Leases – Project update

1 The IASB and FASB met on 22-24 January 2014, during which the *Leases* project was discussed. The Boards were not asked to make any decisions.

2 The staff presented the possible ways forward for lessee and lessor accounting in light of the comments received on IASB ED/2013/9 *Leases*. It is anticipated that the Boards will be asked to make decisions in relation to the project at the March IASB/FASB meeting.

Lessee Accounting Model

3 The staff identified three potential approaches for the lessee accounting model[1]:

Approach 1 – Proposes a single approach, according to which a lessee would account for all leases as the purchase of a right-of-use (ROU) asset on a financed basis. Accordingly, a lessee would account for all leases as Type A leases (that is, recognising amortisation of the ROU asset separately from interest on the lease liability).

Approach 2 – Retains a dual approach, with lease classification similar to that proposed in the 2013 ED, but offers targeted simplifications and improvements to the lease classification test. A lessee would account for all leases of assets other than property as Type A leases and most property leases as Type B leases (that is, recognising a single lease expense).

Approach 3 – Proposes a dual approach, with the lease classification principle broadly consistent with existing US GAAP and IFRS (IAS 17 *Leases*). A lessee would account for the vast majority of existing finance leases as Type A leases, and the vast majority of existing operating leases as Type B leases.

4 The below table summarises, at a high-level, the classification effect of each approach:

[1] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/January/AP03D-LEASES.pdf (accessed 31 January 2014)

<table>
<tr><th>Existing U.S. GAAP (IFRS)</th><th>Approach 1</th><th colspan="2">Approach 2</th><th>Approach 3</th></tr>
<tr><td>Capital (Finance)</td><td>Type A</td><td colspan="2">Type A</td><td>Type A</td></tr>
<tr><td>Operating</td><td>Type A</td><td><u>Non-Property</u>
Type A</td><td><u>Property</u>
Type B</td><td>Type B</td></tr>
</table>

AASB staff analysis

5 In its comment letter to the IASB in response to the ED[2], the AASB expressed disappointment that the IASB was unable to arrive at a single model for lease accounting. The AASB expressed support for a single model for a lessee reflecting a ROU asset and a liability to make lease payments, rather than the dual model proposed in the ED.

6 AASB staff continue to support a single model for lessee accounting (Approach 1). AASB staff also note that the dual model for lessees was highlighted by constituents (including the AASB) in the feedback on the ED as being particularly costly and complex. AASB staff do not consider that either Approach 2 or Approach 3 overcome these concerns.

Small-ticket leases

7 The Boards also discussed potential alternative approaches to provide relief in applying the leases guidance to what they refer to as 'small-ticket' leases held by a lessee[3]:

(a) providing explicit materiality requirements within the leases guidance;

(b) expanding the recognition and measurement exemption proposed in the ED for short-term leases;

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[2] http://www.aasb.gov.au/admin/file/content106/c2/AASB_comment_letter_to_IASB_ED_2013_6_Leases.pdf (accessed 31 January 2014)

[3] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/January/AP03C-LEASES.pdf (accessed 31 January 2014)

(c) permitting the leases guidance proposed in the ED to be applied at a portfolio level; and

(d) providing an explicit scope exclusion for small-ticket leases or leases of noncore assets.

AASB staff analysis

8 In its comment letter to the IASB in response to the ED, the AASB expressed disagreement with the short-term lease exception. The AASB considered that the exception has no conceptual basis and is a departure from the treatment of short-term receivables and obligation under other standards (e.g. financial instruments). The AASB expressed the view that the materiality concept in IAS 1 *Presentation of Financial Statements* could be applied to provide sufficient relief for entities with immaterial leases, regardless of their duration.

9 AASB staff do not support any of the alternative approaches discussed in paragraph 7 above. AASB staff do, however, see some merit in considering permitting the leases requirements proposed in the ED to be applied at a portfolio level, on a similar basis as is proposed in the draft *Revenue from Contracts with Customers* IFRS[4].

Lessor Accounting Model

10 The staff identified three potential approaches for the lessor accounting model[5]:

Approach 1 – An approach that would determine lessor lease classification (Type A versus Type B) based on whether the lease is effectively a financing or a sale, rather than an operating lease (that is, the concept underlying existing US GAAP and IFRS lessor accounting). That determination would be made based on whether the lease transfers substantially all the risks and rewards of ownership of the underlying asset.

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[4] ED/2011/9 *Revenue from Contracts with Customers* includes the following paragraph:

> This [draft] IFRS specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this [draft] IFRS to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the result of doing so would not differ materially from the result of applying this [draft] IFRS to the individual contracts (or performance obligations) (para. 6).

[5] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/January/AP03A-LEASES.pdf (accessed 31 January 2014)

Approach 2 – Like Approach 1, this approach would also determine lessor lease classification (Type A versus Type B) based on whether the lease is effectively a financing or a sale, rather than an operating lease. However, this approach would require that for any lease that gives rise to selling profit (or loss) – generally those of manufacturer and dealer lessors, the lessor would classify the lease as a Type A lease only if the lease transfers control of the underlying asset to the lessee (that is, in line with the notion of a sale in the forthcoming revenue recognition standard). Leases that do not give rise to selling profit (or loss) – generally those of financial lessors, would be classified in the same manner as all leases under Approach 1.

Approach 3 – An approach that would determine lessor lease classification (Type A versus Type B) based on the lessor's business model.

11 The Boards also discussed two approaches for accounting for Type A leases by lessors[6]:

Approach A – To retain the receivable and residual approach proposed in the 2013 ED for all Type A leases.

Approach B – To eliminate the receivable and residual approach proposed in the 2013 ED and instead apply existing IFRS finance lease accounting (which is also existing US GAAP sales-type lease accounting) to all Type A leases, subject to potential minor drafting improvements.

AASB staff analysis

12 In its comment letter to the IASB in response to the ED, the AASB expressed disagreement with the dual accounting model proposed for lessors, and considered 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 part of the underlying asset. The AASB also disagreed with the requirements for the calculation of the residual asset.

13 AASB staff note that the feedback on the ED from the majority of constituents is not supportive of changing the existing lessor model. AASB staff continue to support a

[6] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/January/AP03B-LEASES.pdf (accessed 31 January 2014)

single model for lessors and, therefore, do not support any of the approaches proposed in paragraph 10 above. If the Boards continue with a dual model, AASB staff do not support Approach A, paragraph 11(a) above, to retain the receivable and residual approach. AASB staff have not yet formed a view in relation to Approach B, paragraph 11(b) above. However, at a high level, AASB staff note that the proposal would not result in symmetry between lessee and lessor accounting.

Next steps

14 Nothing from the January 2014 meeting would cause us to recommend that the Board write to the IASB at this stage.

15 The IASB and FASB will continue redeliberation of the *Leases* project in March 2014. AASB staff will provide an update to the Board at the next (April 2014) AASB meeting.