Issues Paper – ED 242 (ED/2013/6) *Leases*

Introduction and background

1 The purpose of this issues paper is to outline potential issues in ED 242 and decide whether these issues, or any other issues, should be included in the AASB's submission on IASB ED/2013/6. This paper is structured to correspond to the questions asked by the IASB in ED/2013/6.

2 The issues raised in this paper incorporate feedback from:

(a) AASB Roundtables held in Melbourne and Sydney in August 2013 (see Agenda Paper 9.3);

(b) Submissions received on ED 242 (see Agenda Paper 9.4); and

(c) Targeted outreach meetings with constituents.

3 Staff will raise at the Board meeting any significant issues included in further submissions received and outreach meetings held that they think have not already been adequately dealt with in this paper.

4 The following key issues are discussed in this paper:

(a) Identifying a lease;

(b) Lessee accounting;

(c) Lessor accounting;

(d) Classification of leases;

(e) Lease term;

(f) Variable lease payments;

(g) Transition;

(h) Disclosure;

(i) Consequential amendments to IAS 40; and

(j) Other comments

Overall thoughts on the proposals

5 AASB staff support the broad direction of the proposals outlined in the ED. In particular, the AASB staff support the proposals to bring assets and liabilities arising from lease arrangements onto the balance sheet. Despite the concerns noted below in relation to the model proposed in the ED, AASB staff do not support a view expressed by some that retaining the requirements of IAS 17 *Leases*, with additional disclosure requirements, as being preferable to continuing with the approach proposed in the ED.

6 AASB staff continue to support a single model for a lessee reflecting a right-of-use asset and a liability to make lease payments, rather than the dual model proposed in the ED. AASB staff consider that a dual model will be likely to result in the creation of 'bright-lines' that encourage structuring between types of leases. AASB staff note that eliminating structuring opportunities was part of the IASB's objective in undertaking the project.

7 Further, AASB staff have concerns around the overall complexity of the requirements proposed in the ED. A consequence of the complexity of the approach proposed by the ED is the need for a number of concessions and exceptions to the proposed requirements (e.g. the exception for short-term leases), which in themselves add further complexity to the requirements of an already complex model. This complexity has the potential to result in reduced transparency in financial reporting, to create structuring opportunities which diminish comparability and reliability of financial reporting, and to increase the cost burden on preparers and users of financial information.

Question 1 to the Board:

(a) Does the Board agree with the staff comments noted in paragraphs 5–7 above?

(b) Are there any other issues in relation to the overall proposals that the Board wishes to raise to the IASB?

Key issues

ED/2013/6 Question 1: Identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether: (a) fulfilment of the contract depends on the use of an identified asset; and (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration. A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6-19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Definition of a lease

8 AASB staff agree with the proposed definition of a lease, and generally support the proposal that the underlying principles for determining whether a contract contains a lease should be based on whether fulfilment of the contract depends on the use of an identified asset, and whether a contract conveys the right to control the use of the identified asset. AASB staff consider that the clarifications provided in the ED overcome the concerns expressed by the AASB in its comments letter on ED/2010/6 *Leases* in regards to distinguishing whether a contract is for a lease or for a service.

9 Some constituents have expressed a view that the lease definition is problematic in that there are not two types of 'leases', and that property arrangements are not 'leases'. Some constituents would support the view that IAS 17 should be retained until such time as the definition of a lease is more fully considered.[1] As noted in paragraph 6 above, AASB staff support a single model, and do not support the retention of IAS 17.

10 Additional guidance may be useful to clarify circumsntaces in which a service is being provided in conjunction with the asset. Separating these components has been identified as a potentially signficiant area of judgement in practice. For example, in the

[1] Some supporting this view would not object to a 'grossing up' of the balance sheet, but maintaining the other requirements of IAS 17.

lease of a shop within a shopping centre, payments for all outgoings may not be specified in the lease contract, and identifying the lease payments attributable to the asset (right of use of the shop) versus payments for ancillary services provided by the lessor to run the shopping centre is likely to be difficult in practice.

Capacity portion of an asset

11 AASB staff disagree with the view expressed in paragraph 11 of the ED that a capacity portion of an asset cannot be an identified asset, and that therefore a lease of a capacity portion of an asset would be outside the scope of the requirements in the ED. AASB staff do not agree with the explanation in paragraph BC105(c) that "it would be unlikely that a customer would have the right to control the use of a capacity portion of a larger asset". AASB staff consider that the question of control of the use of an asset is a question of fact, and that paragraphs 12-19 of the ED provide adequate guidance to assess whether a contract conveys the right to control the use of an identified asset. AASB staff consider, for example, that where an entity leases the capacity portion of a fibre-optic cable, that entity will ordinarily be able to direct the use of that capacity portion and obtain the benefits from its use, including restricting the access of others to those benefits. As such, a lease of a capacity portion of an asset does not appear to be economically different to a lease of a distinct physical portion of an asset, such as a building.

12 AASB staff are concerned that the exclusion of leases for a capacity portion of an asset reflects a rules-based rather than principles-based approach to the scope of the standard, which may not be representative of the economics of such arrangements, and could present structuring opportunities. Accordingly, AASB staff consider that paragraph 11 should be amended to include the capacity portion of an asset as a valid example of an 'identified asset'.

Right to control the use of identified asset

13 AASB staff agree with the approach proposed in paragraphs 12-19 of the ED to identify whether a contract conveys the right to control the use of the identified asset. In particular, the AASB agrees that it is appropriate to apply a concept of 'control' that is consistent with the concept of control applied in other requirements and projects

(i.e. the consolidation requirements in IFRS 10 *Consolidated Financial Statements* and the forthcoming revenue recognition IFRS).

14 A number of constituents have raised issues in relation to circumstances in which an entity takes 100 per cent of the output of an asset. In particular, a number of constituents have questioned whether such arrangements should be within the scope of the proposals. AASB staff agree with the current scope of the proposals, however, as noted in paragraph 15(c) below, we consider additional guidance may be useful in applying the proposals).

15 Further, additional guidance would be useful to assist in applying the control criterion, including in the following areas:

(a) the practical substitutability of assets. For example, applying the criterion to remote assets such as assets associated with some mining operations. There is some concern that an entity could fall outside the scope of the guidance by permitting substitution of assets with no intention or practical ability to do so;

(b) the application of the proposals to specified capacity of an asset. For example, specified time slots to use a rail line. There appear to be divergent views as to whether such arrangements would fall within the scope of the proposals;

(c) take or pay arrangements. For example, when 100% of the output is taken, but operating protocols are established up front such that the entity is not operating or directing the operation of the plant; and

(d) incorporating the principle/agent guidance in IFRS 10.

Question 2 to the Board:

(a) Does the Board agree with the issues noted in paragraphs 8–15 above?

(b) Are there any other issues in relation to identifying a lease that the Board wishes to raise to the IASB?

ED/2013/6 Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

16 As noted above, AASB staff generally support the right-of-use model proposed in the ED, and encourage the IASB's efforts to bring assets and liabilities arising from leases onto the balance sheet of lessees. AASB staff consider that recognising an asset representing the right-of-use asset obtained in a lease, and bringing to account a liability representing the obligation to make lease payments faithfully represents the economics of lease transactions. However, AASB staff have significant concerns about the dual accounting model proposed in the ED, as discussed below.

Dual accounting model

17 AASB staff disagree with the dual model approach to lessee accounting, and consider that it lacks a robust conceptual basis, has the potential to introduce unnecessary complexity into accounting for lease arrangements, and is at odds with an important objective of the *Leases* project, which is to create a single accounting model for leases. In this regard, AASB staff agree with the alternative view of Prabhakar Kalavacheria and Wei-Guo Zhang, and consider a single accounting model should be applied in accounting for all leases.

18 AASB staff agree that many different types of lease arrangements exist, and that such arrangements may involve the lessee consuming a greater or lesser portion of the underlying asset over the term of the lease. However, AASB staff consider that the fundamental economics of a lease (that a lessee obtains a right-of-use asset in exchange for an obligation to a series of payments to the lessor) do not vary depending on whether a lessee consumes a significant portion of the underlying asset. Accordingly, AASB staff consider it inappropriate to regard the extent of consumption as giving rise to two distinctly different types of lease arrangements with differing expense patterns for the lessee. AASB staff consider that all leases include a financing element, and should therefore clearly reflect a finance charge. The expected extent of consumption by the lessee of the underlying asset merely affects the risk borne by the

lessor, and hence would be most appropriately reflected in the finance charge included in the lease payments.

19 Further, AASB staff are concerned that a dual approach to lessee accounting is unnecessarily complex and has the potential to reduce comparability of information about leasing arrangements. To understand the impact of leases on an entity's financial position and performance, a user would need to appreciate that different leasing arrangements were accounted for differently (e.g. right-of-use assets were amortised at different rates, depending on whether they were the subject of Type A or Type B leases), and refer to different line items (interest and amortisation for Type A leases, lease expense for Type B leases, and unspecified line items for variable lease payments and short-term leases) to understand the overall impact of leases on the entity's profit or loss. This complexity has the potential to reduce transparency and impair the overall usefulness of information provided about leases.

Specific comments on accounting model proposed for Type A leases

20 AASB staff agree with the proposed lessee accounting model for Type A leases. In particular, AASB staff agree that a lessee should recognise a right-of-use asset and a liability to make lease payments. [However refer to comments on lease term and variable lease payments]

21 AASB staff agree that the liability is a form of financing provided to the lessee and accordingly interest should be accrued based on a rate that reflects the risk inherent in the contract, consistent with the provisions in IAS 39/IFRS 9.

22 AASB staff agree that the right-of-use asset should be amortised on a basis consistent with other standards. The AASB considers, however, that there is currently inadequate explanation in the ED of the nature of the right-of-use asset – that is, whether it is the underlying physical asset, or an intangible asset. AASB staff consider the right-of-use asset to be an intangible asset.

Specific comments on accounting model proposed for Type B leases

23 As noted above, AASB staff agree that lessees should be required to recognise a lease liability and corresponding right-of-use asset for all leases, and therefore generally supports the proposals for initial recognition and measurement of Type B leases.

However, AASB staff are concerned about the subsequent lessee accounting model proposed for Type B leases. In particular, AASB staff consider that:

(a) the straight-line expense pattern required under the model is not representative of the economics of lease transactions;

(b) the apportionment of amortisation over the life of the asset in a way that is dependent on the financing costs incurred on the lease liability and effectively results in *increasing* amortisation over the lease term, does not faithfully capture the depletion of economic benefits embodied in the right-of-use asset, and is inconsistent with both the definition of an expense in the Conceptual Framework, and with the requirements of existing IFRSs, specifically IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*. Further, the amortisation method removes comparability between leased and purchased assets; and

(c) as a result, the measurement of the right-of-use asset does not reflect the economic benefits embodied in the asset and is therefore inconsistent with the definition of an asset in the Conceptual Framework.

24 As noted above, AASB staff consider that a financing element is inherent in every lease transaction. In particular, the right-of-use model regards the lessee as acquiring a right to use an asset, regardless of whether the lessee consumes a significant or insignificant portion of that asset. This right, rather than the underlying asset, is brought to account as a right-of-use asset by the lessee. A lessee also incurs a liability to pay for this asset. Interest is factored into lease payments, as repayments of the liability, and the benefits embodied in the right-of-use asset are consumed over the term of the lease – reflected as amortisation. Contrary to the economics described above, the straight-line single lease expense pattern attempts to obscure the interest that accrues on the liability, by using amortisation as a balancing item. Such an expense pattern is inconsistent with the fundamental concepts of both the time value of money and amortisation as depletion of economic benefits over the life of an asset.

25 AASB staff consider that the analogy provided for the Type B accounting model in paragraph BC44, which equates a Type B lease to “paying interest on an interest-only loan”, is inappropriate. By way of illustration, this rationale, applied faithfully to a

lease arrangement, would lead the lessee to recognise the full value of the leased asset (rather than the right-of-use portion of the asset) at the inception of a lease and record a corresponding liability, representing the lessee's obligation to return the asset at the end of the lease term. The leased asset would not be amortised but rather derecognised in full at the end of the lease term, while lease payments would simply be regarded as paying down the interest expense accruing on the liability, resulting in a straight-line finance expense. Such an approach, however, is fundamentally at odds with the principles underlying the right-of-use model – a model AASB staff continue to view as a faithful representation of the underlying economics of lease arrangements.

26 It is also unclear how the arbitrarily amortised asset balance would interact with other requirements in the ED, including the revaluation approach for the right-of-use asset, and the impairment testing requirements. For example, it is unclear whether the right-of-use asset is potentially exposed to impairment in earlier periods due to the relatively lower level of amortisation in earlier periods. AASB staff note this issue also raised by the alternative view of R Harold Schroeder (AV28) and agree that it is likely that the resulting impairment analysis will add further complexity to the proposed requirements.

27 In particular, AASB staff agree with the alternative view of R Harold Schroeder paragraphs AV27–AV29:

> AV27 …Mr Schroeder sees no conceptual basis for the prescribed method of determining the periodic amortisation of a Type B right-of-use asset. The financing cost issue, discussed in the preceding paragraphs, is related in that amortisation of the right-of-use asset is affected by financing cost associated with the liability. In other words, a Type B right-of-use asset will decline each period by the difference between the straight-line single expense and the financing cost associated with the liability. As the liability declines over the lease term, financing cost also will decline. To maintain the straight-line expense pattern, the periodic amortisation will by necessity increase over the lease term.
>
> AV28 Mr Schroeder sees no conceptual basis for a pattern of increasing amortisation, because it is unrelated except in extraordinary circumstances, to any allocation that would capture diminution of value. Furthermore, he is concerned that for leased assets that decline in value in a more straight-line pattern, entities may have to more frequently recognise an impairment of the right-of-use asset. That is because the proposed requirements will result in a higher Type B right-of-use asset value than a similar asset that is amortised using a straight-line (or more accelerated) method. Mr Schroeder believes that any resulting impairment analysis will add further complexity to the proposed requirements.
>
> AV29 For the reasons outlined, Mr Schroeder believes that any resulting straight-line single expense for Type B leases is inconsistent with the time value of money and amortisation of the right-of-use asset that would reasonably reflect diminution of value; therefore, it cannot faithfully represent the underlying economics.

28 Accordingly, AASB staff propose that for all leases, the right-of-use asset should be amortised on a basis that reflects the depletion of economic benefits embodied in the asset, rather than serve as a balancing item to the interest accruing on the liability to make lease payments.

29 If the IASB continue with a dual approach to accounting for lessees AASB staff consider that any final standard should acknowledge in the Basis for Conclusions that the measurement of Type B leases is a practical expedient and not based on the economics of lease transactions.

30 Further, regardless of whether a single or dual model approach is taken, AASB staff consider that it would be useful for the IASB to provide additional guidance to clarify the new terms being introduced into the standard, such as 'significant economic incentive'.

Question 3 to the Board:

(a) Does the Board agree with the issues noted in paragraphs 16– 30 above?

(b) Are there any other issues in relation to the lessee proposals that the Board wishes to raise to the IASB?

ED/2013/6 Question 3: Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Dual accounting model

31 AASB staff disagree with the dual accounting model proposed for lessors, and considers that there is no conceptual basis to draw a bright-line distinction between leases depending on whether the lessee is expected to consume an insignificant or a significant part of the underlying asset.

32 AASB staff consider that for all leases where a lessee recognises a liability for its obligation to make lease payments, a lessor should recognise a corresponding asset for the right to receive payments.

Specific comments on accounting model proposed for Type A leases

33 Consistent with the AASB's comment letter to the IASB on ED/2010/6, if the IASB retains the dual accounting approach for lessors, AASB staff prefers the 'full' derecognition approach for Type A leases. AASB staff thinks that this approach better reflects the economics of lease arrangements, is more symmetrical with the accounting proposed for lessees, and is easier to apply and understand.

34 AASB staff are particularly concerned with the lack of symmetry between lessee and lessor accounting. Given the definition of control, and use of the control criterion to determine whether a lease within the scope of the proposals exists or not, AASB staff consider it to be inconsistent that the same asset can be recognised on the balance sheet of both a lessee and lessor. This issue becomes particularly important for sub-lease accounting.

Residual asset and profit

35 AASB staff disagree with the requirements for the calculation of the residual asset, in particular the proposal to calculate the residual as an aggregate of the discounted gross residual asset, and the present value of variable lease payments, less any unrealised profit. AASB staff are concerned that the aggregation of these elements, which represent significantly different concepts with dissimilar cash flow implications, has the potential to obscure the meaning of the residual asset, and hinder users' understanding of the amount, timing, and uncertainty of cash flows arising from lease arrangements.

36 AASB staff consider that the residual asset is inconsistent with the concept of a residual asset under IAS 16. AASB staff propose that the IASB consider including an option to measure the residual asset at its fair value, or at least permit accretion of the residual asset to its fair value.

37 AASB staff also propose that expected variable lease payments should be included in the measurement of the lease receivable, rather than in the residual asset – this is discussed in more detail below in respect of Question 6: variable lease payments.

38 Given its disparate constituent elements, it is unclear how the residual asset should be tested for impairment. For example, should variable lease payments be tested for

impairment under IAS 39 or IAS 36? The latter doesn't appear to make sense, but that is what is required by paragraph 85.

Implications for below-market leases

39 The ED currently does not appear to contain guidance that appropriately addresses how below-market leases should be accounted for by lessors under Type A leases[2]. We are particularly concerned that the proposed requirements might result in either (1) a negative discount rate being applied to such lease arrangements, or (2) a negative residual asset being recognised at the inception of the arrangement. Either way, applying the model for Type A leases, we think there is no circumstance in which a lessor could initially recognise an expense relating to the derecognition of a leased asset for below market consideration.

40 In relation to applying a discount rate to the lease arrangement, paragraph B8 of the ED requires the rate used for the lessor to be 'the rate the lessor charges the lessee'. This rate, in turn, is defined in Appendix A as "a discount rate that takes into account the nature of the transaction and conditions of the lease. The rate … could be, for example, the rate implicit in the lease, or the property yield." The 'rate implicit in the lease' is defined as the rate that causes the sum of the present value of lease payments and the present value of the gross residual to equal the fair value of the underlying asset.

41 It is not clear whether the IASB intended that where lease payments are significantly below market that the rate implicit in the lease would be negative. For example, consider a 9-year peppercorn lease of an asset with a fair value of $150,000, and carrying amount of $100,000 with lease payments of $10 p.a., and a gross residual asset of $10,000 at the end of year 9. Assuming such an arrangement meets the definition of a 'lease', these terms appear to result in a -26% discount rate being applied to the lease – being the rate that discounts the lease payments and gross residual to $150,000. As a result, at the inception of the lease, the lease receivable and residual asset recognised are both higher than the actual amounts that will be received, and the unwinding of the discount on the lease receivable and residual asset appears to result in a 'finance charge' being incurred year-on-year by the lessor.

[2] This issue assumes that such leases would be within the scope of the proposals.

42 As an alternative approach, albeit one that does not appear to be explicitly contemplated in the ED, the lessor might apply a market-based rate to the lease. However, in this case, applying the requirements in paragraphs 73-75 of the ED in relation to realised and unrealised profit would appear to result in an excessively high unrealised profit figure, and give rise to a negative residual asset under paragraph 71 of the ED (because element C is greater than A+ B).

43 AASB staff are concerned that neither outcome truly reflects the economics of a below-market lease arrangement, which we would generally consider to constitute a non-reciprocal contribution from the lessor to the lessee, that we think, economically, should be recognised as an expense by the lessor on the date the arrangement is entered into.

44 An alternative view is that if a lessor enters into a lease for amounts that indicate that the carrying amount of the asset being leased is higher than the lease payments, this event would trigger an impairment test and possibly result in an impairment loss immediately before accounting for the lease transaction. The lessor accounting proposals would then be applied to the revised written-down asset amount.

45 Clarification of this issue is important in the Australian context as such lease transactions are common for both the public sector and private sector entities.

Specific comments on accounting model proposed for Type B leases

46 AASB staff do not agree with the proposed accounting for Type B leases. As noted above, AASB staff consider that for all leases where a lessee recognises a liability for its obligation to make lease payments, a lessor should recognise a corresponding asset for the right to receive payments.

Question 4 to the Board:

(a) Does the Board agree with the issues noted in paragraphs 31–46 above?

(b) Are there any other issues in relation to the lessor proposals that the Board wishes to raise to the IASB?

ED/2013/6 Question 4: Classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

47 As noted above, AASB staff have significant concerns with the proposals to apply a different accounting approach to different leases, both for lessees and lessors. However, if the IASB concludes that there are two different types of models, AASB staff could accept that they should be distinguished based on the principle of "whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset"[3].

48 However, AASB staff are significantly concerned with the inconsistent application of this principle to leases of property and non-property assets. AASB staff consider that an approach that results in different classification based on the nature of the leased asset lacks a conceptual basis, and has the potential to result in inconsistent accounting for transactions that are economically similar. AASB staff do not consider that the basis for this approach, provided in paragraph BC51, offers a sufficiently robust rationale for adopting a different principle for property leases to other leases. In particular, AASB staff consider the implication that the approach "would not always result in conclusions that are consistent with the principle" is not adequately addressed. AASB staff consider that the application of a different classification approach to assets depending on their nature, rather than the economic substance of the transaction, has the potential to result in reduced comparability, for example, the financial statements of a lessee or lessor of property assets would not be comparable to the financial statements of a lessee or lessor of non-property assets, even though the economic benefits and outflows arising from their leasing arrangements were equivalent.

[3] Some constituents have indicated support for retaining the IAS 17 model based on risks and rewards to distinguish between Type A and Type B leases. If the IASB retains the view that there are two different types of models, AASB staff can see some justification for retaining the IAS 17 approach to classification on the basis of costs versus benefits.

49 In addition, AASB staff see no conceptual basis for the proposed difference in the classification criteria for assessing the lease term when classifying leases, namely relative to the remaining economic life of the underlying asset in the case of property but relative to the total economic life of the underlying asset in the case of assets other than property. AASB staff disagree with the reasons for this approach in paragraph BC125-BC126. Thus, if the IASB retains the dual model approach to lease accounting, AASB staff consider that the classification criteria should be consistent for both property and non-property assets, that is, it should be based on the *remaining* economic life of the asset. It is also unclear how to apply this requirement in the context of assets that are acquired part way through their useful life.

Primary asset

50 AASB staff recommend that the requirements in paragraph 32 of the ED to "regard the economic life of the primary asset to be the economic life of the underlying asset when applying the classification criteria" be removed from the proposals and replaced with a requirement to assess assets on an individual basis. Further, if the requirements in paragraph 32 of the ED are retained AASB staff recommend adding an example in which the primary asset is not a building, but rather land on which the building is located. It is our understanding that for many such leases the location of the leased land is significant as compared to the physical structure on the land.

Reassessment of lease classification

51 AASB staff disagree with the requirement to assess lease classification at commencement only, and not reassess classification after the commencement of the lease unless there is a substantive change in the contract. AASB staff disagree with the basis for this requirement in paragraph BC127, that "there would be little benefit in adding complexity to the requirements that, in practice, would be expected to have little effect." If the IASB retains the distinction between two different types of leases, AASB staff consider that there would be little added cost to reassessing lease classification for preparers, compared to the cost of reassessing the lease term and lease liability for changed circumstances. AASB staff share the concerns raised by Messrs Kalavacherla and Zhang, that the prevention of lease classification reassessment may give rise to structuring opportunities (see paragraph AV7).

Additional guidance

52 If the two model proposals proceed AASB staff recommend the IASB clarifies what is meant by "insignificant portion", "substantially all" and "major part" to help avoid diversity arising in practice.

> **Question 5 to the Board:**
>
> (a) Does the Board agree with the issues noted in paragraphs 47–52 above?
>
> (b) Are there any other issues in relation to the classification proposals that the Board wishes to raise to the IASB?

ED/2013/6 Question 5: Lease term

> Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

53 AASB staff generally agree with the proposed measurement of the lease term. AASB staff agree that the reassessment of the estimated lease term is necessary. However, consistent with the AASB's comments on ED/2010/9 *Leases*, AASB staff are concerned that the way in which the proposals are currently expressed would lead entities to reassess their estimations every reporting period. AASB staff thinks that the approach taken to reassessment should be similar to that in IAS 36 *Impairment of Assets*, and that reassessment should be required when there has been a 'trigger' event.

> **Question 6 to the Board:**
>
> (a) Does the Board agree with the issues noted in paragraph 53 above?
>
> (b) Are there any other issues in relation to the lease term proposals that the Board wishes to raise to the IASB?

ED/2013/6 Question 6: Variable lease payments

> Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

54 AASB staff disagree with the proposed accounting for variable lease payments, and considers that variable lease payments meet the definition of assets and liabilities and

should be included in measurement of a lessee's right-of-use asset and lease liability, and a lessor's lease receivable.

55 AASB staff are concerned that the approach to exclude variable lease payments from measurement of the lease asset and liability is inconsistent with the approach taken in other IASB standards and projects. For example, the requirements being developed in the *Revenue from Contracts with Customers* project would recognise variable consideration at an estimate of the amount of consideration the entity will be entitled to under the contract. Further, IFRS 3 *Business Combinations* requires the acquisition-date fair value of contingent consideration to be included in the measurement of consideration transferred. AASB staff are of the view that standards should, to the extent possible, have a consistent approach in dealing with similar items.

56 AASB staff also consider that the proposals to exclude variable payments from measurement of lease payments, except where they depend on an index or rate, or are in-substance fixed, does not reflect the economics of lease arrangements. AASB staff consider that lease payments should not be treated differently solely because the amounts to be paid are uncertain or variable. As noted in the Conceptual Framework, there is a need to balance reporting information which is reliable (i.e. fixed/known) and which is timely, and "if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim". AASB staff consider that when variable rentals are material, capitalising only some of them is not representationally faithful, and has the potential to misrepresent a lessee's obligations and a lessor's entitlement to receive payments under a lease arrangement.

57 From a lessor's point of view in particular, including variable lease payments in the measurement of the residual asset rather than the measurement of the lease receivable is not representative of the nature of the asset – which, unlike the gross residual asset, is in substance a receivable rather than a tangible asset. Consistent with this, it is misleading for lessors to be required to recognise an expense, as required by paragraph 83, representing the variable payments expected to be earned in the period. The expense so recognised appears to be inconsistent with the definition of an expense in the Conceptual Framework, as "a decrease in economic benefits", given that it represents a payment that is expected to be received by the entity in the period. The

treatment is also inconsistent with how the receipt of an uncertain amount of funds is accounted for under other Standards.

58 AASB staff are concerned that the exclusion of variable lease payments from the measurement of lease payments may present structuring opportunities. For example, the proposed requirements would result in a lessee recognising no liability, and a lessor no receivable, where lease payments were based on a factor other than an index or rate (e.g. a percentage of the lessee's sales).

59 AASB staff would propose to include variable payments in the measurement of lease payments arising from a lease contract for both lessees and lessors, recognised and measured on a basis consistent with the approach adopted in the *Revenue from Contracts with Customers* project.

60 AASB staff agree that reassessment of variable lease payments is necessary; however, AASB staff are concerned that the way in which the proposals are currently expressed would require entities to reassess their estimations of variable lease payments every reporting period. AASB staff think that the approach taken to reassessment should be similar to that in IAS 36 Impairment of Assets and that reassessment should be required when there has been a 'trigger' event.

Question 7 to the Board:

(a) Does the Board agree with the issues noted in paragraphs 54–60 above?

(b) Are there any other issues in relation to variable lease payments that the Board wishes to raise to the IASB?

ED/2013/6 Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

61 AASB staff agree with the proposal to allow lessees and lessors to adopt either a full or a partial retrospective approach to transition. General comments received from constituents have indicated that the proposals would be very challenging to implement and will require a significant amount of time for transition.

62 AASB staff would also like to highlight the interaction between the Leases proposals and the forthcoming Revenue IFRS. Given the interaction, in particular in relation to the lessor proposals, the IASB will need to carefully consider the application date of the Leases proposals. Although some constituents expressed support for having both the Revenue and Leases proposals operative as at the same date, the majority of constituent feedback indicated that the staggered approach would be more manageable in terms of available resources.

Question 8 to the Board:

(a) Does the Board agree with the issues noted in paragraph 61–62 above?

(b) Are there any other issues in relation to transition that the Board wishes to raise to the IASB?

ED/2013/6 Question 8: Disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

63 AASB staff consider that the overall volume of disclosure proposed in the ED to be extensive. The level of disclosure appears to highlight the significant complexity associated with the proposed model. In particular, AASB staff note that much of the proposed disclosure could be reduced if a single model, rather than a dual model, was to be adopted.

64 A number of constituents have expressed concern in relation to the usefulness of the proposed narrative information about the nature of lease arrangements. For entities with a significant number of leases of differing natures, this disclosure would be extremely lengthy, or summarised at such a high level as to lose any potential usefulness for users.

65 In terms of short-term leases the ED provides an exemption from the classification, recognition, measurement, and presentation requirements for lessees and lessors for short-term leases (discussed further below). However, many of the disclosure requirements would also appear to be irrelevant outside of the Type A/Type B accounting requirements – e.g. many of the requirements focus on disclosures about

the "lease liability and lease asset", this would technically mean that even less information would be provided about short-term leases than is currently provided about operating leases, since there's no liability or asset recognised. AASB staff think it is generally unclear how short-term leases would be presented and which of the non-excluded disclosures would be relevant to them.

Question 9 to the Board:

(a) Does the Board agree with the issues noted in paragraphs 63–65 above?

(b) Are there any other issues in relation to disclosure that the Board wishes to raise to the IASB?

ED/2013/6 Question 12[4]: Amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

66 AASB staff agree with the proposed amendments to IAS 40.

Question 10 to the Board:

(a) Does the Board agree with the issues noted in paragraph 66 above?

(b) Are there any other issues in relation to the amendments to IAS 40 that the Board wishes to raise to the IASB?

Other issues

Short-term lease exception

67 AASB staff have concerns with the exception from the recognition, measurement and presentation requirements for short-term leases in paragraphs 118-120 of the ED. The AASB considers that the exception has no conceptual basis and is a departure from the treatment of short-term receivables and obligations under other standards (e.g. financial instruments).

[4] Note that Questions 9-11 of the ED are FASB only questions.

68 AASB staff consider that the cost of providing additional information about short-term leases would not outweigh the benefit to users of information about such leases, where the rights and obligations arising from such leases were material. AASB staff are of the view that the materiality concept in AASB 101 *Presentation of Financial Statements* can be applied to provide sufficient relief for entities with immaterial short-term leases.

69 Furthermore, AASB staff are of the view that while this exception may reduce some of the reporting burden on preparers, it has the effect of introducing additional complexity into lease accounting, by effectively adding a third approach to the model. As a result, users would need to look to yet another line item to understand the expected impact of leases on an entity's financial position and performance. AASB staff are of the view that to remove the exception would result in little additional cost to preparers (as they would already need to obtain information about their total lease obligation in order to present short-term lease payments on a straight-line basis) and yield significant benefits to users by simplifying the lease model, and bringing onto the balance sheet any additional information about leases.

70 Finally, AASB staff are concerned that the approach may present a structuring opportunity for entities (e.g. an entity may enter into a 12-month lease with no explicit extension options, but where a significant economic incentive exists for both the lessee and lessor to renew the lease on expiry).

71 If the IASB proceeds with the proposal to provide an exception for short-term leases, AASB staff consider that the IASB should address the following issues, which arise out of the current drafting of paragraphs 118-120.

(a) It is unclear how lessees and lessors should account for variable lease payments arising under the lease (given that paragraphs 118 and 119 only refer to "lease payments", and these are defined in Appendix A to exclude variable lease payments that do not depend on an index or rate, or are in substance fixed).

(b) Further guidance is needed around what presentation requirements are applicable to short-term leases. The AASB notes that among the paragraphs excluded by paragraph 118 is paragraph 57, which contains a requirement to present short-term lease payments separately in the statement of cash flows. No presentation requirements are included for cash flows arising from short-term leases.

(c) Additional disclosures are required to enable users to understand the rights and obligations that are created under short-term lease arrangements for lessees and lessors. Although paragraphs 118 and 119 do not exclude the disclosure paragraphs in the ED, many of the disclosures required by those paragraphs are relevant only to Type A or Type B leases, and would not be applicable to short-term leases (e.g. they require disclosure about right-of-use assets, lease liabilities, or lease receivables). While the AASB does not see additional disclosures about short-term leases as an adequate remedy for the loss of information and additional reporting complexity arising from the exception, the AASB considers that additional disclosures are necessary to at least in part mitigate these impacts. In particular, in addition to the existing disclosures that appear to be relevant to short-term leases, the AASB would encourage the IASB to require disclosures about:

   (i) total future lease payments to be payable under short-term leases for lessees [c.f. AASB117.35(a)];

   (ii) total future lease payments to be receivable under short-term leases for lessors [c.f. AASB117.56(a)];

   (iii) short-term lease expense recognised in the period, with separate amounts for lease payments, variable lease payments not included in the straight-line lease expense calculation, and sublease payments, for lessees [AASB117.35(c)]; and

   (iv) short-term lease income from variable lease payments not included in the straight-line lease income calculation for the period, for lessors [AASB 117.56(b)].

Question 11 to the Board:

(a) Does the Board agree with the issues noted in paragraphs 67–71 above?

(b) Are there any other issues in relation to short-term leases that the Board wishes to raise to the IASB?

Scope: Leases of intangible assets

72 AASB staff agree with the proposal to exclude leases of intangible assets from the scope of the leasing proposals for lessors. However, AASB staff consider it inappropriate to not require lessees to apply the lease accounting proposals to leases of intangible assets.

73 The exclusion for lessees effectively creates a gap in the requirements for lessees, and has the potential to reduce consistency and comparability of accounting for leases of intangible assets by lessees. AASB staff do not consider that the provisions in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* sufficiently address this gap. Given that the expected timing and outcome of a separate and comprehensive review of the accounting for intangible assets is uncertain, AASB staff are of the view that a more appropriate approach would be to require lessees to apply the lease accounting requirements to leases of intangible assets, and to subsequently determine whether the outcome of any review requires the scope of the leasing requirements to be amended.

Question 12 to the Board:

(a) Does the Board agree with the issues noted in paragraphs 72–73 above?

(b) Are there any other issues in relation to intangible assets that the Board wishes to raise to the IASB?

(c) Are there any other issues not addressed in this issues paper that the Board wishes to raise to the IASB?