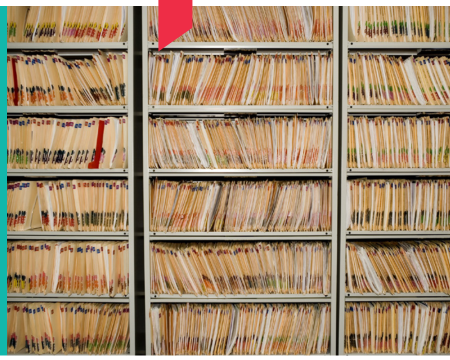
LEASES
INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/12



Summary

The International Accounting Standards Board (IASB) has issued Exposure Draft 2013/06 *Leases* (the ED) for public comment, which sets out proposed changes to the accounting for leases. The ED has been developed through a joint project with the US Financial Accounting Standards Board (FASB).

The existing accounting models under both IFRS and US GAAP require lessees to classify their lease contracts as either *finance leases* or *operating leases*, with only finance leases being recognised in the statement of financial position.

The proposals would now require that all leases (within the scope of the proposals) with a maximum possible lease term of 12 months or more to be recognised in the statement of financial position, to reflect:

– The lessees right to use the lessors asset
– The obligation for the lessee to make payments to the lessor for the right to use the lessors asset.

Subsequent measurement of the lease arrangements are dependent on whether the lease is classified as either a **Type A** or **Type B** lease.

Classification is primarily based on whether the underlying asset is either *property* or *non-property*, subject to additional criteria regarding:

– The level of consumption of the underlying asset by the lessee over the lease term
– The present value of the lease payments versus the fair value of the underlying asset.

As a result, the majority of leases relating to *non-property* assets (i.e. equipment and vehicles) would be classified as **Type A** leases, while the majority of leases relating to *property* (i.e. land and buildings) would be classified as **Type B** leases.

STATUS
Exposure Draft

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
Significant changes proposed to the accounting requirements for both lessees and lessors. The impact will be particularly significant for lessees who currently classify lease arrangements as operating leases, as well as lessors of assets other than property that classify lease arrangements as operating leases.

For lessees:

- In the statement of financial position, a right-of-use asset and lease liability would be recognised for both **Type A** and **Type B** leases
- In the income statement, separate line items for the amortisation of the right-of-use asset and the interest expense on the lease liability must be presented for a **Type A** lease, whereas a only a single lease expense is presented for a **Type B** lease which is recognised on a straight line basis over the lease term
- In the statement of cash flows, separate cash flows in respect of payments of principal and payments of interest must be presented for a **Type A** lease, whereas a single cash flow to reflect the cash paid for lease payments is presented for a **Type B** lease.

For lessors:

- In the statement of financial position, the underlying asset is derecognised and a lease receivable and residual asset is recognised for a **Type A** lease, whereas the underlying asset continues to be recognised for a **Type B** lease
- In the income statement, interest income and any profit on the lease with payments of principal reducing the lease receivable in the statement of financial position is recognised for a **Type A** lease, whereas a single lease income amount (typically on a straight-line basis) is recognised for a **Type B** lease
- In the statement of cash flows, separate cash flows in respect of receipts of principal and interest received are presented separately for a **Type A** lease, whereas a single cash flow to reflect the cash received for lease payments is presented for **Type B** leases.

The ED also proposes a significant increase in the nature and quantum of both qualitative and quantitative disclosures in relation to an entity's lease arrangements. In doing so, the IASB aims to improve the transparency of an entity's leverage, assets used in operations, cash flows for lessees, and residual value of the leased asset for lessors, to the users of the financial statements.

At a high level, specific disclosures are required regarding:

- Management judgements in the application of the proposals
- Risks associated with an entity's lease arrangements
- Reconciliations of carrying amounts relating to lease arrangements
- Maturity analysis of future lease payments payable/receivable.

The proposals also provide specific requirements for sale and lease back transactions, as well as a significant number of illustrative examples (refer to Appendix A for a complete index).

Background

The existing accounting models under both IFRS and US GAAP require lessees to classify their lease contracts as either finance leases or operating leases. However, these models have been criticised for failing to meet the need of users of financial statements as they often omit information regarding the rights and obligations held by lessees and lessors. Typically, these rights and obligations meet the definitions of assets and liabilities under both the IASB and FASB conceptual frameworks.

The current model also leads to a lack of comparability, and additional complexity, due to the distinction between finance leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect assets and liabilities arising from operating leases.

A report released by the US Securities and Exchange Commission (SEC) in 2005 estimated that the extent of off-balance-sheet operating lease commitments, for SEC registrants alone, totalled US$1.25 trillion.

In order to address these concerns, the IASB and the FASB initiated a joint project to develop a new approach to lease accounting that would result in all assets and liabilities arising under lease contracts being recognised in an entity's statement of financial position.

An initial exposure draft, ED 2010/09 *Leases*, was issued in August 2010. This first ED set out an accounting approach based on the premise that lease contracts result in lessees obtaining the right to use an asset for a specified period (the 'right-of-use' model).

The Boards received almost 800 comment letters and initiated extensive constituent outreach through workshops, questionnaires, and targeted round table meetings.

The proposals proved controversial. While there was general support for the proposed 'right-of-use' model, many believed the initial ED was too complex, inconsistent with the economics underlying certain transactions, and for many companies excessively costly to implement. In particular, there were concerns regarding the complexity of measurement, costs associated with required reassessments during lease terms, accounting for multi element contracts (contracts which contain lease and non-lease components), and the proposed lessor accounting model.

During their redeliberations, the Boards have made significant changes to the proposals set out in the initial ED. Consequently, the Boards agreed to re-expose the ED in order to provide interested parties with an opportunity to comment on revisions that the Boards have proposed during their redeliberations.

Introduction

The proposals specify the accounting for leases, with the core principle being that both lessees and lessors recognise all associated assets and liabilities that arise from being party to a lease agreement.

All terms and conditions of a contract as well as all related facts and circumstances must be considered when applying the requirements of the proposal, which must be applied consistently to leases with similar characteristics and in similar circumstances.

Scope

The proposals apply to all leases, except for:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- Leases of biological assets
- Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*.

Lease arrangements for the above are accounted for in accordance with the IFRS(s) that govern the underlying asset.

Scope – short term leases

A short-term lease is defined as a lease with a maximum possible contractual lease term (including any options to extend) of **12 months or less**.

Both lessees and lessors, for each class of underlying asset, can opt to account for *short-term* leases either:

- Under the proposals
- On a straight line basis (or other systematic basis for lessors).

[Note: Any lease that contains a purchase option is **not** a short-term lease.]

Initial recognition requirements

In order to apply the proposals, entities are required to to:

i. Identify lease contracts
ii. Separate the components of lease components
iii. Determine the lease term.

i. Identifying a lease

The proposals only apply to those contracts that meet the definition of a *lease*.

In summary, a lease is a contract that conveys:

- The use of an identified asset (i.e. an asset, or part thereof, that can be identified, and not a proportion of a larger asset, and one that the lessor cannot substitute with another asset without the lessees approval)
- Right to control the use of an identified asset (i.e. the lessee can direct the use of the identified asset and derive benefits from its use).

ii. Separating components of a contract

Entities must identify, and then separate, each component within a lease arrangement.

Separate components exist within a lease arrangement where both:

- The lessee can benefit from use of the asset either, on its own, or together with other resources that are *readily available* to the lessee (i.e. resources that have already been obtained, or able to be obtained from the lessor or other parties)
- The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

Separation of the components of the contract is essential in allocating the contractual lease payments:

- For lessees, allocation of the lease payments payable is based on the observable stand-alone prices for each component
- For lessors, allocation of the lease payments receivable is based on the requirements of the forthcoming IFRS *Revenue from Contracts with Customers*.

iii. Determining the lease term

The lease term is the non-cancellable period of the lease, which includes the effect of:

- Lease extension options where there is *significant economic incentive* for the lessee to exercise
- Lease termination options where there is *significant economic incentive* for the lessee **not** to exercise.

Determining the existence or otherwise of *significant economic incentives* requires the consideration of various factors (i.e. contract-based, asset-based, entity-based, and market-based factors).

Subsequently, the lease term is only reassessed if either:

a) There is a change in relevant factors that effect the lessees *significant economic incentives*
b) The actual exercise, or non-exercise, of an option by a lessee differs from what was expected when initially determining the lease term.

Contract modifications

If modifications to the lease arrangement result in a substantive change to the existing contractual terms of the lease (i.e. the lease term, lease payments etc.) the modification is treated as a new contract at the date the modifications become effective.

Any difference in the carrying amounts of lease assets and liabilities between the original and modified lease arrangement is recognised in profit or loss.

Sale and lease-back transactions

The proposals would require an entity to apply the control principle within the soon to be released IFRS *Revenue from Contracts with Customers* to determine whether a sale of the transferred asset has occurred.

Lease classification

The proposals require an entity to classify a lease at commencement date into either **Type A** or **Type B**.

This classification cannot subsequently be changed.

The classifications are based on whether the identified asset is *property* or some other asset (*non-property*), subject to additional criteria regarding:

- The consumption of the underlying asset by the lessee during the lease term
- The present value of the lease payments compared with the fair value of the underlying asset at the commencement date.

Type A Classification

A lease is normally classified as a **Type A** lease if the underlying asset in the lease is *non-property*.

If either of the following are met the lease is classified as **Type B**:

a) The lease term is for an **insignificant part** of the total economic life of the underlying asset

b) The present value of the lease payments is **insignificant** relative to the fair value of the underlying asset at the commencement date.

Type B Classification

A lease is normally classified as a **Type B** lease if the underlying asset in the lease is *property*.

If either of the following are met the lease is classified as **Type A**:

a) The lease term is for a **major part** of the total economic life of the property

b) The present value of the lease payments accounts for **substantially all** of the fair value of the property at the commencement date.

The proposals also provide guidance in respect to classifications:

- Where there are options to purchase the underlying asset (if there is a significant economic incentive to do so, the lease is classified as **Type A**)
- Where the component contains the right to use more than one asset (classification is based on the nature of the primary asset)
- Of sub-leases (classification is based on the underlying asset)
- Where the alternative measurement basis for right-of-use asset (see section below) has been used by the lessee.

Lessee Accounting

Recognition

At commencement date, a lessee recognises in its statement of financial position:

i. Lease liability

ii. Right-of-use asset.

i. Lease liability

Initial measurement

The lease liability is equal to the present value of the *lease payments* discounted using the rate the lessor charges the lessee (or if unknown, the lessee's incremental borrowing rate), and includes:

- Fixed payments, less any lease incentives receivable from the lessor
- Variable lease payments that depend on an index or a rate (e.g. Consumer Price Index, market interest rate etc.)
- Variable lease payments that are in-substance fixed payments
- Amounts expected to be payable under lessee residual value guarantees.

Subsequent measurement

Subsequently, the lease liability is:

- Increased: to reflect the unwinding of the discount on the lease liability
- Reduced: to reflect the lease payments made during the period.

The lease liability and the discount rate are also required to be reassessed and remeasured (for example, if the assessment of the lease term changes due to a change in expectations about whether a lease extension option will be exercised).

ii. Right-of-use asset

Initial measurement

The right-of-use asset includes the following:

a) The amount of the initial measurement of the lease liability (see above)

b) Lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor

c) *Any initial direct costs* incurred by the lessee (i.e. those directly attributable to negotiating and arranging a lease and would not have been incurred without entering into the lease).

Subsequent measurement

Subsequently, the right-of-use asset is measured at cost less any accumulated amortisation and any accumulated impairment losses.

The nature of the amortisation of the right-of-use asset depends on whether the lease is classified as **Type A** or **Type B**. For certain **Type B** leases, there are **alternative measurement bases** for the right-of-use asset (see section below).

Amortisation of the right-of-use asset - Type A lease

The right-of-use asset is amortised on a straight-line basis (unless another systematic basis is more representative of the pattern of the lessee's consumption of the assets economic benefits), from the commencement date to the **earlier** of either:

- The end of the useful life of the right-of-use asset
- The end of the lease term.

However, if there is significant economic incentive to exercise a purchase option, the right-of-use asset is amortised to the end of the useful life of the underlying asset.

Amortisation of the right-of-use asset - Type B lease

The amortisation of the right-of-use asset for the period is calculated as the difference between:

– The periodic lease cost
– The periodic unwinding of the discount on the lease liability.

Essentially, the amortisation charge is the balancing figure that ensures that the overall charge to profit or loss is consistent each period.

Mandatory alternative measurement basis for the right-of-use asset (Investment property)

If the right-of-use asset relates to:

– Property that meets the definition of investment property in accordance with IAS 40 *Investment Property*, **and**
– The lessee measures investment property using the fair value model.

the right-of-use asset relating to the property **is required** to be measured in accordance with the fair value model in IAS 40.

Optional alternative measurement basis for the right-of-use asset (Property, Plant and Equipment)

If the right-of-use asset relates to:

– A class of property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment*, **and**
– The lessee measures that class of property, plant and equipment using the revaluation model

the right-of-use asset relating to relating to the class of property, plant and equipment **may** be measured instead at a revalued amount in accordance with IAS 16.

Impairment of the right of use asset

Impairment is recognised in accordance with IAS 36 *Impairment of Assets*.

Presentation

The proposals require specific presentation requirements which are summarised in the table below. Presentation is dependent on whether the lease is Type A or Type B.

Disclosures

Information must be disclosed that enables users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases.

This includes, at a high level, disclosures in relation to:

– Lease agreements (i.e. lease term, contingent rentals, options etc.)
– Significant judgements (i.e. determining whether a contract contains a lease, allocation of consideration, determination of discount rate etc.)
– Reconciliations of the opening and closing carrying amounts of the right of use asset and lease liability
– Maturity analysis of the undiscounted lease liability contractual payments.

The full list of disclosures can be found in paragraphs 58 – 67 of the ED.

	Statement of financial position[1]	Statement of profit or loss and other comprehensive income	Statement of cash flows[2]
Type A	The *right of use* asset and *lease liability* must be disaggregated between: – Type A – Type B.	Present separately: – Amortisation of right-of-use asset – Interest expense.	Present separately: – Principal paid[3] – Interest expense paid[4].
Type B		Present a single *lease expense*.	Present a single *lease expense paid*.

[1] This presentation may alternatively be made in the notes to the financial statements; however additional disclosure and presentation requirements will apply

[2] Variable lease payments and short-term lease payments that are not included in the lease liability are presented within operating activities

[3] Present as financing activities

[4] Present in accordance with the requirements of IAS 7 *Statement of cash flows* (i.e. either as *operating activities, investing activities*, or *financing activities* so long as presentation is consistent from period to period [IAS 7.31])

Figure 1 – Proposed presentation requirements for lessees

Lessor Accounting – Type A leases

Recognition

At commencement date, the carrying amount of the underlying asset is derecognised followed by the recognition of:

i. Lease receivable
ii. Residual asset
iii. Any resulting profit or loss on the lease in profit or loss.

i. Lease receivable

Initial measurement

The lease receivable is equal to the present value of the *lease payments* discounted using the rate the lessor charges the lessee (or if unknown, the lessee's incremental borrowing rate), plus any initial direct costs (i.e. those directly attributable to negotiating and arranging a lease and would not have been incurred without entering into the lease).

Lease payments include:

a) Fixed payments, less any lease incentives receivable from the lessor
b) Variable lease payments that depend on an index or a rate (e.g. Consumer Price Index, market interest rate etc.), measured using the index/rate as at commencement date
c) Variable lease payments that are in-substance fixed payments
d) Amounts expected to be payable under lessee residual value guarantees
e) The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option
f) Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Subsequent measurement

Subsequently, the lease receivable is:

- Increased: to reflect the unwinding of the discount on the lease receivable
- Reduced: to reflect the lease payments received during the period.

The lease payments receivable and the discount rate are also required to be reassessed and remeasured (for example, if the assessment of the lease term changes due to a change in expectations about whether a lease extension will be exercised by the lessee).

Impairment of lease receivable

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

Collateral relating to the lease receivable is taken into consideration when determining the loss allowance (but **excludes** cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term as these relate to the residual asset).

ii. Residual asset

Initial measurement

The residual asset is equal to the sum of A + B – C, where:

A = the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term, discounted using the rate the lessor charges the lessee (gross residual asset).

B = the present value of expected variable lease payments.

C = any unearned profit.

The unearned profit included in the initial measurement of the residual asset is determined as the difference between:

- The fair value and the carrying amount of the underlying asset immediately before the commencement date
- The profit recognised at the commencement date.

Subsequent measurement

The carrying amount of the residual asset is increased to account for the effect of the unwinding of the discount on the gross residual asset, using the rate the lessor charges the lessee.

If a lessor includes variable lease payments in the initial measurement of the residual asset, the lessor is required to derecognise a portion of the carrying amount of the residual asset in each period and recognise a corresponding expense in profit or loss.

The portion to derecognise is determined on the basis of the variable lease payments expected to be earned in the period.

Presentation

Statement of financial position

Leased assets (i.e. the sum of the carrying amounts of lease receivables and residual assets) are presented separately in the statement of financial position.

In addition, the following amounts are presented separately in the statement of financial position (or in the notes):

- Lease receivables
- Residual assets.

Statement of profit or loss and other comprehensive income

Income arising from leases is presented separately in the statement of profit or loss and other comprehensive income (or in the notes – additional disclosures and presentations required).

Any profit or loss on the lease recognised at the commencement date is presented in a manner that best reflects the lessor's business model(s).

Statement of cash flows

Cash receipts relating to lease payments received are classified within operating activities.

Disclosures

Disclosures must present information that enables users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases.

These include, at a high level, general disclosures in relation to:

- Lease agreements (i.e. lease term, contingent rentals, options etc.)
- Significant judgements (i.e. determining whether a contract contains a lease, allocation of consideration, determination of discount rate etc.)
- Tabular representation of various income streams from **Type A**, **Type B**, and short-term lease arrangements, as well as variable lease payments.

The full list of the above general disclosures can be found in paragraphs 98 – 101 of the ED.

In addition, there are specific disclosure requirements for **Type A** leases, which include:

- Reconciliations of the opening and closing carrying amounts of the right of use asset and residual asset
- Maturity analysis of the undiscounted lease receivable contractual receipts
- Information regarding how the lessor manages risks associated with residual assets.

The full list of specific **Type A** lease disclosures for lessors can be found in paragraphs 98 – 101 of the ED.

Lessor Accounting – Type B leases

Recognition

Lease payments received are recognised on a straight-line basis over the lease term (unless another systematic basis is more representative).

The underlying asset continues to be recognised in accordance with other applicable IFRSs.

Any Initial direct costs are recognised as an expense over the lease term on the same basis as lease income.

Any variable lease payments are recognised in profit or loss in the period in which that income is earned.

Cash receipts from lease payments received presented within *operating activities* in the statement of cash flows.

Disclosures

General lessor disclosure requirements are the same as those for **Type A** leases.

In addition, there are specific **Type B** lease disclosure requirements, which include a maturity analysis of the undiscounted lease receivable contractual receipts.

The full list of lessor **Type B** lease disclosures can be found in paragraphs 108 – 109 of the ED.

Effective date and transition

Effective date

The IASB will decide on the effective date only upon completion of its re-deliberations.

Transition

It is proposed that the proposals are applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except in respect to the additional transition reliefs provided (paragraphs C2 – C24).

The ED would apply to all leases in existence at the beginning of the earliest comparative period presented upon adoption. The grandfathering of existing leases is not considered in the proposals.

Appendix A – Index of illustrative examples in the ED

Identifying a lease

- Example 1—Contract for rail cars
- Example 2—Contract for coffee services
- Example 3—Contract for medical equipment
- Example 4—Contract for fibre-optic cable
- Example 5—Contract for energy/power

Allocating consideration to components of a contract

- Example 6—Lessee allocation of consideration to lease and non-lease components of a contract

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- Example 11—Short-term lease

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- Example 21—Lessor accounting for **Type A** leases—residual value guarantees
- Example 22—Lessor accounting for **Type A** leases—impairment of the lease receivable

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- Example 24—Lessee transition—operating lease to **Type A** lease

Lessee transition - Operating lease to a Type B lease

- Example 25—Lessee transition—operating lease to **Type B** lease

Lessor transition – Operating lease to a Type A lease

- Example 26—Lessor transition—operating lease to **Type A** lease

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