

Snapshot: Leases

This Snapshot introduces the revised Exposure Draft *Leases* ('ED') published jointly by the International Accounting Standards Board (IASB) and the US based Financial Accounting Standards Board (FASB).

It provides an overview of the main proposals developed by the IASB and the FASB.

It also summarises the feedback received on an earlier version of proposals published by the boards in 2010 ('2010 ED') and how the boards responded to that feedback.

Project objectives:	To improve the quality and comparability of financial reporting by providing greater transparency about leverage, the assets an entity uses in its operations, and the risks to which it is exposed from entering into lease transactions.
Project stage:	The boards are inviting comments on their revised proposals for a new <i>Leases</i> Standard. This ED includes modifications, simplifications and clarifications that the boards have made to their proposals on the basis of the feedback received on the 2010 ED.
Comment deadline:	13 September 2013
Next steps:	The boards will undertake outreach activities during the comment period to obtain additional feedback that will be considered when they finalise the Standard. Following redeliberations on this additional consultation, the boards expect to have received sufficient information to proceed with and finalise the Standard. During those redeliberations, the boards will decide upon the effective date of the new <i>Leases</i> Standard.

Why change the accounting for leases?

Leasing is a prevalent business activity that is often omitted from the face of the financial statements. In 2005, the SEC estimated that US public companies may have approximately \$1.25 trillion of off-balance-sheet undiscounted operating lease commitments.

Leasing is an important activity for many entities. The 2013 *World Leasing Yearbook* reported that new leases entered into worldwide in 2011 amounted to almost \$800 billion.

Under existing accounting standards, the majority of those leases are not reported on a lessee's balance sheet. For many entities, the off-balance-sheet financing numbers can be substantial. In 2005, the US Securities and Exchange Commission (SEC) estimated that US public companies may have approximately \$1.25 trillion of off-balance-sheet undiscounted operating lease commitments.¹

Responding to concerns about the lack of transparency of information about lease obligations, in 2006 the IASB and the FASB initiated a joint project to improve the financial reporting of leasing activities under International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP).

Existing lease accounting

Lease accounting (for example, IAS 17 *Leases* within IFRS) has historically focused on identifying when a lease is economically similar to purchasing the asset being leased (the 'underlying asset'). When a lease is determined to be economically similar to purchasing the underlying asset, the lease is classified as a finance lease and reported on the lessee's balance sheet. All other leases are classified as operating leases and are not reported on the lessee's balance sheet. Nevertheless, commitments arise from operating leases as they do from finance leases and other similar financial liabilities. Consequently, a lessee's balance sheet provides a misleading picture about leverage and the assets that the lessee uses in its operations.

In addition, the significant difference in accounting for finance and operating leases has created incentives to structure some transactions as operating leases to achieve off-balance-sheet accounting.

¹ Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers

Insufficient information provided today

When analysing a lessee's financial position and performance, many users of financial statements make adjustments to the reported financial information to capitalise operating leases. Those adjustments can be based on the annual operating lease expense or on information about undiscounted future operating lease payments available in the notes to the financial statements. That information is a subset of the information available to management and is insufficient to allow users of financial statements to make reliable adjustments. The adjustments can, therefore, be incomplete or inaccurate, resulting in different adjustments being made even when users are attempting to measure the same amounts.

Enhancing disclosures is not enough

The boards think that disclosure in the notes to the financial statements is not a substitute for reporting assets and liabilities arising from a lease. That is because failing to report those assets and liabilities on the balance sheet provides a misleading picture of the financial position of a lessee.

Improving the quality and comparability of financial reporting

Under the proposals in this ED, a lessee would report assets and liabilities for all leases of more than 12 months on its balance sheet. This would provide a more faithful representation of the financial position of the lessee and, together with enhanced disclosures, greater transparency about the lessee's leverage.

The proposals require lease assets and liabilities to be measured on a discounted basis. This information is useful to users of financial statements because it provides information about future cash outflows arising from leases, which is comparable with information provided about other financial liabilities that are reported on an entity's balance sheet and measured on a discounted basis.

Lessor accounting

The main concern from users of financial statements about current lessor accounting is the lack of transparency about the residual values of equipment and vehicles that are subject to operating leases. Those users are interested in understanding the assumptions that lessors make about residual values, particularly when those residual values are significant. Those who analyse the financial statements of equipment and vehicle lessors also told the boards that it would be beneficial to distinguish credit risk (associated with receivables from lessees) from asset risk (associated with residual interests in underlying assets).

The proposals would assist in providing that information for most equipment and vehicle leases by requiring a lessor to account for its residual interest in underlying assets separately from its receivables from lessees. The lessor would also be required to provide information about how it manages its exposure to that residual interest.

Overview of lessee accounting model—balance sheet

The boards have developed a new approach to lease accounting that would require a lessee to recognise assets and liabilities for the rights and obligations created by leases. The model reflects that, at the start of a lease, the lessee obtains a right to use the underlying asset for a period of time, and the lessor has provided or delivered that right. Consequently, the boards have referred to the model as a ‘right-of-use’ model.

Are all leases recognised on the balance sheet?

A lessee would recognise a right-of-use asset and a lease liability for all leases of more than 12 months. A lessee can choose to recognise a right-of-use asset and a lease liability for leases of 12 months or less but is not required to do so.

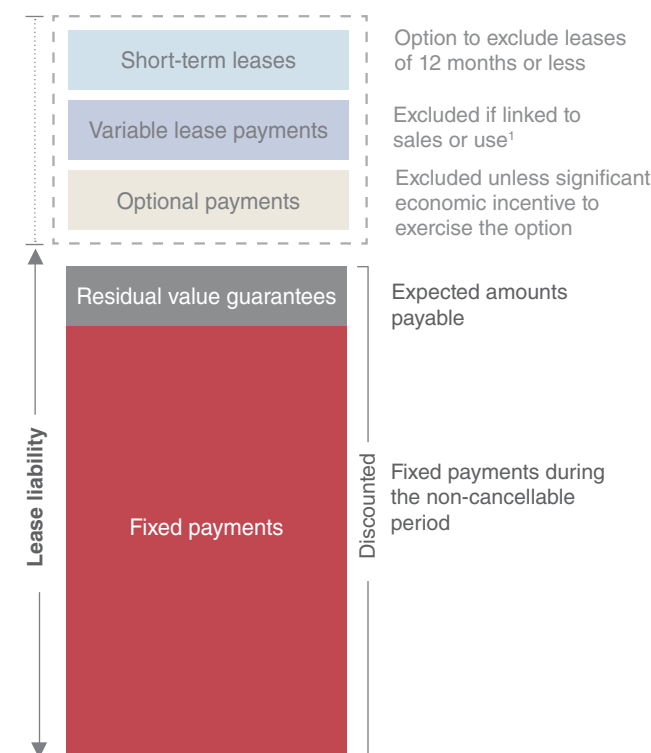
By not requiring the recognition of assets and liabilities for leases of 12 months or less, concerns about cost and complexity are addressed without a material change to the information provided to users of financial statements.

How does a lessee measure lease assets and liabilities?

Both the asset and the liability are initially measured at the present value of lease payments. The right-of-use asset also includes any costs incurred that are directly related to entering into the lease. The lease liability would be measured in the same way regardless of the nature of the underlying asset.

Excluding most variable payments and payments in optional periods from the measurement of lease assets and liabilities addresses concerns raised about cost and complexity.

The lease liability (and the corresponding right-of-use asset) includes the following lease payments:



¹ Included only if payments linked to an index or a rate

A dual approach to the recognition of lease expense

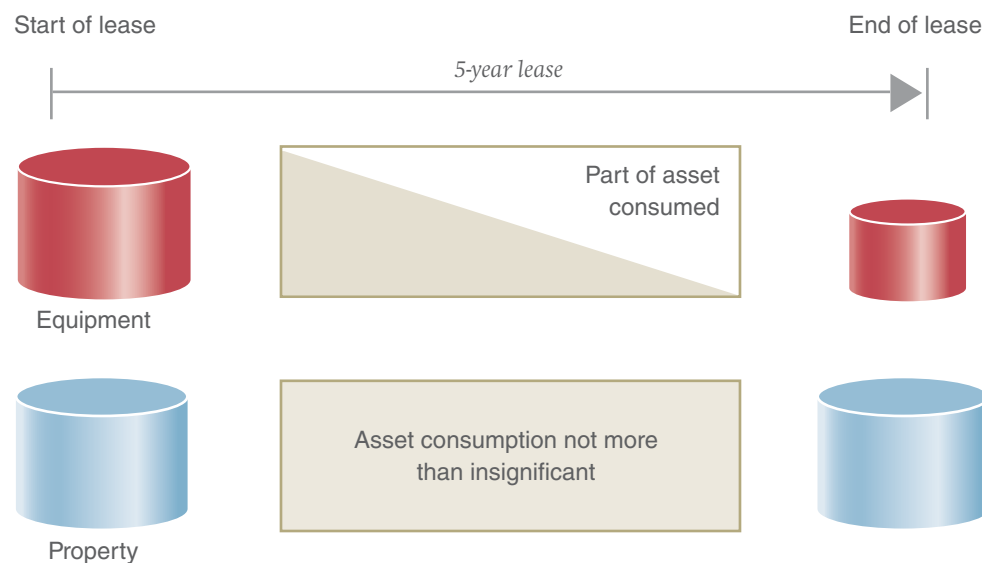
Why account for most equipment leases differently from most property leases?

There are a wide variety of lease transactions with different economics. To better reflect these differences, this ED proposes a dual approach to the recognition, measurement and presentation of expenses and cash flows arising from a lease.

The boards have introduced a dual approach for lease expenses in this ED in response to feedback on the 2010 ED. Many noted that a single lessee accounting model would not reflect the differing economics of the wide variety of lease contracts.

The principle for determining which approach to apply is based on the amount of consumption of the underlying asset. This reflects that there is a difference between a lease for which the lessee pays for the part of the underlying asset that it consumes (or uses up) during the lease term, and a lease for which the lessee merely pays for use.

The consumption principle



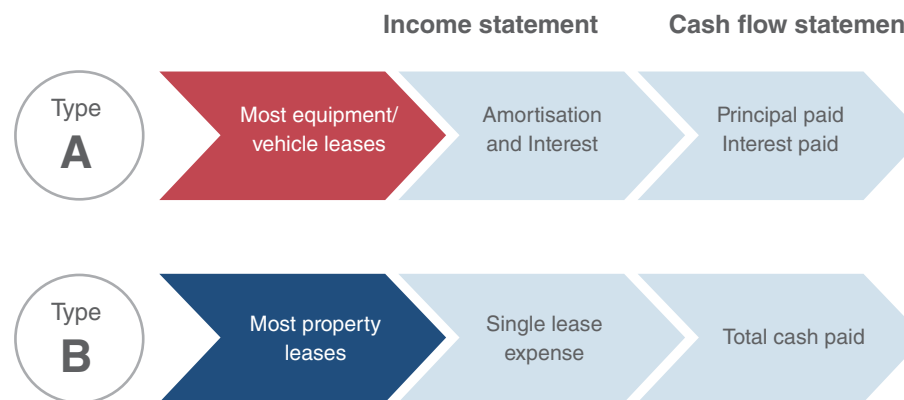
A lessee typically consumes a part of any equipment or vehicle that it leases (such as aircraft, ships, mining equipment, cars and trucks). That is because equipment and vehicles are depreciating assets, whose value not only declines over their economic lives but generally declines faster in the early years of their lives than in the later years. In such leases, the lessor prices the lease to recover the value of the part of the asset consumed as well as obtaining a return on its investment in the asset.

In other leases, the lessee merely uses the underlying asset without consuming more than an insignificant part of it. This is typically the case for most leases of real estate, ie leases of land and/or a building ('property'). Property typically has a relatively long life, and a large proportion of the lease payments for some property leases relates to the land element inherent in those leases. Land has an indefinite life and the value of the land would not be expected to be consumed by a lessee. In such leases, the lessor prices the lease to obtain a *return* on its investment in the underlying asset (without requiring recovery of the investment itself).

This ED applies this concept in a simplified way. An entity would classify a lease largely on the basis of the nature of the underlying asset, ie:

- most leases of **equipment** or **vehicles** would be classified as **Type A leases**.
- most leases of **property** would be classified as **Type B leases**.

Recognition of leases expenses and cash outflows



A lessee that enters into a Type A lease, in effect, acquires the part of the underlying asset that it consumes, which is typically paid for over time in the form of lease payments. Accordingly, a lessee would present amortisation of the right-of-use asset in the same line item as other similar expenses (for example, depreciation of property, plant, and equipment) and interest on the lease liability in the same line item as interest on other, similar financial liabilities.

In contrast, the lease payments made in a Type B lease would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, ie a charge for the use of the asset. That return or charge would be expected to be relatively even over the lease term. Accordingly, those payments for use are presented as one amount in a lessee's income statement and recognised on a straight-line basis.

The presentation of cash outflows in the cash flow statement is consistent with the presentation of expenses in the income statement. For Type A leases, the principal portion of cash payments is presented within financing activities and the interest portion within operating or financing activities. Cash payments for Type B leases are presented as one amount within operating activities.

Illustrative example

The following example illustrates the proposed accounting for a 3-year equipment lease (classified as a Type A lease) and a 3-year property lease (classified as a Type B lease) by a lessee:

		EQUIPMENT			PROPERTY		
Years	0	1	2	3	1	2	3
BALANCE SHEET							
Right-of-use asset	600	400	200	-	414	215	-
Lease liability	(600)	(414)	(215)	-	(414)	(215)	-
INCOME STATEMENT							
Operating expense		200	200	200	231	231	231
Financing expense		45	32	16			
TOTAL LEASE EXPENSE		245	232	216	231	231	231

Lessor accounting

What is changing?

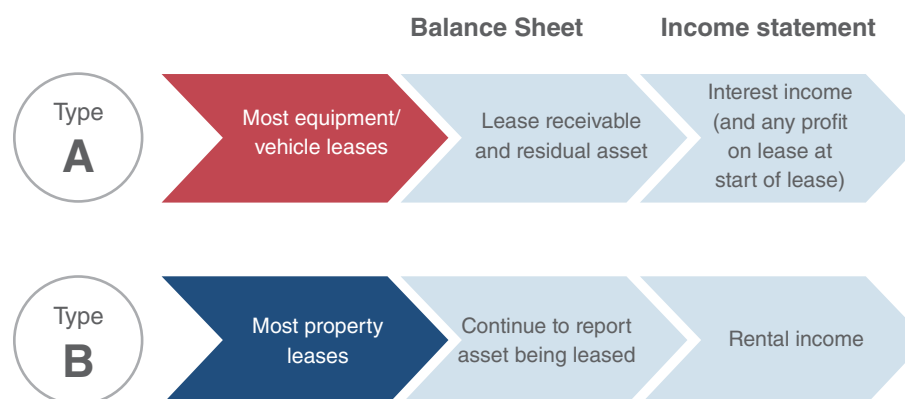
For all practical purposes, there are few changes proposed to the accounting applied by lessors of finance leases. For operating leases, the extent of change would depend on whether the underlying asset is property or equipment. A lessor would distinguish between most property and most equipment leases in the same way that a lessee would under the proposals. For operating leases of property, the accounting applied by the lessor is essentially unchanged. For operating leases of equipment or vehicles, however, the changes proposed are significant.

The boards have changed the lessor accounting proposals to more closely reflect how a lessor prices its leases in response to feedback on the 2010 ED.

A lessor of most equipment or vehicles leases would:

- (a) recognise a lease receivable and a retained interest in the underlying asset (the residual asset), and derecognise the underlying asset; and
- (b) recognise interest income on both the lease receivable and the residual asset over the lease term.

A manufacturer or dealer lessor might also recognise profit on the lease when the underlying asset is made available for use by the lessee.



Why change the accounting for many equipment and vehicle leases?

The largest lessors of equipment and vehicles are financial institutions, subsidiaries of manufacturers that operate like financial institutions or independent asset financing companies. Those lessors typically view their leasing activities as a way of providing secured funding to customers and, for some lessors, as an alternative means of providing products to customers.

IAS 17 requires many lessors of equipment or vehicles to apply two different accounting models to their leases (that is, both finance and operating lease accounting), even though those lessors may price all leases as financing transactions, providing secured funding to customers. Because the accounting for operating and finance leases is very different, there is a lack of comparability within a lessor's own financial statements.

The proposals outlined in this ED are designed to better reflect the way in which a lessor manages its business. The proposals also respond to concerns raised by some users of financial statements about the lack of transparency about a lessor's exposure to credit risk and asset risk.²

² Refer to 'why change the accounting for leases?' earlier in this document for further information.

Why not change the accounting for property leases?

Many lessors of property view their leasing activities as an important component of their broader investment strategy. Leases are priced to earn a particular yield based on the fair value of the property and the lessor would often expect to also generate returns from capital appreciation of the property.

Most property that is the subject of a lease meets the definition of investment property in IFRS³, which means that a lessor either measures the property at fair value or discloses information about the fair value in its financial statements. Users of financial statements informed the IASB that information about rental income and the property's fair value provides them with more useful information about the lessor's leasing activities than other approaches. Other approaches are also likely to be more complicated to apply.

³ IAS 40 *Investment Property*.

Responding to feedback

Extensive consultation has taken place.

On the basis of the feedback received, the proposals have changed substantively, including the lessee and lessor accounting models and how lease assets and lease liabilities are measured.

The boards received almost 800 comment letters in response to the 2010 ED. The IASB and staff also discussed the proposals at more than 300 meetings and other events held throughout the world, including conferences, workshops and round-table discussions, involving:

- preparers from various industries (eg retail, financial services, real estate, transport, power and utilities, oil and gas, telecommunications, technology, outsourcing, shipping, aviation, healthcare and hospitality)
- investors, analysts and other users of financial statements
- accounting firms
- securities regulators; and
- accounting standard-setters.

Feedback received on the 2010 ED

Feedback received on the proposals in the 2010 ED mainly related to the following areas discussed below:

- (a) Lessee accounting model
 - i. Recognition of assets and liabilities
 - ii. Effect on profit or loss
- (b) Lessor accounting model
- (c) Measurement complexities
- (d) Definition of a lease

In response to feedback received, the boards have also changed the proposals regarding sale and leaseback transactions, the separation of lease and non-lease components of a contract and how entities would transition to the new model.

Lessee accounting model

2010 ED	Feedback	Response
<p>Recognition of assets and liabilities</p> <p>Proposed that a lessee would recognise a right-of-use asset and a lease liability for all leases.</p>	<ul style="list-style-type: none"> • General support for the recognition of lease assets and liabilities, particularly from users of financial statements, regulators, standard-setters and accounting firms. Some preparers questioned the benefit of reporting all leases on the balance sheet. • Some suggested excluding particular leases (for example, short-term leases or leases of non-core assets). • Others suggested only enhancing disclosures in the notes to the financial statements. 	<ul style="list-style-type: none"> • The boards confirmed their view that leases create rights and obligations that meet the definition of an asset and a liability for a lessee and that the recognition of lease assets and liabilities by a lessee would substantially enhance the information provided to users of financial statements. • The boards have simplified the proposals by permitting a lessee not to recognise assets and liabilities for leases with a maximum lease term of 12 months or less and simplifying measurement.
<p>Effect on profit or loss</p> <p>Proposed that a lessee would amortise the right-of-use asset over the lease term, typically on a straight-line basis. In addition, interest on the lease liability would be recognised separately.</p>	<ul style="list-style-type: none"> • Respondents had mixed views. Many noted that, in their view, the proposals would not reflect the economics of all leases. • The boards consulted extensively. • That consultation emphasised that different stakeholders have different views about the economics of leases. Some view all leases as financing transactions. Others view almost no leases as financing transactions. For others, the economics are different for different leases. 	<ul style="list-style-type: none"> • The boards decided to propose a dual approach to the recognition and presentation of lease expenses and cash flows for lessees to better reflect the differing economics of different leases.

Lessor accounting model

2010 ED	Feedback	Response
<p>Proposed two different lessor accounting models.</p> <p>If a lessor transferred the significant risks or benefits associated with the underlying asset to the lessee, the lessor would derecognise the part of the underlying asset relating to the right of use and recognise a lease receivable. The rights retained in the underlying asset would be reclassified as a residual asset.</p> <p>If a lessor retained the significant risks or benefits associated with the underlying asset, the lessor would continue to recognise the underlying asset, and also recognise:</p> <ul style="list-style-type: none"> • a lease receivable; and • a liability for the obligation to permit the lessee to use the asset. <p>This latter model was described as the performance obligation approach.</p>	<ul style="list-style-type: none"> • Very little support for the performance obligation approach. Many thought the approach would inappropriately inflate a lessor's balance sheet—ie they disagreed with the recognition of both the lease receivable and the underlying asset and questioned how the obligation to permit the lessee to use the asset would meet the definition of a liability. 	<p>The boards decided:</p> <ul style="list-style-type: none"> • for most equipment and vehicle leases, that a lessor would recognise a lease receivable and a retained interest in the underlying asset (the residual asset). • not to propose the recognition of a liability by a lessor. • not to propose the recognition of lease receivables for most property leases. For most leased property, a lessor provides information about the fair value of the property in its financial statements. Users of financial statements confirmed that information about rental income and the property's fair value provides them with more useful information about the lessor's business than other approaches.

Measurement complexities

2010 ED	Feedback	Response
Proposed including all expected variable lease payments in the measurement of lease assets and liabilities, and including lease payments payable in optional renewal periods on a ‘more likely than not’ basis. Those expectations would be reassessed when changes in the lessee’s liability or the lessor’s receivable would be significant.	<ul style="list-style-type: none"> Many disagreed with those proposals. Most were concerned about cost and complexity. 	<p>The boards have changed the proposals for options and variable lease payments as follows:</p> <ul style="list-style-type: none"> variable lease payments are not included in the measurement of lease assets and liabilities unless those payments are in-substance fixed payments or linked to an index or a rate. lease payments payable in optional renewal periods are not included in the measurement of lease assets and liabilities unless the lessee has a significant economic incentive to exercise the option.

Definition of a lease

2010 ED	Feedback	Response
Retained the definition of a lease in IAS 17 as the right to use an asset for a period of time in exchange for consideration. Also retained the requirements included in IFRIC 4 <i>Determining whether an Arrangement contains a Lease</i> , but with some minor changes to the wording of those requirements.	<ul style="list-style-type: none"> Respondents generally agreed with the definition of a lease but many were concerned that the guidance setting out how to apply the definition would capture contracts that they perceived to be service contracts. Some common contracts were identified as being difficult to assess under the proposals. 	<ul style="list-style-type: none"> The boards decided to retain the definition of a lease in IAS 17 but change the guidance setting out how to apply it. The changes proposed mainly relate to the concept of control used within the definition – ie a contract contains a lease when the lessee obtains the right to control the use of an identified asset for a period of time. The changes are expected to narrow the population of contracts to which the proposals apply by excluding service contracts that, under the previous proposals, may have been considered to be leases (for example, some take-or-pay contracts).

Further information

This Exposure Draft includes questions on the proposals. Respondents are invited to comment on any or all of those questions and to comment on any other issue that the IASB should consider when finalising the proposals.

The IASB's redeliberations of the proposals will take place in public meetings. Information about these public meetings will be available from the IASB's website.

The deadline for comments on the Exposure Draft is **13 September 2013**. To view the Exposure Draft and to submit your comments, visit <http://go.ifrs.org/leases>

Previous exposure documents and the comment letters are also available on the project homepage.

To stay up to date with the latest developments of this project and to sign up for email alerts, please visit the project homepage on www.ifrs.org

Important information

This Snapshot has been compiled by the staff of the IFRS Foundation for the convenience of interested parties. The views expressed within this document are those of the staff who prepared the document. They do not purport to represent the views of the IASB and should not be considered as authoritative. Comments made in relation to the application of IFRS do not purport to be acceptable or unacceptable application of IFRS.

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