

Leases – Project update April 2014

Introduction

1 The IASB and FASB held a joint meeting on 22-25 April 2014 at which they made a number of tentative decisions in relation to the *Leases* project.¹ The Boards discussed the following key topics:

- (a) Lease modifications and contract combinations (paragraphs 3–8 below);
- (b) Variable lease payments (paragraphs 9–11 below);
- (c) In-substance fixed payments (paragraphs 12–14 below); and
- (d) Discount rate (paragraphs 15–17 below).

Staff recommendation

2 Despite concerns (noted below) in relation to some of the tentative decisions made by the IASB and FASB at their April 2014 meeting, AASB staff do not consider that there are any issues that are sufficiently substantive to warrant them being raised with the IASB at this stage.

Lease modifications and contract combinations

3 The Boards tentatively decided:

- (a) to define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease. The Boards also tentatively decided that the substance of the modification should take precedence over its form.
- (b) that both a lessee and a lessor should account for a lease modification as a new lease, separate from the original lease, when:
 - (i) the lease grants the lessee an additional right-of-use not included in the original lease; and
 - (ii) the additional right of use is priced commensurate with its stand-alone price (within the context of that particular contract).

¹ <http://media.ifrs.org/2014/IASB/April/IASB-Update-April-2014.pdf> (accessed 5 May 2014)

- (c) For lease modifications that are not accounted for as separate new leases:
- (i) When a lease modification results in a change in the scope or consideration of the lease, a lessee should remeasure the lease liability using a discount rate determined at the effective date of the modification. For modifications that increase the scope of, or change the consideration paid for, the lease, the lessee should make a corresponding adjustment to the right-of-use asset. For modifications that decrease the scope of the lease, the lessee should decrease the carrying amount of the right of use asset to reflect the partial or full termination of the lease and should recognise a gain or a loss on a proportionate basis to the decrease in scope.
 - (ii) A lessor should account for:
 - (A) modifications to a Type B lease as, in effect, a new lease from the effective date of the modification, considering any prepaid or accrued lease rentals relating to the original lease as part of the lease payments for the modified lease; and
 - (B) modifications to a Type A lease in accordance with IFRS 9 *Financial Instruments*(IFRS), or Topic 310 *Receivables* (US GAAP).
- (d) to include in the final *Leases* Standard guidance on **contract combination** that would indicate when two or more contracts should be considered a single transaction. Such guidance would be similar to that which will be included in the forthcoming Revenue Recognition Standard.
- 4 The AASB did not comment on the issue of lease modifications and contract combinations in its comment letter to the IASB.²

AASB staff analysis

- 5 AASB staff agree, in principle, with the tentative decisions made by the IASB and FASB as outlined in paragraph 3 above. However, AASB staff have some concerns in relation to the tentative decisions relating to lease modifications that are not accounted for as separate new leases (paragraph 3(c)(i)).
- 6 The IASB staff paper provided the following summary of the key aspects of the approach³:

² http://www.aasb.gov.au/admin/file/content106/c2/AASB_comment_letter_to_IASB_ED_2013_6_Leases.pdf (accessed 5 May 2014)

³ IASB/FASB April 2014 Staff Paper 3A *Lease Modifications and Contract Combinations* <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/April/AP03A-LEASES.pdf> (accessed 5 May 2014)

Modification type	Require lease liability re-measurement ? (1)	Discount rate	Adjustment to the ROU asset	Adjustment to the lease liability	P&I effect
Change in scope – increase (Example 2)	√	Modification date (2)	Amount of the adjustment to the lease liability	Difference between the modified liability and the liability immediately before the modification	None
Change in scope – decrease (Example 3)	√	Modification date (2)	Proportionate decrease to reflect the partial or full termination of the lease	Difference between the modified liability and the liability immediately before the modification	Gain or loss attributable to the partial or full termination of the original lease (3)
Change in consideration (Example 4)	√	Modification date (2)	Amount of the adjustment to the lease liability	Difference between the modified liability and the liability immediately before the modification	None

(1) The lease liability remeasurement would reflect the modified contractual payments.

(2) Lessee's incremental borrowing rate (or the rate the lessor charges the lessee if readily determinable) at the effective date of the modification.

(3) Difference between the adjustment to the ROU asset and the adjustment to the lease liability.

8 AASB staff are concerned that decreases in consideration are adjusted against the right-of-use (ROU) asset. In circumstances where the ROU asset is measured at cost, AASB staff do not consider that a corresponding adjustment to the ROU asset would always be appropriate. By reducing the carrying value of the asset, the 'benefit' of the reduced lease payments is reflected (from a profit and loss perspective) over a period of time due to lower depreciation expense. AASB staff are not convinced that this accounting treatment will always appropriately reflect the economics of the lease renegotiation. AASB staff would support immediate recognition in profit or loss of the reduction of the liability, with a corresponding trigger for impairment testing of the asset.

Variable lease payments

9 The Boards tentatively decided that:

- (a) only variable lease payments that depend on an index or a rate should be included in the initial measurement of lease assets and lease liabilities. The Boards also tentatively decided that an entity should measure those payments using the index or rate at lease commencement; and
- (b) a lessor should not be required to reassess variable lease payments that depend on an index or a rate

The IASB tentatively decided that a lessee should reassess variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for other reasons (for example, because of a reassessment of the lease term) and when there is a change in the cash flows resulting from a change in the reference index or rate (that is, when an adjustment to the lease payments takes effect).⁴

- 10 The tentative decisions outlined in paragraph 9 above confirm the IASB's proposals in ED/2013/6. However, they do not align with the views expressed by the AASB in its comment letter to the IASB in response to ED/2013/6. The AASB provided the following comments in relation to variable lease payments:

The AASB disagrees 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.

The AASB is 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. The AASB is of the view that standards should, to the extent possible, have a consistent approach in dealing with similar items.

The AASB also considers 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. The AASB considers 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". The AASB considers that when variable rentals are material, capitalising only some variable lease payments is not representationally faithful, and has the potential

⁴ The FASB tentatively decided that a lessee should reassess variable lease payments that depend on an index or a rate only when the lessee remeasures the lease liability for other reasons (for example, because of a reassessment of the lease term).

to misrepresent a lessee's obligations and a lessor's entitlement to receive payments under a lease arrangement.

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.

The AASB is also 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).

The AASB recommends including 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.

The AASB agrees that reassessment of variable lease payments is necessary; however, the AASB is 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. The AASB recommends the approach taken to reassessment of the lease term should be clarified to be similar to that in IAS 36. That is, reassessment should only be required when there has been a ‘trigger’ event that indicates reassessment may be required.

If the IASB decides to continue with the proposals, the AASB recommends the IASB provides additional guidance to clarify the meaning of ‘in substance fixed payments’ to help avoid diversity in practice arising.

AASB staff analysis

- 11 Consistent with the views expressed by the AASB in its comment letter to the IASB, AASB staff disagree with the tentative decisions made by the IASB and FASB in relation to variable lease payments. However, if the IASB proceeds with its tentative decisions, the AASB staff can accept the IASB's tentative decision in relation to reassessment of variable lease payments. AASB staff consider this decision to be clearer than the ED proposals.

In-substance fixed payments

- 12 The Boards tentatively decided to:

- (a) retain the principle that variable lease payments that are in-substance fixed payments should be included in the definition of lease payments and to provide additional clarifying guidance; and
 - (b) note in the Basis for Conclusions that some variable lease payments are in-substance fixed payments under current practice.
- 13 The AASB did not specifically comment on the issue of in-substance fixed payments in its comment letter to the IASB.

AASB staff analysis

- 14 AASB staff agree with the IASB's tentative decisions, given the IASB's tentative decisions in relation to variable lease payments.

Discount rate

- 15 With respect to the determination of the discount rate the Boards tentatively decided to:
- (a) clarify in the implementation guidance what 'value' refers to in the definition of the lessee's incremental borrowing rate, but otherwise make no changes to the definition in the May 2013 Exposure Draft;
 - (b) describe the rate the lessor charges the lessee as the rate implicit in the lease, consistent with existing lessor guidance; and
 - (c) include initial direct costs of the lessor in determining the rate implicit in the lease.

With respect to reassessment of the discount rate, the Boards tentatively decided:

- (a) to require a lessee to reassess the discount rate only when there is a change to either the lease term or the assessment of whether the lessee is (or is not) reasonably certain to exercise an option to purchase the underlying asset.
 - (b) not to require a lessor to reassess the discount rate.
- 16 The AASB did not specifically comment on the issue of discount rate in its comment letter to the IASB.

AASB staff analysis

- 17 AASB staff agree with the IASB's tentative decisions.

Next steps

- 18 The Boards will continue their joint redeliberations of the 2013 ED at a future joint meeting. The IASB has not yet indicated any timing for finalising the IFRS.

Staff recommendation

- 19 Staff do not consider that there are any issues that are sufficiently substantive to warrant them being raised with the IASB at this stage in relation to the tentative decisions made at the April 2014 IASB/FASB meeting.

Question to Board members

Do you agree with staff's recommendation?