

The future of lease accounting



Highlights

- Boards announce formal re-exposure of leasing proposals
- Lessors to apply a single 'receivable and residual' model
- Leases of investment property measured at fair value out of scope
- Variable lease payments based on an index or rate to be measured at lease commencement and re-assessed

Time for some R&R?

In July 2011 the IASB¹ and FASB² (the Boards) finally resolved their differences on lessor accounting. They settled on a variant of the derecognition model, now renamed the 'receivable and residual' model. Previously, the IASB supported the derecognition model and the FASB supported a version of the current lease classification approach of IAS 17 *Leases*.

Under the receivable and residual model, the lessor would derecognise the underlying asset, recognise a lease receivable and recognise a residual asset. The lessor may also recognise an upfront profit on transfer of the right-of-use asset, if that profit is reasonably assured. What constitutes reasonably assured? The Boards intend this new threshold to be applied consistently in the new revenue and leases standards.

Over the lease term, the lessor would recognise interest income on the lease receivable and income on accretion of the residual asset.

Derecognition of the underlying asset, upfront profit recognition and the assumed financing nature of all leases, have caused some to question whether this model should be applied to all leases. A key concern is whether this model provides a good description of, for example, a real estate lease.

Sceptics may take some comfort from the Boards' confirmation that lessors need not apply the receivable and residual model to:

- leases of investment property measured at fair value, which will be outside the scope of the leasing standard; and
- short-term leases, for which lessors may apply current operating lease accounting.

The Boards also had a lively discussion regarding variable lease payments based on an index or rate, with some Board members suggesting the Boards re-debate all tentative decisions taken on variable lease payments to date. Mercifully, this did not happen but the discussions highlighted continuing conceptual tensions. Instead, the Boards tentatively decided to require initial measurement of these variable lease payments at spot rates and re-assessment if the index or rate changes.

Re-assessment of variable lease payments should be reflected:


- in profit or loss to the extent it relates to the current period; and
- as an adjustment to the right-of-use asset to the extent the change relates to future periods.

The Boards announced their intention to re-expose the lease standard later in 2011. Board members may feel they deserve some reward and recognition for their efforts, and may be planning some rest and relaxation in August, before returning to the receivable and residual model in September.

Background to the leases project

The Boards issued a joint exposure draft on lease accounting in August 2010. It proposed that:

- a lessee adopt a right-of-use model that would result in the recognition of an asset for its right to use the leased asset and a liability for its obligation to make future lease payments; and
- based on the terms of each lease, a lessor applies one of two accounting approaches: a performance obligation approach or a derecognition approach.

 See our publication [New on the Horizon: Leases](#) for more detail about the exposure draft, including possible application issues.

This edition of *IFRS – Leases Newsletter* highlights recent developments on this project for users of IFRSs, including discussions at the Boards' June and July 2011 meetings.

Towards a final standard

In June and July the Boards continued to devote significant time and effort to the leases project. This included many hours of deliberations in joint meetings, largely focused on choosing an accounting model for lessors. However, the Boards did make a number of additional decisions.

Tentative decisions in other areas include the following.

- Retaining the requirement in current IFRSs to consider whether lease contracts contain embedded derivatives. If an embedded derivative is not clearly and closely related to the lease contract, then it would be separated and accounted for in accordance with applicable IFRSs. The Boards noted that a lessor's lease receivable is not a financial asset within the scope of IFRS 9 *Financial Instruments* and hence embedded derivatives would continue to be separated from lease contracts.
- Recognising foreign currency exchange gains and losses related to the liability to make lease payments on leases denominated in a foreign currency in profit and loss, consistent with foreign exchange guidance in existing IFRSs.
- Referring to existing guidance in IFRSs for the impairment of right-of-use assets.
- Allowing revaluation of right-of-use assets.
- Requiring lease payments to be split between principal and interest for the purpose of presentation in the statement of cash flows.

- Retaining the requirement for lessees to disclose a reconciliation of the opening and closing balances of:
 - the right-of-use assets by underlying asset type; and
 - the total liability to make lease payments (no requirement to disaggregate).
- Requiring lessees to disclose a maturity analysis of undiscounted amounts to be paid in respect of the lease liability.
- Removing the requirement from the exposure draft to disclose the existence of purchase options and initial direct costs.
- Requiring lessees to present a tabular disclosure of all expenses related to leases in one note to the financial statements.

Some constituents will welcome this detailed disclosure of lease liabilities and expenses by lessees. However, others may question whether it is necessary to retain and expand the disclosures required under current IAS 17, given the fundamental change in the lessee accounting model.

Next steps

Few, if any, constituents will have been surprised to hear the Boards confirm that they intend to formally re-expose the leasing proposals. This means that the Boards will not achieve their revised goal of finalising the leases project in the second half of 2011. Instead, the Boards intend to complete their redeliberations in the third quarter of 2011 with a view to publishing a revised exposure draft shortly thereafter. We will all then have a chance to comment publicly on the outcome of the Boards' redeliberations.

Reaching a tentative conclusion on the lessor accounting model brings the Boards closer to completion of their redeliberations. Other topics that the Boards plan to discuss in forthcoming meetings prior to re-exposure include:

- presentation of changes in variable lease payments arising from re-assessment for lessors;
- leasehold improvements and restoration obligations;
- presentation and disclosure;
- consequential amendments and the impact on business combinations;
- transitional issues, including full retrospective application and the impact on first-time adopters;
- considerations for private companies, including transitional issues, and implications for not-for-profit entities; and
- cost/benefit considerations of the proposals as a whole.

The lessor receivable and residual model explained

Summary

On lease commencement, the lessor would derecognise the underlying asset (if previously recognised on its balance sheet), recognise a receivable representing its right to receive lease payments and recognise a residual asset representing its right to the return of the underlying asset at the end of the lease term. The lessor may also recognise an upfront profit on transfer of the right-of-use asset, depending on the facts and circumstances.

Over the term of the lease, the lessor would recognise interest income on the lease receivable and income on accretion of the residual asset.

Scope of the receivable and residual model

The receivable and residual model would be the 'single' lessor accounting model. However, there would be a number of exceptions including for leases of investment property measured at fair value, for which lessors would apply IAS 40 *Investment Property*, and short-term leases, for which lessors may apply current operating lease accounting.

The receivable

At lease commencement a lessor would measure its lease receivable at the present value of the lease payments, discounted at the rate that the lessor charges the lessee.

Variable lease payments based on an index or a rate would be estimated and included in the lease receivable based on the spot rate at commencement of the lease, such that future increases in inflation indices (e.g. CPI) would not be included in the initial measurement. Variable lease payments based on an index or rate would be re-assessed each period if the index or rate changes. Variable lease payments based on other factors, e.g. the lessee's turnover, would not generally be included in the lease receivable.

Over the term of the lease, the lessor would recognise interest income on the lease receivable and test the lease receivable for impairment in accordance with the financial instruments standards, similar to amortised cost accounting for other financial assets.

The residual

Although accounting for the lessor's lease receivable is broadly symmetrical with the accounting for the lessee's lease liability, the accounting for the lessor's residual

asset introduces new concepts and complexity to lessor accounting.

The lessor's approach to the residual asset depends on whether any profit arising on transfer of the right-of-use asset to the lessee on commencement of the lease is reasonably assured. This profit is measured by reference to the amount derecognised on transfer of the right-of-use asset to the lessee (calculated as carrying amount of the underlying asset \times the lease receivable \div the fair value of the underlying asset).

If the profit on transfer of the right-of-use asset is reasonably assured, then the lessor:

- recognises this profit on commencement of the lease;
- measures the residual asset initially as an allocation of the carrying amount of the underlying asset, determined as the carrying amount of the underlying asset less the amount derecognised on transfer of the right-of-use asset to the lessee; and
- recognises income over the lease term by accreting the carrying amount of the residual asset by the rate that the lessor charges the lessee.

If the profit on transfer of the right-of-use asset is not reasonably assured, then the lessor:

- deducts the profit relating to transfer of the right-of-use asset from the initial carrying amount of the residual asset; and
- recognises income over the lease term by accreting the carrying amount of the residual asset up to an amount equalling the underlying asset's carrying amount at the end of the lease term if it had been subject to depreciation.

The total profit arising on commencement is calculated as the difference between (a) the carrying amount of the underlying asset and (b) the sum of the initial measurement of the right to receive lease payments and the residual asset.

If the amount of the lease receivable is greater than the carrying amount of the underlying asset at the date of lease commencement, then the lessor would, as a minimum, recognise the difference between those two amounts as profit at that date irrespective of whether the profit on transfer of the right-of-use asset is reasonably assured.

Tentative decisions in the June and July Board meetings

Key decisions taken by the Boards in their June and July meetings are outlined in the following pages. All decisions are tentative and will be confirmed only when the Boards approve a new standard.

Accounting model for lessors

Key proposals in the exposure draft

The exposure draft proposed two accounting models for lessors:

- a performance obligation approach; and
- a derecognition approach.

If a lessor retained 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 approach to be applied to each lease would depend on the terms of the contract. Under both approaches, the lessor would recognise an asset representing its right to receive future lease payments and interest income because there is a financing component to the arrangement that affects the pattern of profit or loss recognition.

The exposure draft proposed that a lessor would not be required to apply either approach to leases of investment property measured at fair value and short-term leases.

Results of post exposure draft deliberations

The Boards have opted for a model based on the derecognition approach, now renamed the 'receivable and residual' model. Under this model the lessor:

- derecognises the full carrying amount of the underlying asset;
- recognises a lease receivable;
- recognises a residual asset;
- recognise a profit on lease commencement if reasonably assured; and
- recognises interest income on the lease receivable and income on accretion of the residual asset over the term of the lease.

In addition the Boards made the following tentative decisions.

- Consistent with the exposure draft, a lessor with leases of investment property measured at fair value would exclude these leases from the requirements of the new leases standard and would apply IAS 40.
- A lessor may apply simplified requirements to short-term leases, for which a lessor may apply current operating lease accounting.

KPMG observations

The receivable and residual model to lessor accounting is broadly consistent with the right-of-use approach to lessee accounting. The Boards commitment to the receivable and residual model also allays concerns of a number of constituents that the dual approach in the exposure draft retained the subjectivity of current lease classification and added significant unnecessary complexity. The Boards now appear closer to their stated objective of a single, principles-based, converged and less complex approach to lessee and lessor accounting. However, there remain significant exceptions from the lessor accounting model and some may find the requirements for accounting for the residual asset complex.

However, not all constituents will welcome these proposals. Application of the model will require significant judgement in order to assess whether any profit on commencement is 'reasonably assured'. Also, just as the lessee right-of-use model treats every lease as containing a financing component, the lessor receivable and residual model treats every lease as containing a financing component. The Boards received feedback from some constituents that property leases are different from equipment lease and therefore different models should apply.

However, the Boards voted for a simplified approach that increases comparability by treating all leases in the same way. In order to address some of the concerns raised, the Boards re-affirmed their decision in the exposure draft to allow investment property lessors that follow a fair value model to apply the IAS 40 model to their transactions as opposed to the new leases guidance.

Re-assessment of variable lease payments

Key proposals in the exposure draft

Both the lessee and lessor would re-assess variable lease payments.

For a lessee, the change in the lease liability would be recognised:

- in profit or loss to the extent it relates to the current period; and
- as an adjustment to the right-of-use asset to the extent the change relates to future periods.

For a lessor applying the derecognition model, the change in the lease receivable would be recognised in profit or loss.

For a lessor applying the performance obligation model, the change in the lease receivable would be recognised:

- in profit or loss to the extent the performance obligation is satisfied or zero; otherwise
- as an adjustment to the performance obligation.

Results of post exposure draft deliberations

Initially, lessees and lessors will estimate variable lease payments based on an index or a rate by reference to the spot rate at lease commencement.

Both the lessee and lessor would re-assess only those variable lease payments that depend on an index or rate.

For a lessee, the change in the lease liability would be recognised:

- in profit or loss to the extent it relates to the current period; and
- as an adjustment to the right-of-use asset to the extent the change relates to future periods.

KPMG observations

Some constituents may see the remeasurement of contingent rents based on an index or rate to be burdensome. However, when these proposals are compared to the exposure draft the amount of work required is significantly reduced. Rather than having to continuously consider all variable lease payments the Boards have provided practical relief by allowing all variable lease payments other than those based on a rate or index to be accounted for as period costs as they occur. The Boards considered the feedback from some constituents calling for no remeasurement at all, but concluded that once the lease measurement formula is set-up making an adjustment for a rate or index should be relatively straight forward.

The Boards nearly concluded that a lessor should recognise the change in the lease receivable in profit or loss. However, further deliberations highlighted that this may not be appropriate if, on initial recognition, the profit on the right-of-use asset was not reasonably assured and therefore deferred. The Boards therefore postponed concluding on this issue until a future meeting when the staff have had a chance to perform more research and analysis.

Subleases

Key proposals in the exposure draft

Generally, an intermediate lessor would apply the requirements proposed in the exposure draft to such arrangements. An intermediate lessor would therefore:

- account for its lessee arrangement in the head lease in accordance with the lessee right-of-use model; and
- account for its lessor arrangement in the sublease in accordance with either the performance obligation approach or the derecognition approach.

Results of post exposure draft deliberations

The Boards tentatively decided that separate accounting applies to the head lease and the sublease. An intermediate lessor would therefore:

- account for its lessee arrangement in the head lease in accordance with the lessee right-of-use model; and
- account for its lessor arrangement in the sublease in accordance with the lessor receivable and residual model.

KPMG observations

Consistent with the exposure draft, the proposals do 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 determination of the appropriate discount rate.

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

Lessee cash flow presentation

Key proposals in the exposure draft

Classify cash payments of principal and interest as financing activities, separately from other financing cash flows.

Results of post exposure draft deliberations

Cash payments would be split between principal and interest with the principal component presented as a financing activity and the interest component presented as either an operating or financing component, consistent with the entity's accounting policy.

Cash payments for short-term leases and cash payments for variable lease payments, other than those included in the measurement of the right-of-use asset and corresponding lease liability, would be classified within operating activities.

KPMG observations

The requirement in the exposure draft for lessees to classify the entire lease payment as a financing activity meant that the interest portion of the lease payments would automatically be classified as a financing activity. This proposal was inconsistent with interest payments on other debt obligations, which may be classified as operating or financing activities under IFRSs. The Boards' proposals are now consistent with the treatment of payments under other debt obligations.

Short-term leases

Key proposals in the exposure draft

The exposure draft defined a short-term lease as a lease that, at the date of commencement, has a maximum possible lease term, including any options to renew or extend, of 12 months or less.

Lessees and lessors may elect, on a *lease-by-lease* basis to apply the following simplified requirements to short-term 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 instead would recognise lease payments in profit or loss over the lease term.

Results of post exposure draft deliberations

The Boards confirmed that a short-term lease is a lease that, at the date of commencement, has a maximum possible term, including any options to renew or extend, of 12 months or less.

In June and July the Boards confirmed their previous tentative decision to permit lessees and lessors to elect on a *class of asset* basis to apply simplified requirements to short-term leases. Under the simplified requirements lessees and lessors would not recognise lease assets or lease liabilities. Instead, lessees and lessors would recognise lease payments in profit or loss over the lease term similar to current operating lease accounting.

KPMG observations

With these earlier tentative decisions regarding short-term leases, the Boards appeared to have moved away from the requirement that lessees recognise all leases on balance sheet. Instead, lessees would have an option not to recognise short-term leases on balance sheet.

This option would apply irrespective of the total size of an entity's commitment to short-term leases. The proposal is likely to be welcomed by lessees and lessors with multiple short-term low-value lease arrangements. The simplified requirements are recognisable to constituents currently applying IAS 17 as they are based on current operating lease accounting. They offer lessees the same relief as lessors for short-term leases.

Tentative decisions in previous Board meetings

Key decisions taken by the Boards in their January to May meetings are outlined in the following pages. All decisions are tentative and will be confirmed only when the Boards approve a new standard.

It should be noted that the Boards have not reconsidered many of these tentative decisions in light of their most recent decisions regarding the lessee and lessor accounting models. *Prima facie*, the decisions discussed below will remain relevant to lessees applying the right-of-use model and lessors applying the receivable and residual model. The primary exception is that the lessor performance obligation approach will no longer be regarded as an option.

Lessee accounting model

Key proposals in the exposure draft

The exposure draft proposed that a lessee recognise:

- an asset for its right to use the leased asset and a liability for its obligation to make future lease payments; and
- amortisation of the right-of-use asset and finance expense arising on the liability.

The proposed amortisation of the right-of-use asset and finance expense arising on the liability gives rise to a profit or loss pattern of lease expense recognition that is front loaded; i.e. in the earlier years of the lease term the lease expense recognised will be greater than that in the later years.

Results of post exposure draft deliberations

The Boards tentatively agreed that lessees should apply the lease accounting model set out in the exposure draft, abandoning the concept of other-than-finance leases.

They had previously proposed that there are two types of leases for both lessees and lessors: finance leases and other-than-finance leases. The intention was that lessees would recognise both types of leases on balance sheet, but would recognise a straight-line pattern of expense for other-than-finance leases.

With this return to the exposure draft model, all leases accounted for by lessees will have a front-loaded pattern of profit or loss recognition with a potential exception for short-term leases (those with a maximum lease term of 12 months).

The Boards propose to address constituents' concerns that a front-loaded pattern of lease expense recognition is not appropriate for all leases via enhanced disclosure. The Boards will consider whether to require separate disclosure of cash flows related to leases as a line item on the face of the statement of cash flows. They also decided to reconsider whether to allow short-term leases to remain off balance sheet.

KPMG observations

Constituents who believe that not all leases are the same and that a straight-line profit or loss recognition pattern is appropriate in some circumstances may be dismayed to learn of the Boards' change of mind. The Boards' future decisions in relation to lease disclosures will be of particular importance to these constituents.

The Boards' previous decision in relation to the other-than-finance leases proposal created a clear tension between the requirement for a lessee to recognise an asset and liability upfront and the requirement to recognise the straight-line pattern of expense. This tension was most evident in the proposed approaches to achieving a desired overall straight-line expense, which were to plug either depreciation or the statement of other comprehensive income. Constituents concerned by the additional complexity this would have created will be relieved to hear these proposals will not be pursued.

The Boards are now closer to achieving their goal of a single, principles-based, converged and less complex approach to lease accounting for lessees. Although the proposed accounting model for lessees will not be without its critics, it will at least be more straightforward to apply one lessee model with no lease classification test.

Contract modifications or changes in circumstances

Key proposals in the exposure draft

The exposure draft proposed that a lessor would not change its accounting approach after the date of inception of the lease. However, the exposure draft did not provide any guidance on accounting for:

- a modification to the contractual terms of a contract; or
- a change in circumstances that would affect whether a contract is, or contains, a lease.

Results of post exposure draft deliberations

The Boards tentatively decided that:

- a substantive contract modification results in the modified lease being accounted for as a new lease (i.e. terminate the existing lease and account for the modified lease as if it were a new lease); and
- a change in circumstance that affects the assessment of whether a contract is, or contains, a lease results in a re-assessment of the contract by both the lessee and the lessor. On re-assessment if it is determined that the contract contains a lease, then the lessee and lessor should apply lease accounting from the date of change in circumstances and *vice versa*.

KPMG observations

Some constituents saw inconsistency with current guidance in the exposure draft's proposal that a lessee/lessor should not, after the date of inception of the lease, change the assessment of whether a contract is or contains a lease. They will be pleased that the Boards have addressed this issue. The new guidance will address practice issues that would have arisen had the proposal in the exposure draft been adopted; this is a welcome development.

Re-assessment of options in a lease

Key proposals in the exposure draft

The exposure draft proposed that:

- the exercise price of a purchase option is not a lease payment and therefore is excluded from a lessee's lease liability and a lessor's lease receivable;
- a lease contract ceases to be a lease and is considered to be a purchase/sale when a lessee exercises its purchase option;
- a lease with a bargain purchase option is considered to be a purchase/sale and therefore is not within the scope of the standard;
- an entity should account for the longest possible lease term that is more likely than not to occur when evaluating options to extend or terminate a lease; and
- an ongoing re-assessment of the lease term is required.

Results of post exposure draft deliberations

In earlier meetings, the Boards tentatively agreed that renewal periods and purchase options should be included in lease accounting when there is a significant economic incentive to exercise the option. In their May meetings they tentatively decided that when assessing and re-assessing whether a significant economic incentive to exercise an option exists, an entity should take into consideration:

- market-based factors (initial assessment only)
- contract-based factors
- asset-based factors
- entity-specific factors.

Also the Boards re-affirmed the proposals in the exposure draft that a change in lease payments due to a re-assessment should result in a lessee adjusting its right-of-use asset.

KPMG observations

IAS 17 uses the term 'reasonably certain' when describing the recognition threshold for recognition of renewal and purchase options. Following the Boards' initial decision to use the term 'significant economic incentive' to describe the recognition threshold for renewal and purchase options, a key question was whether this was intended to be a higher or lower threshold than under current practice; the Boards have added a significant amount of judgement and complexity to this aspect of lease accounting.

The Boards intend that an entity would assess the indicators in their entirety. However, issues will arise with regard to which indicators should be considered more persuasive in evaluating whether a significant economic incentive exists. The Boards intend that an entity-specific factor based on management intent would not be considered persuasive in this evaluation. They intend to develop further application guidance to articulate how an entity might perform this evaluation.

Variable lease payments – initial measurement

Key proposals in the exposure draft

The exposure draft proposed that for variable lease payments on initial recognition:

- recognise using an expected outcome technique, i.e. probability-weighted average;
- for lessors, include only expected outcomes that can be measured reliably; and
- if contingent rentals are based on an index or rate, then use:
 - forward rates if readily available; otherwise
 - spot rates at inception of the lease.

Results of post exposure draft deliberations

The Boards tentatively decided the following approach for variable lease payments on initial recognition:

- recognise variable lease payments that are based on an index or rate, using spot rates at the beginning of the lease; and
- introduce anti-avoidance measures designed to capture in-substance minimum lease payments, e.g. when variable lease payments are based on monthly sales and minimum monthly sales are specified then the payment based on the minimum monthly sales would be considered a fixed lease payment.

All other types of variable lease payments would not be included in the initial measurement of the lessee's liability to make lease payments or the lessor's lease receivable.

KPMG observations

As compared to the exposure draft, the proposals substantially reduce the variable lease payments that would be accounted for on balance sheet as part of the lessee's lease liability and the lessor's lease receivable.

Constituents who believed that the exposure draft's requirements were overly burdensome will likely appreciate the Boards' recent tentative decisions. Rather than having to make an estimate for all variable lease payments at the beginning of a lease, the current direction of the Boards' deliberations calls for variable lease payments other than those based on a rate or index or those that are in-substance minimum lease payments to be recognised in profit or loss as they are incurred. This will be a significant relief, for example, for retailers with real estate leases with lease payments that are based in whole or in part on the retailer's turnover, and certain vehicle leases in which the lease payments depend on mileage.

Conversely, constituents of the view that many of these variable lease payments meet the definition of a liability at the time the contract is entered into will be disappointed that they remain off balance sheet. The Boards acknowledge this tension, but have concluded that a pragmatic approach is preferable to relieve the measurement burden on lessees and lessors.

Under the requirements of the exposure draft, differences in access to information could result in substantially different estimates in certain types of leases, such as leases with payments based on a percentage of sales, i.e. lessees are much more likely to be able to estimate their own sales and therefore the lease payment than a lessor would be. The revised requirements are likely to reduce the difference between a lessee's estimated lease payable and a lessor's lease receivable.

In July the Boards discussed when variable lease payments should be re-assessed; see 'Re-assessment of variable lease payments'.

Definition of a lease

Key proposals in the exposure draft

The exposure draft defined a lease as a contract in which the right to use a specified asset, i.e. the underlying asset, is conveyed for a period of time, in exchange for consideration.

The exposure draft retained the principal requirements of IFRIC 4 *Determining whether an Arrangement contains a Lease* regarding the identification of lease transactions. That is, a contract is or contains a lease if the following conditions are met:

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

Results of post exposure draft deliberations

The Boards have confirmed the overall definition of a lease in the exposure draft and have tentatively concluded on the key conditions in the definition of a lease: a specified asset and control.

For the specified asset criterion, they confirmed that a specified asset needs to be uniquely identifiable and that a physically distinct portion of a larger asset can be a specified asset, e.g. a floor of an office building.

For the control criterion, the Boards supported creating a revised description of control that is aligned with the proposed new revenue recognition standard. Under this proposal, control is conveyed when a customer has the ability to direct the use, and received the benefit from the use, of a specified asset throughout the lease term.

In addition, the Boards tentatively clarified that a contract may identify explicitly or implicitly an underlying asset. However, an asset will not be the subject of a lease if the asset is inseparable from a service, e.g. a digital box included as part of a cable subscription.

KPMG observations

The proposals move the line between what is considered a lease and what is considered a service. For example, IFRIC 4 does not address portions of larger assets whereas the Boards have concluded that a physically distinct portion of a larger asset may be the subject of a lease. This is consistent with the practice of tenants who rent part (e.g. a floor) of a building as these types of agreements are likely being accounted for as leases. However, it is not clear how the Boards' decision will affect other fact patterns.

The exclusion of assets that are 'inseparable from services' is a pragmatic step that will reduce the number of occasions in which entities will be required to identify leases in some arrangements. Whilst the cable box example discussed by the Boards seems relatively uncontroversial, further work will be required to assess how widely this principle will be applied in practice.

The Boards have expressed a preference for the new standard to contain control criteria that align with those in the revenue recognition project as opposed to the current guidance in IFRIC 4. The Boards appear to believe that using criteria from the revenue recognition project will provide a clearer principle and also address concerns that the scope of the exposure draft was too wide. The Boards are replacing the well understood control criteria in current leasing guidance and it will be interesting to see how this affects the nature and number of agreements that are accounted for as lease or service agreements.

Lease term

Key proposals in the exposure draft

The exposure draft proposed that the lease term be the longest possible term that is *more likely than not* to occur.

Lease term would be assessed at inception of the lease and subsequently if facts or circumstances indicate that there has been a significant change in the lessee's lease liability or the lessor's lease receivable. The revised lease term would be assessed using the same criteria as the initial measurement.

Results of post exposure draft deliberations

The Boards tentatively decided that the lease term would be the contractual minimum lease term plus any optional periods for which there is a significant economic incentive to exercise the renewal option. This assessment would be based on economic factors.

The lease term would be re-assessed on a basis consistent with the initial determination of the lease term, except that market-based factors would be excluded from the re-assessment. Given the tentative criteria to determine initial lease term, generally re-assessment would only occur when economic factors affecting the decision to extend or terminate a lease change.

KPMG observations

IAS 17 uses the phrase 'reasonably certain' when describing the recognition threshold of renewal and purchase options. A key practice question will be whether the Boards intend 'significant economic incentive' to describe a materially different recognition threshold from 'reasonably certain'.

Purchase options

Key proposals in the exposure draft

The exposure draft proposed that:

- the exercise price of a purchase option is not a lease payment and therefore excluded from a lessee's lease liability and a lessor's lease receivable;
- a lease contract ceases to be a lease and is considered to be a purchase/sale at the point a lessee exercises its purchase option; and
- a lease with a bargain purchase option is considered to be a purchase/sale and therefore is not within the scope of the standard.

Results of post exposure draft deliberations

During redeliberations, the Boards decided tentatively that:

- lessees and lessors should include the exercise price of a purchase option to measure a lessee's lease liability and a lessor's lease receivable if the lessee has a significant economic incentive to exercise the purchase option;
- if it is determined that the lessee has a significant economic incentive to exercise the purchase option, then the leased asset would be amortised over the economic life of the underlying asset, rather than over the lease term; and
- that the re-assessment guidance for options to extend or terminate a lease also would be applied for purchase options.

KPMG observations

Under the tentative decisions reached by the Boards, the same accounting approach would be applied to renewal options and purchase options when there is a significant incentive to exercise the purchase option. This will help dissuade criticism from some constituents who thought that the exposure draft proposals could create structuring opportunities due to different accounting approaches to economically similar renewal options and purchase options.

IAS 17 uses the phrase 'reasonably certain' when describing the recognition threshold for recognition of renewal and purchase options. A key practice question will be whether the Boards intend 'significant economic incentive' to describe a materially different recognition threshold from 'reasonably certain'.

In-substance purchases and sales

Key proposals in the exposure draft

The exposure draft proposed that a contract that represents the purchase/sale of an underlying asset would not be a lease and therefore would not be within the scope of the proposals.

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 its risks and benefits to another entity.

The exposure draft proposed 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.

Results of post exposure draft deliberations

The Boards revisited the guidance in the exposure draft to distinguish between a lease and a purchase/sale of an underlying asset. They tentatively decided that if an arrangement does not contain a lease, then it should be accounted for in accordance with other applicable standards, for example IAS 16 *Property, Plant and Equipment* or the new revenue standard.

The Boards no longer expect to provide guidance in the new leases standard for distinguishing a lease of an underlying asset from a purchase/sale of an underlying asset.

KPMG observations

The guidance in the exposure draft created tension for some constituents because, 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. The Boards appear to believe that an appropriate definition of a lease combined with appropriate revenue recognition guidance would remove the need to provide guidance to distinguish a lease and a purchase/sale. Taking this approach may eliminate the tension noted by some constituents. Conversely, this puts further pressure on the Boards to develop a robust definition of a lease.

Initial direct costs

Key proposals in the exposure draft

The exposure draft defined initial direct costs as recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made. The exposure draft proposed that:

- a lessee capitalise its initial direct costs by adding them to the carrying amount of its right-of-use asset; and
- a lessor capitalise its initial direct costs by adding them to its lease receivable.

Results of post exposure draft deliberations

The Boards confirmed the definition of initial direct costs, other than deleting the reference to 'recoverable'.

The Boards confirmed that lessees and lessors capitalise initial direct costs, as proposed in the exposure draft.

KPMG observations

The Boards' latest discussion of initial direct costs follows requests from constituents to align the treatment of the costs of obtaining different forms of contracts. At present, each of the Boards' four priority projects – financial instruments, insurance, leases and revenue – includes guidance on the costs of obtaining a contract. However, the exposure drafts on each project use different terminology and there are differences in the proposed accounting. In this discussion, the Boards confirmed the approach to the costs of obtaining a lease set out in the exposure draft.

Inception vs commencement

Key proposals in the exposure draft

The exposure draft proposed that a lessee and lessor:

- measure the assets and liabilities arising from a lease at the date of inception, being the earlier of the date of the agreement or commitment to the terms of the lease; and
- recognise the assets and liabilities arising from a lease at the date of commencement, being the date on which the lessor makes the underlying asset available for use by the lessee.

The exposure draft proposed that a lease contract that is onerous between the dates of inception and commencement would be within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The exposure draft did not discuss costs and lease payments incurred by a lessee prior to lease commencement, or lease incentives.

Results of post exposure draft deliberations

The Boards tentatively decided that a lessee should measure and recognise the assets and liabilities arising from a lease contract at the date of commencement using the discount rate at that date.

The Boards confirmed that a lease contract that is onerous between the dates of inception and commencement should be within the scope of IAS 37.

The Boards agreed that the leases standard should include application guidance on:

- costs incurred by a lessee prior to lease commencement;
- lease payments made before lease commencement; and
- lease incentives, which the Boards tentatively decided a lessee should deduct from the carrying amount of its right-of-use asset.

KPMG observations

Many constituents expressed concerns that the exposure draft was unclear on how to account for a lease contract between the dates of inception and commencement. The Boards' focus in this discussion on the nuts and bolts of the accounting entries may help to re-assure some that the Boards are aware of the practical issues that entities will face in applying the new standard.

Discount rate

Key proposals in the exposure draft

The exposure draft proposed that at the date of inception of a lease:

- a lessee measure its lease liability by discounting lease payments at its incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee; and
- a lessor measures its lease asset by discounting lease payments at the rate it charges the lessee.

Results of post exposure draft deliberations

The Boards confirmed the approach set out in the exposure draft, clarifying that if a lessee can determine the rate that the lessor charges the lessee, then the lessee should use that discount rate in preference to its incremental borrowing rate.

The Boards tentatively decided to develop application guidance on the determination of the discount rate.

KPMG observations

Many constituents felt that the exposure draft's proposals regarding discount rates were unclear. The new application guidance will address practical issues such as determining the discount rate when multiple rates are available and determining the yield on a property.

Re-assessment of the discount rate in a lease

Key proposals in the exposure draft

The exposure draft proposed that neither the lessee nor the lessor should change the rate used to discount the lease payments except to reflect changes in reference interest rates when variable lease payments are based on those reference interest rates.

When variable lease payments are based on reference interest rates, a lessor should recognise any change to the right to receive lease payments arising from changes in the discount rate in profit or loss.

Results of post exposure draft deliberations

The Boards tentatively decided that:

- the discount rate should not be re-assessed on a periodic basis if there is no change in the lease payments;
- the discount rate should be re-assessed when there is a change in lease payments due to:
 - a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease or purchase the underlying asset; or
 - the exercise of an option that the lessee did not have a significant economic incentive to exercise; and
- a revised discount rate is determined at the re-assessment date and an entity should apply that rate to the remaining lease payments.

KPMG observations

Many constituents commented that the exposure draft proposals on discount rates were unclear. The Boards in their redeliberations have gone a long way to addressing these concerns. Thus far, they have clarified that lessees should use the discount rate implicit in the lease in preference to other available discount rates and the discount rate should not be re-assessed if there is no change in the lease payments. Many constituents will feel these are welcome developments.

Separating lease and non-lease components

Key proposals in the exposure draft

The FASB and IASB versions of the exposure draft included different proposals on when and how to separate the lease and non-lease elements of a multiple element contract.

Both versions of the exposure draft proposed that in some circumstances an entity would not separate the lease and non-lease elements of a multiple element contract and instead would apply the lease accounting proposals to the whole of the contract, including the non-lease element.

Results of post exposure draft deliberations

The Boards tentatively decided that:

- a lessor always should account separately for the lease and non-lease elements of a multiple element contract, allocating payments between the elements of the contract using the guidance on revenue recognition;
- a lessee should account separately for the lease and non-lease elements of a multiple element contract if the purchase price of either the lease or non-lease elements is observable, allocating payments by reference to the observable prices; and
- a lessee should account for the whole contract as a lease if there are no observable purchase prices.

KPMG observations

In these discussions, the Boards finally reached a converged position on when to separate the lease and non-lease elements of a multiple element arrangement. Broadly, these tentative decisions will reduce the circumstances in which an entity will be required to apply lease accounting to a service element of a contract compared to the proposals in the exposure draft.

However, the circumstances in which a lessee and lessor will be required to separate a contract, and how they will allocate contract payments, will be different. This may result in lessees and lessors accounting for the same contract in different ways.

Sale and leaseback transactions

Key proposals in the exposure draft

The exposure draft proposed that an entity apply sale and leaseback accounting when the sale leg of the transaction is considered to be a sale/purchase of the whole of the underlying asset. Otherwise, an entity would account for a sale and leaseback transaction as a financing transaction.

The exposure draft included specific guidance on determining whether the underlying asset should be considered to be sold/purchased.

Results of post exposure draft deliberations

The Boards confirmed that the assessment of whether an entity should apply sale and leaseback accounting should depend on whether the sale leg of the transaction is considered to be a sale of the whole of the underlying asset. However, they tentatively decided that this assessment should be based on the revenue recognition guidance.

The Boards confirmed that the mechanics of sale and leaseback accounting should follow the proposals in the exposure draft.

KPMG observations

Under current IFRSs, sale and leaseback accounting is applied to all sale and leaseback transactions other than those within the scope of SIC-27 *Evaluating the Substance of Transactions in the Legal Form of a Lease*, irrespective of whether the sale leg of the transaction would be recognised as a sale under IAS 18 *Revenue*. Under the exposure draft, sale and leaseback accounting would be restricted to cases when the sale leg is considered to be a sale/purchase of the whole of the underlying asset. The Boards' tentative decisions appear to confirm that sale and leaseback accounting will be less common as compared to current practice, under which it is not necessary to meet the definition of a sale in order to apply sale and leaseback accounting, and more transactions are likely to qualify for sale and leaseback accounting than would have qualified under the exposure draft.

Other lease payment considerations

Key proposals in the exposure draft

The exposure draft proposed that lease payments would:

- not include an estimate of amounts payable/receivable under residual value guarantees (RVGs) provided by an unrelated third party;
- include an estimate of the expected payment/receipt, i.e. the difference between the expected value of the asset at the end of the lease and the RVG, under RVGs that are not provided by an unrelated third party; and
- include term option penalties.

Results of post exposure draft deliberations

The Boards tentatively re-affirmed a number of decisions regarding other lease payment issues included in the exposure draft. In particular, lease payments would:

- not include an estimate of amounts payable/receivable under RVGs provided by an unrelated third party;
- include an estimate of the expected payment/receipt, i.e. the difference between the expected value of the asset at the end of the lease and the RVG, under RVGs that are provided by the lessee; and
- include term option penalties.

KPMG observations

The Boards consider that RVGs are another form of contingent rental. However, the proposed requirements are inconsistent with the current redeliberations on variable lease payments whereby variable lease payments, other than those based on a rate or index are recognised in profit or loss as they are incurred.

The [IASB's website](#) and the [FASB's website](#) contain summaries of the Boards' meetings, meeting materials, project summaries and status updates.

Abbreviations

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

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