asset (performance obligation). 	<ul style="list-style-type: none"> Present each of the following separately from other interest income, income, and depreciation expense: <ul style="list-style-type: none"> interest income on lease receivable income from satisfaction of the lease liability depreciation of underlying asset. 	<ul style="list-style-type: none"> Classify cash receipts of principal and interest as operating activities, separately from other operating cash flows.

5.3 Accounting under the derecognition approach

5.3.1 Initial recognition and measurement



ED 46

Under the derecognition approach, the lessor would derecognise a portion of the underlying leased asset, representing the lessee's rights; and reclassify the remaining portion as a residual asset, representing its right to the underlying leased asset at the end of the lease term.

ED 49-53

The ED proposes that the lessor initially recognise and measure its lease asset as described under the performance obligation approach (see section 5.2).

ED 49, 50

The residual asset would be determined, at inception of the lease, as an allocation of the original carrying amount of the underlying asset. The ratio of the fair value of the lease payments to the fair value of the underlying asset would determine the portion of the carrying amount of the underlying asset to be derecognised. The remainder would be reclassified as a residual asset.

The lessor would recognise any gain or loss arising on commencement of the lease in profit or loss.

Illustrative example – Initial measurement under the derecognition approach

Lessor L enters into a non-cancellable lease contract with Lessee Y under which Y leases a truck for a term of 4 years. The useful life of the truck is estimated to be 4 years. Management of L concludes that L does not retain exposure to significant risks and benefits related to the truck either during or after the lease term.

The annual lease payments, which are due at the end of the year, are 500 and L's discount rate is 5.6 percent.

The present value of the lease payments recognised as a lease asset on commencement of the lease is 1,750. It is assumed that initial direct costs are zero.

The fair value of the truck is 1,900 and at commencement of the lease the truck has a carrying amount of 1,400. The fair value of the right to receive lease payments, for the purpose of this example, equals the present value of the right to receive lease payments (i.e. 1,750).

L, using the derecognition approach, derecognises a portion of the carrying amount of the truck and reclassifies the remaining interest therein as a residual asset as illustrated below:

	<i>Debit</i>	<i>Credit</i>
Lease asset (receivable)	1,750	
Underlying asset (1,400 x 1,750 / 1,900)		1,289
Profit or loss		461
<i>To recognise lease asset and derecognise portion of underlying asset</i>		

The gain recognised is the difference between the present value of the lease payments of 1,750 and the portion of the carrying amount of the asset derecognised of 1,289.

	<i>Debit</i>	<i>Credit</i>
Residual asset (1,400 - 1,289)	111	
Underlying asset		111
<i>To reclassify remaining portion of underlying asset as residual asset</i>		

The amount of the residual asset is defined by the difference between the carrying amount of the asset and the portion of the carrying amount derecognised.

The accounting entries presented above are intended to segregate the residual asset from the other assets presented within property, plant and equipment.

Observations

At first glance, the derecognition approach appears closer to current finance lease accounting than the performance obligation approach. However, significant differences remain:

- Firstly, the lessor's lease asset is measured differently from a finance lease receivable under IAS 17 (see section 5.2).
- Secondly, the approach to the lessor's remaining interest in the underlying asset is different. Under IAS 17, the entire underlying asset is derecognised and the lessor's remaining interest is included in the lessor's finance lease receivable. That is, the remaining interest becomes part of a financial asset.

Under the ED, the residual asset remains a separate asset. In effect, the original underlying asset, a non-financial asset, would be separated into a part that has been transferred to the lessee (the derecognised part) and a part that remains with the lessor (the residual asset).

5.3.2 Subsequent measurement

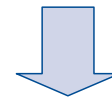
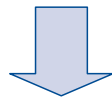
Derecognition approach – subsequent measurement

Lease asset

- Amortised cost using the effective interest method
- Impairment in accordance with IAS 39
- Reassessment of the lease asset if facts and circumstances indicate a significant change:
 - Reassessment of the lease term
 - Reassessment of amounts receivable for contingent rentals, termination options and residual value guarantees

Residual asset

- Impairment in accordance with IAS 36
- Adjustments to the lease asset that result from reassessment of the lease term



Profit or loss will include:

- Interest income related to the lease asset
- Impairment losses related to the lease asset
- The effect of reassessment of the lease term on the portion of the underlying asset that was derecognised
- The effect of reassessment of amounts receivable for contingent rentals, termination options and residual value guarantees
- Impairment related to the residual asset

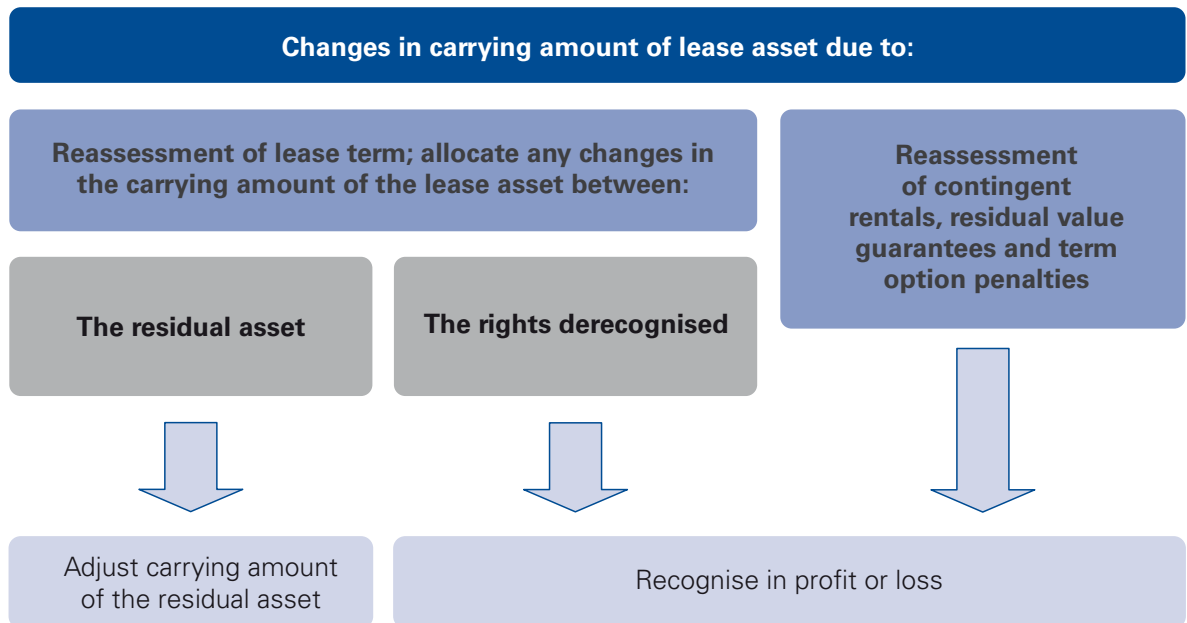
ED 54, 58 The ED proposes that from commencement of the lease the lessor would measure its lease asset at amortised cost using the effective interest method and recognise any impairment loss in accordance with IAS 39. This is similar to the subsequent measurement of the lease asset under the performance obligation approach.

ED 54, 55, 59 The residual asset would be subject to impairment testing in accordance with IAS 36, and may be adjusted if the lease term is reassessed, but otherwise would not be remeasured.

ED 56, 57 The lessor would reassess its lease asset in a manner similar to how a lessor under the performance obligation approach would reassess its asset, except for the following:

- *Reassessment of the lease term.* The lessor would allocate any change in the carrying amount of its lease asset that is attributable to a reassessment of the lease term between its residual asset and the rights derecognised in a similar manner to that used to measure those items at commencement date. Allocating an amount to the rights derecognised would result in recognition of a profit or loss.

- *Reassessment of the amounts of any contingent rentals, term option penalties and residual value guarantees.* The lessor would recognise those changes in the carrying amount of its lease asset in profit or loss.



Illustrative example – Subsequent measurement under the derecognition approach

Lessor L has entered into a lease contract with lessee D under which D leases a car for a term of five years. The annual lease payments, which are due at the end of the year and include reliably determinable contingent rentals, are determined to be 275. L's discount rate is 4.72 percent.

At commencement of the lease the car has a carrying amount of 1,000 and a remaining expected useful life of 5 years. The fair value of the car is 1,300. The fair value of the right to receive lease payments is 1,200, which for the purpose of this example equals the present value of the right to receive lease payments. Assume that the car is an item of property, plant and equipment in L's business.

Lessor L, using the derecognition approach, derecognises a portion of the carrying amount of the car and reclassifies the remaining interest therein as residual asset as illustrated below:

	Debit	Credit
Lease asset (receivable)	1,200	
Underlying asset (1,000 x 1,200 / 1,300)		923
Profit or loss		277
<i>To recognise lease asset and derecognise portion of underlying asset</i>		

The gain recognised is the difference between the present value of the lease payments of 1,200 and the portion of the carrying amount of the asset derecognised of 923.

	Debit	Credit
Residual asset (1,000 - 923)	77	
Underlying asset		77
<i>To reclassify remaining portion of underlying asset as residual asset</i>		

The amount of the residual asset is defined by the difference between the carrying amount of the asset and the portion of the carrying amount derecognised.

At the end of the first year L recognises the following entries:

	<i>Debit</i>	<i>Credit</i>
Cash	275	
Finance income (1,200 x 4.72%)		57
Lease asset (receivable)		218
<i>To recognise receipt of first annual lease payment</i>		
Depreciation expense (77 / 5)	15	
Residual asset		15
<i>To recognise depreciation of underlying asset</i>		

At the end of the second year, due to the terms of the contingent rent, D pays an amount of 280 rather than the originally estimated 275. L records the following entries in respect of year 2:

	<i>Debit</i>	<i>Credit</i>
Cash	280	
Finance income ((1,200 - 218) x 4.72%)		46
Lease asset (receivable)		234
<i>To recognise receipt of first annual lease payment</i>		
Depreciation expense (77 / 5)	15	
Residual asset		15
<i>To recognise depreciation of underlying asset</i>		

At this point, L revises its expectations about the annual lease payments for the next 3 years and now expects to receive 285 per year. The present value of the lease asset at the end of the second year, based on a remaining lease term of 3 years, the same discount rate of 4.72 percent, and expected annual lease payments of 285, is 780.

The receivable at the end of the second year is 748 (1,200 - 218 - 234); therefore, 32 needs to be added to the receivable. Accordingly, L records the following entry:

	<i>Debit</i>	<i>Credit</i>
Lease asset (receivable) (780 - 748)	32	
Profit or loss		32
<i>To recognise change in receivable for lease rentals</i>		

Observations

The proposals on subsequent measurement of the lessor's lease asset are similar to those under the performance obligation approach and similar considerations apply.

Reassessment of the lease asset for amounts related to contingent rentals, termination options and residual value guarantees would be viewed as changes to the consideration transferred in respect of a performance obligation that was satisfied at lease commencement, and as such would be recognised in profit or loss. This would likely result in greater volatility in profit or loss for lessors under the derecognition approach, as under the performance obligation approach some changes to the lease asset would be recognised as adjustments to the lessor's performance obligation and therefore recognised in profit or loss only as the performance obligation is amortised.

Conversely, changes to the lease asset that are the result of the reassessment of the lease term would be viewed as evidence that the interest that was transferred to the lessee is different from that estimated initially. Therefore, in this case the carrying amount of the residual asset and the rights derecognised would be adjusted.

Some may be concerned that the proposal to remeasure the residual asset only for impairment would distort the lessor's profit profile, and is more restrictive than the approach to the measurement of other asset classes. In effect, if a lessor sells or re-lets the underlying asset on expiry of the initial lease, then the lessor would recognise a gain or loss that represents in part fair value changes in the underlying asset during the previous lease term and the discounting inherent in the initial measurement of the residual asset that would not be unwound subsequently.

5.3.3 Presentation

ED 60 A lessor would present the lease asset separately from other financial assets, and the residual asset separately within property, plant and equipment in the statement of financial position.

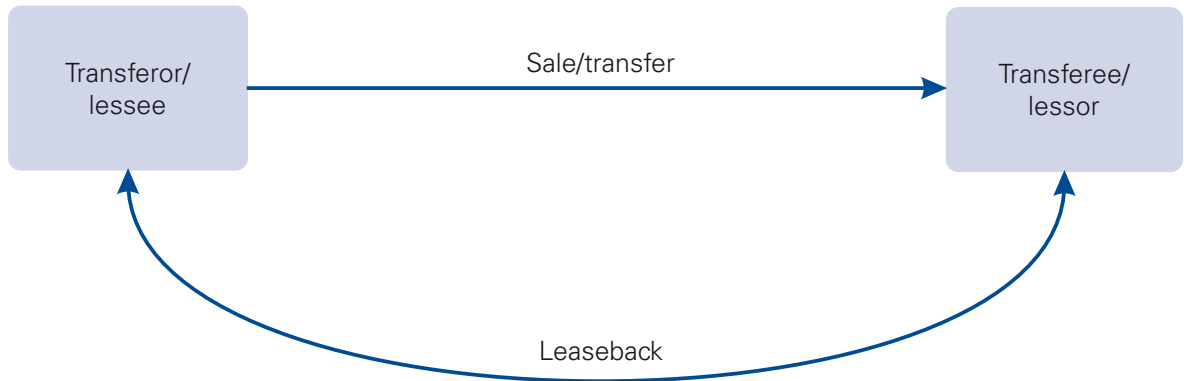
ED 61 Presentation in profit or loss would depend on the lessor's business model:

- If the lessor uses lease arrangements for the purpose of financing, then the lessor would present net lease income and expense in a single line item.
- However, if the lessor uses leases as an alternative to selling (e.g. many manufacturers and dealers), then the lessor would present lease income and expense as separate line items.

ED 63 In the statement of cash flows, the lessor would classify cash receipts of principal and interest as operating activities, separately from other operating cash flows.

6. Other lease accounting topics

6.1 Sale and leaseback transactions



ED 66 The ED proposes specific guidance on transactions in which an entity transfers an asset to another party and leases it back. Broadly, this guidance would apply if the transfer and lease contracts are entered into, negotiated or performed at the same time. The accounting treatment would then depend on whether the transfer leg of the transaction meets the conditions for a purchase/sale of the underlying asset.

ED 67, 68 If the transfer *meets* the conditions for a purchase/sale of the asset, then:

- the transferor/lessee would account for the sale in accordance with applicable IFRSs and for the leaseback in accordance with the right-of-use model for lessees (see section 4); and
- the transferee/lessor would account for the purchase in accordance with applicable IFRSs and for the leaseback under the performance obligation approach (see section 5.2).

ED 67, 68 However, if the transfer does *not* meet the conditions for a purchase/sale of the asset, then:

- the transferor/lessee would account for the contract as a financing, that is, not derecognise the asset and account for the proceeds received from the sale of the asset as a financial liability; and
- the transferee/lessor would not recognise the underlying asset and would account for amounts receivable in accordance with applicable IFRSs.

ED B31 The ED includes conditions that normally would preclude an arrangement from being a purchase/sale of the underlying asset, including:

- the seller/lessee has an obligation or an option to repurchase the asset or the buyer/lessor can compel the seller/lessee to repurchase the asset at an amount that is not fair value;
- the seller/lessee guarantees the buyer/lessor's investment or a return on that investment;
- the seller/lessee provides the buyer/lessor with a residual value guarantee;
- the seller/lessee provides non-recourse financing to the buyer/lessor;
- the seller/lessee is not relieved of the obligation under any existing debt related to the asset;
- the seller/lessee provides collateral on behalf of the buyer/lessor (other than the underlying asset) or guarantees the buyer/lessor's debt;
- the seller/lessee's rental payments are contingent on some predetermined or determinable level of future operations of the buyer/lessor;
- the seller/lessee enters into a sale and leaseback transaction involving asset enhancements without leasing the underlying asset from the buyer/lessor;

- the buyer/lessor is obliged to share with the seller/lessee a significant portion of the appreciation of the asset; or
- any other provision or circumstance that allows the seller/lessee to participate in any future profits of the buyer/lessor or the appreciation of the underlying asset.

ED 69

If the consideration for the purchase or sale or the lease payments are not at fair value, then the ED proposes that:

- the transferor/lessee adjust the right-of-use asset to reflect current market rates for the lease payments, and adjust the gain or loss on disposal of the underlying asset accordingly; and
- the transferee/lessor adjust the carrying amount of the underlying asset and the performance obligation to reflect current market rates.

Observations

The proposed approach to sale (transfer) and leaseback transactions is significantly different from that under IAS 17.

The analysis of a sale and leaseback transaction under currently applicable IFRSs focuses on the classification of the leaseback leg of the transaction as either an operating lease or a finance lease. There is no requirement for a transaction to meet the conditions for a sale of the underlying asset under IAS 18 *Revenue*, as IAS 17 rather than IAS 18 provides the more specific guidance on such transactions.

For this reason, transactions that transfer only a small portion of the risks and rewards related to the underlying asset to the lessor are classified as sale and operating leasebacks. Such transactions commonly are used as a form of off-balance sheet financing at present.

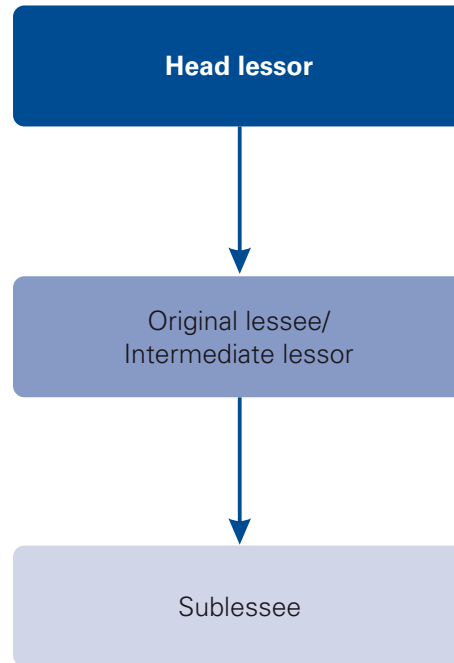
Conversely, sale and leaseback transactions generally will be on-balance sheet for the lessee under the ED. Many such transactions will not meet the conditions to be a purchase/sale of the underlying asset and so would be treated as financings by the lessee. In other cases, the lessee would recognise a liability for its obligation to make lease payments in accordance with the right-of-use model (see 4.3).

6.2

ED App A

Subleases

The ED defines a *sublease* as a transaction in which an underlying asset is re-leased by the original lessee (or intermediate lessor) to a third party, and the lease agreement between the original lessor and the lessee remains in effect. The relationship can be shown as:



ED 43

Generally, intermediate lessors would apply the proposed requirements to such arrangements. However, the ED includes specific guidance on the presentation of subleases by an intermediate lessor that applies the performance obligation approach, who would be required to present separately:

- its liability to make lease payments under the head lease; and
- the net total of all other assets and liabilities arising from the sublease contract (i.e. right-of-use asset, lease receivables from the sublease contract, and liability to permit the sublessee to use the underlying asset).

Illustrative example – Presentation under the performance obligation approach by an intermediate lessor

The example below illustrates the presentation of the statement of financial position of an intermediate lessor applying the performance obligation approach.

Property, plant and equipment		1,100
Cash		1,000
<i>Right-of-use asset from the head lease</i>	<i>1,900</i>	
<i>Lease receivables from the sublease contract</i>	<i>2,100</i>	
<i>Liability to permit the lessee to use the underlying asset</i>	<i>(2,100)</i>	
<i>Net sublease asset</i>		<u>1,900</u>
Total assets		<u>4,000</u>
Trade and other payables		600
<i>Liability to pay for the lease payments of the head lease</i>		<u>1,900</u>
Total liabilities		<u>2,500</u>

Under the derecognition approach (see section 5.3), the intermediate lessor would be required to present the rights to receive lease payments and the residual asset from a sublease contract separately from other financial assets and lease contracts (i.e. leases in which the entity is the head lessor).

Observations

The ED does not propose any measurement exceptions for subleases. As such an intermediate lessor may, depending on the facts and circumstances, measure the lease liability related to a head lease differently from its lease asset related to a sublease of the same underlying asset. For example, differences may arise from the inclusion of contingent rentals etc. in the lease payments, and the determination of the appropriate discount rate (see 5.2.2).

The IASB proposes this approach on the basis that the head lease and the sublease are separate transactions, and that subleases would be measured on the same basis as other leases.

In practice, subleases are common and there are some arrangements that intermediate lessors treat as a pass-through. The ED does not discuss the possibility that an intermediate lessor may act as agent, and does not comment on whether the guidance in the Revenue ED would apply to lease contracts, or on whether the guidance in IAS 39 on offsetting financial assets and liabilities would apply to an intermediate lessor's lease asset and lease liability.

7 Disclosure

7.1 General disclosure objective

ED 70

The ED proposes that an entity disclose quantitative and qualitative financial information that identifies and explains the amounts recognised in its financial statements arising from lease contracts; and describes how the amount, timing and uncertainty of an entity's future cash flows may be affected by leases.

ED 73(a)

This general objective would be satisfied through the following proposed disclosures about the nature of lease arrangements:

- a general description of lease arrangements;
- the basis and terms on which contingent rentals are determined;
- the existence and terms of renewal and termination options;
- the existence and principal terms of any options for the lessee to purchase the underlying asset;
- information about (changes to) assumptions and judgements relating to the amortisation methods used;
- the existence and terms of residual value guarantees;
- initial direct costs incurred; and
- restrictions imposed by lease arrangements, such as those relating to dividends, additional debt and further leasing.

ED 73(b)

The ED also proposes that an entity disclose information about the principal terms of a lease if there are significant rights and obligations between the date of inception and the date of commencement of that lease.

Further disclosures proposed for lessees and lessors include:

ED 74

- the nature and amounts disclosed in respect of significant subleases;

ED 75

- how the entity has accounted for short-term leases;

ED 83

- information about significant assumptions and judgements with respect to options, contingent rentals, term option penalties, residual value guarantees and the discount rate; and

ED 84

- information relating to risks arising from lease contracts, in accordance with IFRS 7.

Observations

The ED follows other recent due process documents published by the IASB in setting out an overall objective for the proposed disclosures. The ED proposes that an entity assess the level of detail that will best satisfy the overall disclosure objective, e.g. the level of aggregation at which information is disclosed. The ED also proposes that an entity consider whether the information disclosed meets the overall disclosure objective, and to supplement the required disclosures if not.

In taking this approach, the ED allows entities some flexibility in meeting the detailed disclosure requirements, but also requires entities to use their judgement to assess whether the detailed disclosures have met the overall objective.

A number of the proposed detailed disclosures are familiar from IAS 17 but acquire a new significance given the other proposals in the ED. For example, IAS 17 requires lessors to disclose a general description of their leasing business; this disclosure would now shed light on the lessor's decision as to which accounting approach to follow, and the presentation adopted for leases recognised under the derecognition approach.

7.2 Additional disclosures for lessees

The ED proposes that a *lessee* disclose:

- ED 76* ● terms and conditions for sale and leaseback transactions, including the amount of any gains or losses associated with such transactions; and
- ED 77* ● a reconciliation between opening and closing balances of right-of-use assets and obligations to make lease payments, disaggregated by class of underlying asset and separately disclosing the total cash lease payments paid during the period.

ED 85 The ED proposes that the requirement to disclose maturity analyses in accordance with paragraphs 39(a) and (b) of IFRS 7 would not apply to lessees. Instead, a lessee would disclose a maturity analysis of the obligation to make lease payments, showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years. The maturity analysis would distinguish the minimum obligations specified in the lease and the amounts recognised in the statement of financial position.

Observations

Generally, the proposed disclosure requirements for lessees are more extensive than those for finance lessees under IAS 17. For example, the ED proposes new disclosure requirements for sale and leaseback transactions. IAS 17 does not include specific disclosure requirements for sale and leaseback transactions, though it notes that such transactions are subject to the general disclosure requirements of IAS 1 *Presentation of Financial Statements* and IAS 17.

7.3 Additional disclosures for lessors

The ED proposes that a *lessor* disclose:

- ED 78* ● information about its exposure to risks or benefits associated with the underlying asset on which it based its determination of whether to apply the performance obligation or derecognition approach;
- ED 79* ● any impairment losses separately disclosed in respect of both approaches;
- ED 80* ● a reconciliation between opening and closing balances of lease receivables (under either approach), lease liabilities (under the performance obligation approach) and residual assets (under the derecognition approach);
- ED 82* ● information about the nature of significant service obligations related to its leasing activities; and
- ED 81* ● information about the nature and amount of each class of residual asset (under the derecognition approach).

ED 86 The ED proposes that the requirement to disclose maturity analyses in accordance with paragraph 37(a) of IFRS 7 would not apply to lessors. Instead, a lessor would disclose a maturity analysis of the right to receive lease payments, showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years. The maturity analysis would distinguish the cash flows attributable to the minimum receivables in the lease and the amounts recognised in the statement of financial position.

Observations

Generally, the proposed disclosure requirements for lessors are more extensive than those for finance lessors under IAS 17. In some cases, the additional disclosure requirements arise as a consequence of the lessor accounting proposals, which include alternative approaches to lessor accounting with different assets and liabilities recognised under each approach.

8. Effective date and transition

8.1 Effective date

The ED does not propose an effective date for the new standard and does not specify whether early adoption would be permitted.

The Boards plan an additional consultation on the effective dates of this and other proposed new standards.

Observations

As described below, first-time application of the new standard could be a time-consuming and costly exercise for many. The Boards state that they plan to allow sufficient time for entities to implement the proposals. It will be important that the Boards consult widely with preparers so that they have a proper understanding of just how much time may be required.

8.2 Lessee approach to transition

The ED proposes a simplified retrospective approach to transition for lessees.

ED 90

Lessees would apply the right-of-use model to all outstanding lease contracts at the date of initial application of the new standard, i.e. at the beginning of the earliest comparative period presented in the first financial statements issued after the effective date of the new standard.

ED 90(a)

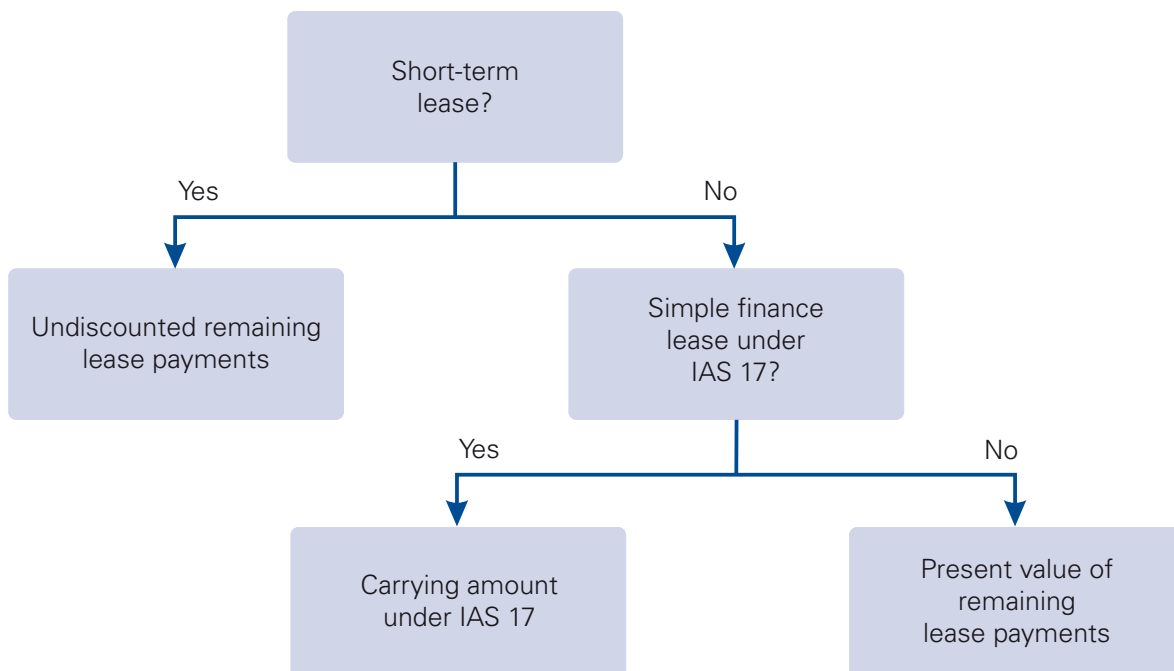
Generally, a lessee would recognise the liability to make lease payments at the present value of the remaining lease payments, discounted using its incremental borrowing rate at the date of initial application. The right-of-use asset would be measured at the amount recognised for the lease liability, subject to any impairment adjustments.

ED 92, 93

The ED proposes further relief for the measurement of a lessee's assets and liabilities in the following cases:

- If the outstanding lease contract meets the definition of a short-term lease, then on initial application a lessee would recognise the liability to make lease payments at the undiscounted amount of the remaining lease payments. The right-of-use asset would be measured at the amount of the liability.
- If the outstanding lease contract does not meet the definition of a short-term lease but is classified as a finance lease under IAS 17 and is a simple lease (i.e. the lease contract does not contain options, contingent rentals or residual value guarantees), then on initial application a lessee would recognise the liability to make lease payments and the right-of-use asset at the carrying amount of the liability and the asset under IAS 17.

The following diagram illustrates the potential measurement bases of a lessee's lease liability on initial application of the new standard:



Observations

Although they may appear complex on a first read, the transition proposals justify their description as a “simplified retrospective approach” in that they are simpler than the full retrospective adoption that otherwise would be required under IAS 8. If a lessee were to apply IAS 8 on initial application of the standard, then it would be required to compute the balances that it would have recognised on commencement of the lease, by reference to the values that it would have estimated at inception of the lease, and prepare lease amortisation schedules showing the movements in those balances between commencement of the lease and the date of initial application of the new standard. In comparison, the proposed requirements are significantly less onerous.

In addition, the relief for short-term leases and simple finance leases will facilitate transition for lessees with simpler leasing arrangements.

However, first-time application of the proposals will remain a time-consuming and costly process for many. At the computational level, lessees will be required to gather additional data for all but the simplest leases, especially for those classified currently as operating leases, and perform new calculations in order to compute the amounts to be included in the financial statements.

More importantly, lessees that would see a significant change in their reported financial position on application of the new requirements may wish to ensure that their shareholders and other users of their financial statements understand those changes, so that application of the new proposals is a “no surprises” exercise.

In some cases, lessees will need to assess as soon as possible the effect of application of the proposals on their key financial ratios and covenants, to assess whether there is any threat to their compliance with key loan agreements and other regulations. Those currently renegotiating loan agreements may wish to ensure that covenants entered into while IAS 17 remains in force can be flexed to reflect application of the proposed new requirements.

8.3 Lessor approach to transition

The ED proposes a simplified retrospective approach to transition for lessors, with different transition requirements for leases accounted for under the performance obligation and derecognition approaches.

ED 94 For all outstanding lease contracts to which a lessor applies the performance obligation approach, the lessor would on initial application:

- recognise the right to receive lease payments, measured at the present value of the remaining lease payments discounted using the rate the lessor charged the lessee on inception, subject to impairment;
- recognise the liability to permit the lessee to use the underlying asset, measured at the same amount as the right to receive lease payments; and
- reinstate previously derecognised underlying assets at depreciated cost as if the asset never had been derecognised, subject to impairment.

ED 95 For all outstanding lease contracts to which a lessor applies the derecognition approach, the lessor would on initial application:

- recognise the right to receive lease payments, measured at the present value of the remaining lease payments discounted using the rate the lessor charged the lessee at inception of the lease, subject to impairment; and
- recognise the residual asset at fair value determined at the date of initial application.

Observations

Similar to the transition proposals for lessees, those for lessors are simpler than would be required under IAS 8. However, they remain complex and in some ways require greater use of estimates and judgement than those required for lessees.

In particular, under the performance obligation approach, a lessor would be required to reinstate the underlying asset as if it had never been derecognised. This requirement to reinstate would apply only in the case of a lease that was classified as a finance lease under IAS 17 and to which the lessor applies the derecognition approach under the new standard. However, in the cases in which it does apply, this requirement will represent full retrospective application of the standard to previously derecognised assets.

In the case of the derecognition approach, we expect that the requirement to determine the fair value of the residual asset at the date of initial application may be complex and costly to apply. Often a lessor will not have this information to hand, unless a lease is near its end date and the lessor has begun to market the asset for sale.

8.4 Other transition issues

The ED proposes no specific transition arrangements for contracts that are accounted for as leases under IAS 17 but are considered to be purchases/sales of the underlying asset, or for sale and leaseback transactions.

Observations

The proposed transition arrangements focus on contracts that are classified as leases under the proposals; they are silent on other forms of contracts that may be affected by the proposals. In the absence of specific transition relief, full retrospective application would be required under IAS 8.

We expect that a number of contracts that were classified as finance leases under IAS 17 will not be considered to be leases under the proposals. It is not clear whether the IASB actively supports full retrospective restatement of such contracts on first-time application of the standard, or whether the lack of specific transition relief is an oversight.

Similarly, the intention of the IASB regarding the treatment of sale and leaseback transactions on first-time application of the proposals is not clear. No specific transition relief is proposed and it is not clear whether an entity that is a party to a sale and leaseback transaction is intended to adopt a full retrospective approach to the sale leg and then apply the simplified retrospective approach to the leaseback, or how such an approach would be applied.

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