

# Briefing Sheet

Exposure draft *ED/2010/9 Leases*

August 2010, Issue 18

This Briefing Sheet summarises the IASB's<sup>1</sup> and FASB's<sup>2</sup> (together the Boards) exposure drafts *ED/2010/9 Leases* (the ED), which was published on 17 August 2010. Comments are due to the IASB by 15 December 2010.

Lessees would recognise the assets and liabilities arising from lease contracts in their statement of financial position, including lease contracts classified as operating leases under current requirements.

Two accounting models are proposed for lessors: the performance obligation approach and the derecognition approach.

The 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.

**KPMG's update on International Financial Reporting Standards (IFRSs) developments**

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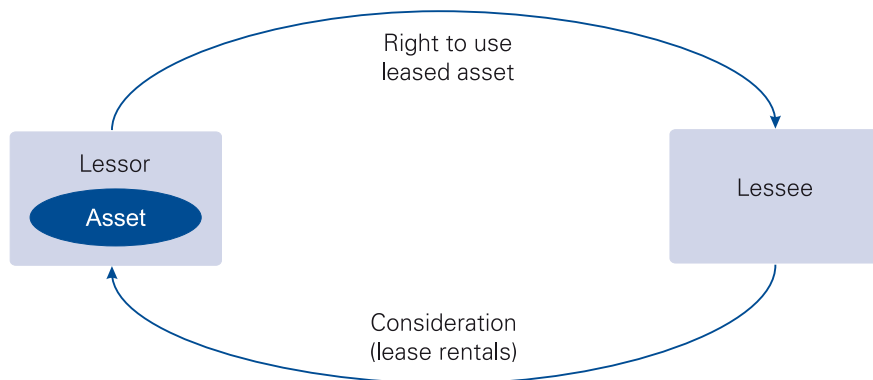
**Our forthcoming publication *New on the Horizon: Leases* will provide more detail about the ED and discuss possible application issues. Speak to your usual KPMG contact if you would like a copy of this publication.**

## **Executive summary**

The ED proposes that a new standard on lease accounting for lessees and lessors 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 ED proposes new models for lessee and lessor accounting, which would change current lease accounting requirements significantly.

The ED proposes a model for *lessee* accounting under which a lessee would recognise a "right-of-use" asset representing its right to use the underlying asset, and a liability representing its obligation to pay lease rentals over the lease term.

The lessor/lessee relationship can be illustrated as follows:



The ED proposes two different accounting models for *lessors*: the performance obligation approach and the derecognition approach. If a lessor retains exposure to significant risks and benefits associated with the underlying asset, then it would apply the performance obligation approach to the lease; otherwise it would apply the derecognition approach.

Under the *performance obligation* approach the lessor would continue to recognise its interest in the underlying asset. It also would recognise a new asset representing its right to receive lease payments from the lessee and a new liability representing its obligation to deliver use of the underlying asset to the lessee over the lease term.

Under the *derecognition* approach the lessor would recognise a new asset representing its right to receive lease payments from the lessee, derecognise a portion of the underlying 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.

In order to determine the lessee's liability and the lessor's receivable, it would be necessary to estimate

future lease payments over the longest possible lease term that is more likely than not to occur. Amounts arising under contingent rentals, lessee residual value guarantees and term option penalties would be included in the lease payments on a probability-weighted average basis. Amounts payable under purchase options would not be included in the lease payments.

The proposals include scope exemptions for leases of intangible assets and, for lessors, leases of investment property measured at fair value. The ED proposes simplified requirements for short-term leases and would not apply to a contract that represents a purchase or sale of the underlying asset.

A simplified retrospective approach to initial application of the new standard has been proposed. However, an effective date for the new standard has not been proposed since the Boards plan an additional consultation on the effective dates of this and other proposed standards.

## Overview of the key proposals

### Scope

Under the proposals a lease is 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 ED proposes to incorporate within the new standard the principles included in IFRIC 4 regarding the identification of leases.

The ED proposes that a contract that represents a purchase or sale of an underlying asset would not be a lease. For these purposes, a contract would represent a purchase or sale if it transfers control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset. In addition, the ED proposes specific scope exemptions for:

- leases of intangible assets, other than right-of-use assets arising in subleases;
- leases to explore for or use minerals, oil, natural gas and similar assets;
- leases of biological assets; and
- leases that meet the definition of an onerous contract prior to the date of commencement of the lease.

Other exceptions and exemptions, including those proposed for investment property, are discussed under the heading "Other proposals" below.

## Proposed accounting model for lessees

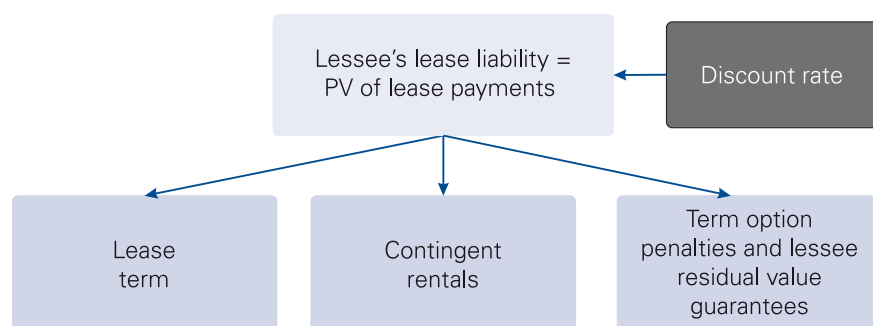
### Right-of-use model

The ED proposes that a lessee would recognise a right-of-use asset representing its right to use the underlying asset and a liability representing its obligation to pay lease rentals over the lease term.

### Initial measurement

The ED proposes that a lessee initially measure its liability at inception of the lease at the present value of the estimated future lease payments.

The elements that would affect the initial measurement of the liability consist of the following:



**Discount rate.** This would be the lessee's incremental borrowing rate or the rate charged by the lessor if it can be readily determined.

**Lease term.** This would be estimated as the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.

**Contingent rentals, lessee residual value guarantees and term option penalties.** These would be estimated and included in the lease payments based on a probability-weighted average for a reasonable number of possible outcomes. Contingent rentals based on changes in an index or rate, e.g. the consumer price index or prime interest rate, would be estimated using forward rates or indices if readily available, or else by reference to prevailing spot rates or indices.

Amounts payable under purchase options would be excluded from the lease payments.

The right-of-use asset would be measured initially at the amount of the liability, adjusted for any prepaid lease rentals, and any recoverable initial direct costs incurred by the lessee.

The asset and liability would be measured at inception of the lease but would not be recognised until commencement of the lease, the date on which the lessor makes the underlying asset available for use by the lessee. A lease contract that is onerous between the dates of inception and commencement of a lease would be measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

#### Subsequent measurement

The ED proposes that a lessee subsequently measure its liability at amortised cost using the effective interest rate method.

On subsequent measurement, the lessee would assess whether facts and circumstances indicate that there has been a significant change in the liability since the last reporting period. If so, then the lease term and the expected amounts payable in respect of contingent rentals, term option penalties and lessee residual value guarantees would be reassessed and the carrying amount of the liability adjusted accordingly.

Changes in the carrying amount of the liability that arise from reassessment of the lease term would be included in the carrying

amount of the right-of-use asset. Changes that arise from reassessment of contingent rentals, lessee residual value guarantees and term option penalties would be:

- included in the right-of-use asset to the extent that the changes relate to future periods; and
- recognised in profit or loss to the extent that the changes relate to current or prior periods.

The lessee would measure its right-of-use asset subsequently under either a cost model or a revaluation model. An active market would not be required in order to apply a revaluation model. Amortisation and revaluation gains and losses would be recognised in accordance with IAS 38 *Intangible Assets*, and impairment losses and recoveries would be recognised in accordance with IAS 36 *Impairment of Assets*.

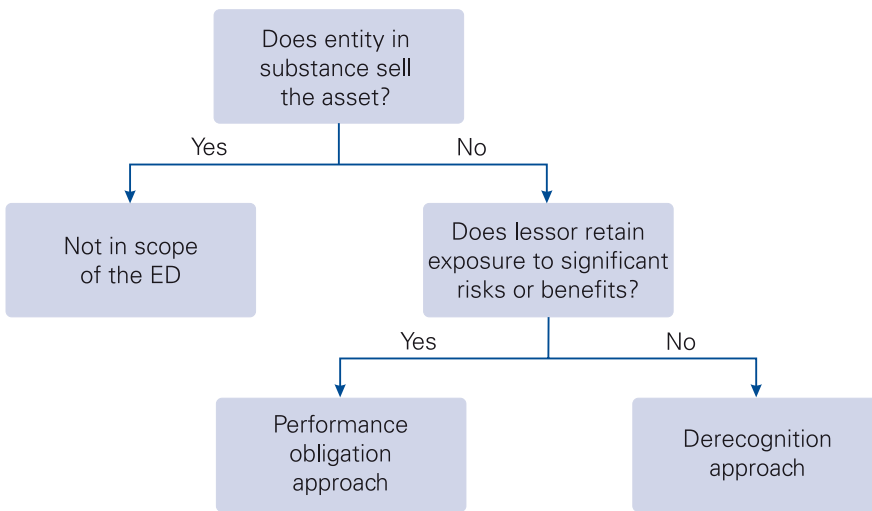
#### Presentation

The ED proposes that following commencement of a lease a lessee would present right-of-use assets in the statement of financial position as if they were tangible assets within property, plant and equipment, separately from owned assets. The liability would be presented separately from other financial liabilities.

#### Proposed accounting models for lessors

The ED proposes two accounting models for lessors: the performance obligation approach and the derecognition approach. If a lessor retains exposure to significant risks and benefits associated with the underlying asset, then it would apply the performance obligation approach to the lease; otherwise it would apply the derecognition approach to the lease.

The lessor determines the appropriate accounting model using the decision tree below:



#### Performance obligation approach

Under the performance obligation approach the lessor would continue to recognise its interest in the underlying asset and, at commencement of the lease, would recognise a new asset (the lease asset) representing its right to receive lease payments from the lessee over the lease term and a liability representing its obligation to deliver use of the underlying asset to the lessee.

#### Initial measurement

The ED proposes that the lessor initially measure its lease asset at inception of the lease at the present value of the future lease payments, plus any recoverable initial direct costs incurred by the lessor. 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 lessee residual value guarantees would be included only if the lessor can measure the amounts reliably.

The liability would be measured initially at the present value of the estimated lease payments, adjusted for any prepaid rentals received from the lessee.

Under this approach, no day one profit or loss arises at commencement of a lease.

#### Subsequent measurement

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 in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

The lessor would reassess its lease asset in a manner similar to how a lessee would reassess its lease liability, except that in the circumstances in which the lessee would adjust its right-of-use asset the lessor would adjust its liability.

The liability subsequently would be amortised based on the pattern of use of the underlying asset by the lessee. If the lessor cannot determine this pattern reliably, then it would use the straight-line method.

#### Presentation

The ED proposes that a lessor would present the underlying asset, the right to receive lease payments and the performance obligation together in the statement of financial position totalling to a net lease asset or liability. Interest income, lease income and depreciation expense would be presented separately in profit or loss.

#### Derecognition approach

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

#### Initial measurement

The ED proposes that the lessor initially measure its lease asset as described under the performance obligation approach.

The residual asset would be measured by allocating the original carrying amount of the underlying asset. The allocation is based on the ratio of the fair value of the lease payments to the fair value of the underlying asset at the date of inception of the lease. This would determine the portion of the carrying amount of the underlying asset to be derecognised; with the remainder reclassified as a residual asset.

Any gain or loss arising at commencement of the lease would be recognised in profit or loss.

#### Subsequent measurement

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 in accordance with IAS 39.

The lessor would reassess its lease asset in a manner similar to how a lessee would reassess its liability, except that 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 profit or loss; and
- recognise other changes in the carrying amount of its lease asset in profit or loss.

The residual asset would be subject to impairment testing in accordance with IAS 36 but, except as noted above, would not be remeasured.

### Presentation

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.

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; and
- 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.

### Other proposals

#### Investment property

A lessor would apply IAS 40 *Investment Property* and not the new standard to leases of investment property measured at fair value. A lessee of investment property would be permitted to measure its right-of-use asset in accordance with the fair value model in IAS 40, and would

recognise changes in the liability to make lease payments in profit or loss.

### Contracts with service and lease components

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. If both these conditions are met, then the entities would account for the distinct components separately. However:

- if the service component is distinct but it is impracticable to allocate the payments, then the lessee, and a lessor following the performance obligation approach, would account for the whole contract as a lease;
- if the service component is not distinct, then a lessee, and a lessor following the performance obligation approach, would account for the whole contract as a lease, and a lessor following the derecognition approach would allocate the payments on a reasonable basis, e.g. by reference to the stand-alone selling price of the service.

### Short-term leases

The ED proposes that the accounting models for lessees and lessors as described above need not be applied to short-term leases, i.e. leases for which the maximum possible lease term is 12 months or less.

In the case of a short-term lease:

- a lessee would be permitted to measure the right-of-use asset at the undiscounted amount of the lease payments plus recoverable initial direct costs, and the obligation to pay rentals at the undiscounted amount of the estimated future lease payments; and

- a lessor would be permitted not to recognise assets and liabilities arising from the lease contract and not to derecognise any portion of the underlying asset.

Lessees and lessors following these simplified requirements would recognise lease payments in profit or loss over the lease term. Lessees and lessors would be permitted to elect whether to apply these simplified requirements on a lease-by-lease basis.

### Subleases and sale and leaseback transactions

An entity may act as both a lessor and a lessee of the same item. That is, an entity may lease a piece of equipment from a lessor under a head lease and then sublet that piece of equipment to a lessee under a sublease, thereby acting as an intermediate lessor.

The ED proposes that in such cases the proposed accounting models for lessees and lessors be applied, and includes specific proposed disclosure requirements.

The ED also proposes specific accounting and disclosure requirements for sale and leaseback transactions. The accounting would depend on whether the sale meets the conditions for a sale as proposed in the ED. If the sale criteria are not met, then the seller/lessee would account for the transaction as a financing arrangement under IAS 39. If the sale criteria are met, then the proposed accounting for the lease generally would follow the requirements as proposed in the accounting models for lessees and lessors, except that a purchaser/lessor would be required to apply the performance obligation approach to the lease element of the transaction.

### Effective date and transition

The ED does not propose an effective date and does not specify whether early adoption would be permitted since the Boards plan an additional

consultation on the effective dates of this and other proposed standards.

The ED proposes a simplified retrospective approach to initial application of the new standard, as follows:

- 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. the beginning of the earliest comparative period presented in the first financial statements issued after the effective date of the new standard). The carrying amount of right-of-use assets recognised initially by lessees upon adoption of the new standard generally would be equal to the amount of the lease liability at that date measured in accordance with the guidance in the new standard. However, the ED proposes that for leases that

do not have options, contingent rentals, term option penalties and lessee residual value guarantees, and previously were classified as finance leases under IAS 17, the carrying amount of the right-of-use asset and obligation to pay rentals would be based on the carrying amounts of the asset and liability recognised under IAS 17.

- Lessors using the performance obligation approach would apply the proposed accounting requirements to all outstanding lease contracts at the date of initial application; reinstating previously derecognised assets at depreciated cost as if the asset had never been derecognised. The present value of the remaining lease payments would be determined using the original rate charged to the lessee.
- Lessors using the derecognition approach would apply the proposed accounting requirements

to all outstanding lease contracts at the date of initial application, and the residual asset would be recognised at fair value at that date. The present value of the remaining lease payments would be determined using the original rate charged to the lessee.

No specific transition arrangements are proposed for contracts that were classified as leases under IAS 17 but would be classified as sales and purchases of the underlying asset under the new standard.

If you would like further information on any of the matters discussed in this issue of *Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

## Abbreviations

- 1 IASB: International Accounting Standards Board
- 2 FASB: US Financial Accounting Standards Board

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