Australian Government
Australian Accounting Standards Board

NEW ZEALAND INSTITUTE OF CHARTERED ACCOUNTANTS

Memorandum

To:	AASB and FRSB Members	Date:	11 October 2010
From:	Jessica Lion and Clive Brodie	Agenda Item:	B11
Subject:	Issues Memo on ED/2010/9 *Leases*	File:	

Action

Consider the issues discussed in this memorandum and:

(a) decide whether those issues or any other issues should be included in the AASB's and FRSB's submissions on the proposals in the IASB's Exposure Draft ED/2010/9 *Leases*; and

(b) agree on a process for finalising the respective submissions to the IASB.

Background

At the last AASB meeting, the Board received an education session on the ED. This is the first meeting where the FRSB has had an opportunity to discuss the ED. ED/2010/9 was published by the IASB in August 2010 and is open for comment until 15 December 2010. The AASB issued ED 202R *Leases*, based on the IASB's ED, for comment by 12 November 2010 and the FRSB issued the IASB's ED for comment by 1 December 2010. AASB staff are in the process of conducting meetings with constituents to obtain feedback on the proposals. Any feedback from constituents to date has been incorporated into this memorandum.

Issues that could be included in a submission to the IASB

1. Scope of the ED (incorporating ED/2010/9 question 5)

Intangible Assets

The ED proposes to scope out leases of intangible assets. This is consistent with the current scope of US GAAP lease accounting. However, staff have concerns with reducing the scope of the current IFRS standard. Some argue that there is no difference in substance between, for example, a lease of an aeroplane and a lease of a licence to use that aeroplane.

Staff view: that leases of tangible and intangible assets should be accounted for consistently and both included in the scope.
Question 1.1 for the Boards: do the Boards agree with the staff view?

Investment Property

There have been mixed views as to whether leases of Investment Property ('IP'), from the lessor's perspective, should be scoped in or out of these proposals. The ED currently proposes that lessors that measured leased IP at fair value are scoped out, whereas leased IP measured at cost is scoped in. Whether leased IP should be included or excluded from the proposals, all are in agreement that all leased IP, whether measured at fair value or cost, should be treated consistently. Those who think that all leased IP should be scoped out think that IAS 40 *Investment Property* meets users' needs and best reflects the economics of this type of transaction. However, some feel that scoping out leased IP from the proposals is inconsistent with how leases of items of Property, Plant and Equipment ('PPE') carried at revalued amounts will be treated and hence raises the question as to whether the proposed lease model is adequate. They feel that IAS 40 does not deal with leases sufficiently and would prefer leases of all assets to be within the scope of the proposals.

Question 1.2 for the Boards: do the Boards think that leases of IP should be in or out of the scope of the proposals?

2. Definition of a lease (incorporating ED/2010/9 questions 4 and 6)

Non-Cancellable

It is still not clear whether cancellable leases are within scope of the proposals, as the current reference in IAS 17 *Leases* to 'non-cancellable' has not been retained. Some argue that this is important because cancellable leases to do not create liabilities and hence should not be in the scope of the proposals. Others think that cancellable leases can create assets and liabilities in the context of the proposals, and hence it can be rationalised that there is no need to retain the cancellable/non-cancellable distinction.

Staff view: that there is no need to retain the cancellable/non-cancellable distinction in the context of the proposals, but the Basis for Conclusions should justify why this distinction is not needed.
Question 2.1 for the Boards: do the Boards agree with the staff view?

Sales of Leased Assets

The ED proposes that a lease should be treated as a sale of the underlying asset if the contract, 'results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits

associated with the underlying asset'. The guidance states that a sale has normally occurred if title automatically transfers at the end of the lease or the lease includes a bargain purchase option. Concern has been raised that the notion of control is not being applied consistently across all standards and that reference to, 'all but a trivial amount of the risks and benefits' should be removed. Instead, more guidance should be included that uses examples of circumstances that frequently arise in lease contracts that are normally indicative of cases where control of the underlying asset has passed. Furthermore, concerns have been raised about how the notion of control has been applied when a lease contains a 'bargain purchase option'. One view is that all purchase options should be accounted for when they are exercised, whether they are a bargain or not. However, some agree that purchase options should be considered at the inception of the lease to aid determination of whether control has passed, but they think that the consideration should be based on whether the options are likely to be exercised or not. Therefore, this approach would state that a bargain purchase option is just an indication that the option is likely to be exercised, but should not be the basis for a 'rule'.

Question 2.2 for the Boards: do the Boards think that purchase options should only be accounted for when exercised? If not, do the Boards think that, when determining whether control has passed, regard should be had to all purchase options based on expectations rather than just reference to bargain purchase options?

Service versus Lease

The ED proposes that, where a lease contract contains distinct services, those services be split and accounted for under the revenue recognition proposals. This applies to all lease contracts unless a lessor applies the derecognition model. In this case the lessor must split out the service component even if it is not distinct. Some have raised concerns that, practically, it will be very hard to split out service components if they are not distinct, and that it would be useful if the proposals contained some guidance on how lessors should perform the 'split'. Concerns have also been raised that the proposals still do no go far enough to determine a lease versus a service. Although the application guidance in the ED includes some of the guidance that currently exists in IFRIC 4 *Determining whether an Arrangement contains a Lease*, staff consider that some of the guidance not 'retained' is useful and should be included. The proposals refer to determination of a lease by providing a 'specified' asset in the contract, whereas IFRIC 4 referred to a 'specific' asset and it is not clear if this was an intended wording change.

Staff view: that more guidance is needed to help entities determine whether the contract is for the supply of services rather than for a lease.

Question 2.3 for the Boards: do the Boards agree with the staff view?

3. Lessee model – overall comment (incorporating ED/2010/9 question 1, 16 and 17)

Cost

Staff have not received any argument in disagreement with the proposals for lessee accounting conceptually. However, constituents are still raising concerns about the cost of complying with the proposals, particularly those entities that currently have a large volume of operating leases. There are three main areas that were raised as an issue:

- transition accounting (capturing all open leases on transition in an information system);
- buying new computer systems and training staff (as the systems will need to be far more sophisticated than that of a simple fixed asset register, due to all of the estimations and reassessments proposed);
- the cost of reassessment (as current lease accounting is more of a 'set and forget' approach).

The IASB has posted a lessee and lessor questionnaire on its website and is performing significant 'outreach' to try and ensure that the proposals meet the cost-benefit criteria.

Staff view: that the comment letter should show support for the lessee model, but highlight these cost concerns. The IASB should consider a long transition period to help mitigate cost concerns and to facilitate the renegotiation of commitments with banks, due to the impact on lessees' balance sheets and hence ratios/bank covenants. The transition period should also be consistent with the revenue proposals for ease of accounting for those entities with leases containing significant distinct service components.

Question 3.1 for the Boards: do the Boards agree with the staff view?

Short-term Leases

One way in which the IASB has tried to reduce the cost burden on lessees is to allow simplified requirements for short-term leases (those less than twelve months in term including all option periods). However, most constituents are in agreement that the simplified requirements are not any less onerous and this proposal needs to be simplified further, including more relief from the disclosure requirements.

Staff view: the proposed simplified requirements are not helpful and support including alternative simplifications in the proposals that relieve lessees from the disclosure requirements in certain circumstances.

Question 3.2 for the Boards: do the Boards agree with the staff view?

Right-of-Use Asset

Concerns have been raised as to the classification of the leased asset which is transferred to the lessee. The ED proposes that this intangible 'right-of-use' asset is classified as Property, Plant and Equipment ('PPE').

It is proposed that these rights-of-use can be fair valued using IAS 38 *Intangible Assets*, but that there is no need for an active market. Given that it is classified as PPE and using the revaluation model under IAS 16 *Property, Plant and Equipment* would give the same result as using the fair value model in IAS 38 (modified to remove the active market condition), some think that the proposals should just state that part of the underlying asset has been transferred to the lessee and classify and to account for this transferred asset under IAS 16.

From the lessee point of view, there is no difference in the future cash flows from operating an owned piece of machinery, compared to renting one. Those who prefer this approach also think that this is conceptually consistent with the lessor derecognising a portion of the underlying asset. The residual asset is still considered to be an item of PPE, even though it is not the whole underlying asset, and it is consistent to require the lessee to also treat the leased asset as an item of PPE. However, there is an alternative view that the 'right-of use' asset is an intangible and hence should be accounted for under IAS 38 only.

Question 3.3 for the Boards: do the Boards think that the lessee should account for the leased asset received:

(i) as an item of PPE and account for it in accordance with IAS 16?

(ii) as a right-of-use asset and account for it in accordance with IAS 38? or

(iii) under the approach proposed by the proposals?

Fair Value

Some constituents think that the lessee's lease liability should be able to be measured at fair value. They think that the proposals should be as consistent with IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* as possible.

Staff view: that the lessee should be allowed to fair value the lease liability as an alternative accounting policy choice.

Question 3.4 for the Boards: do the Boards agree with the staff view?

4. Lessor model – overall comment (incorporating ED/2010/9 question 2)

Performance Obligation versus Derecognition versus a Hybrid Model

The ED proposes a hybrid model to lessor accounting based on whether the significant risks and rewards have been transferred to the lessee. Although some support has been shown for this proposed approach, stronger support has been received from constituents for a derecognition approach.

Given that one of the reasons for the ED/2010/9 proposals is to remove the substantial risks and rewards distinction between operating and finance lease accounting for lessees, some are questioning why that same distinction is now proposed for lessor accounting. In the AASB's response to the IASB on the discussion paper we supported a performance obligation approach, based on consistency with the revenue proposals, whereas the FRSB supported a derecognition approach. Based on feedback from constituents, staff are proposing that the Boards support a single derecognition approach for lessor accounting. The arguments for this approach are:

- the derecognition approach better reflects the economics of a lease transaction;
- it is more consistent with the proposed approach to lessee accounting (easier/more intuitive for sublessors and consolidations);
- most lessors use/manage residual assets so it is more useful for users if preparers present in the financial statements the same numbers that management are using to operate the business;
- the IASB/FASB proposed a partial derecognition approach as they did not want day one gains/losses, however, the partial derecognition approach may result in day one gains/losses anyway, so this is not a valid argument for the partial derecognition approach;
- partial derecognition does not give intuitive outcomes when the fair value of the residual asset is greater than its carrying amount, as a profit may be recognised at the end of the lease contract if the residual asset is subsequently revalued;
- the performance obligation approach assumes that there is an ongoing obligation by the lessor, which some see as inconsistent with the lessee recognising an unconditional right to used the leased asset;
- it is consistent with the revenue recognition proposals. This approach assumes that the performance obligation was satisfied with the transfer of the underlying asset on day one;
- the lessor is required to obtain the fair value of the underlying asset to be able to apply the partial derecognition approach, yet it is the fair value of the residual asset that lessors currently focus on in managing their business, so derecognition is likely to be less costly to apply by lessors;
- the derecognition approach is more conceptually correct as there is no potential 'double-counting' of cash flows as seen in the performance obligation approach; and
- impairment testing is easier to apply where there is no potential for double counting.

If the lessor proposals proceed:

- more guidance would be needed as to what constitutes 'significant' in the context of transferring risks and rewards. It would be useful to have more guidance as to how the concept of risk and rewards interacts with the concept of control in determining whether a sale has occurred. Some feel that transferring significant risks and rewards is an indicator that control has passed;

- more guidance is needed on how to account for the underlying asset once it is returned to the lessor;
- the residual asset should be allowed to be revalued. If this approach is not going to be taken then a method should be applied to the residual value that allows accretion up to the fair value of the residual asset when that fair value is greater than the residual asset carrying amount; and
- it may be difficult for the lessor to measure the performance obligation based on the pattern of usage of the underlying asset by the lessee, as the lessor may not have access to this information.

Staff view: is to show support for the derecognition model (based on the benefits identified) and include the concerns listed directly above on the basis that the Boards may proceed with the hybrid model.
Question 4.1 for the Boards: do the Boards agree with the staff view?

Measurement of the lessor's receivable

Concerns have been raised that the measurement of the lease receivable by a lessor is not consistent with the measurement model of IAS 39/IFRS 9, as effectively the lease receivable is a loan and should be accounted for consistently with other financial assets. The proposals state that the lease receivable should be tested for impairment in accordance with IAS 39 (although it is not clear where the existing IAS 39 impairment requirements will be retained). In the AASB's comment letter on ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*, a comment was raised that, 'the AASB is concerned that the IASB is abandoning the notion that like transactions should be treated in like ways by using different measurement methods for different types of financial assets that are declared as being measured at cost…Based on the tentative decisions taken to date by the IASB, the impairment model proposed in ED/2009/12 would probably not be readily applicable to the lessor accounting model being developed, under which a lessor would recognise lease receivable, leased assets and lease performance obligations.'

Staff view: the measurement (including impairment) of lease receivables should be done on the same basis as for other financial assets. Any new proposals on the measurement of financial assets at amortised cost, should be considered in relation to how they will be applied to lease receivables and guidance added to the lease requirements as necessary.
Question 4.2 for the Boards: do the Boards agree with the staff view?

5. Lease term (incorporating ED/2010/9 question 8)

It is not clear whether the lease term can be longer than the contractual term if management estimate that they will roll the lease into a future period. A similar concern arises for perpetual leases with no fixed term.

The interaction with local law is also not clear (for example in some jurisdictions lessors can't just force lessees to vacate the property at the end of the lease term).

Concerns have also been raised that the proposed lease term refers to the 'longest term more likely than not to occur'. Under the proposals a minor change of view on the 'longest term more likely than not to occur' could lead to artificial volatility in the financial statements, given that renewal options are often for many years. For example, if there were a small change in the initial expectation made by management of extending the lease into another option period from 10% to 15%, due to the mathematical calculation of the lease term, the lease term may 'jump' into the next option period. If this next option period is long, significant changes to the lease assets and liabilities will result from the minor change in expectation. Under current lease accounting the 'high hurdle' for the recognition of additional option periods rarely leads to such significant changes in lease assets and liabilities from a minor change in expectations. Some constituents have suggested that there should be a principle that lease terms are determined on the basis of management expectations in line with an entity's business model, and 'techniques' such as 'more likely than not' should not be prescribed.

Staff view: that: (i) the proposals should clarify whether lease term can extend beyond the contractual term and whether local law should be considered in the determination of lease term, even if those terms are not explicitly stated in the lease contract; and (ii) the lease term should be based on a high level principle that uses management expectations.

Question 5 for the Boards: do the Boards agree with the staff view?

6. Lease payments (incorporating ED/2010/9 question 9)

Contingent Rentals

Some constituents have raised concerns with the inclusion of contingent rentals in the initial lease payments. They think that there is no present obligation and it would be more conceptually correct to account for these when the contingent event has occurred. They also argue that, practically, they can be difficult to reliably estimate up-front. They prefer the current accounting, which is to recognise them when they are incurred. It is also not clear if future rent reviews, with a re-set to future market rentals are considered to be contingent rentals and hence would need to be estimated at the inception of the lease.

Staff view: that contingent rentals should be included in the lease payments and the proposals should make it clear that future market re-sets are contingent lease payments.

Question 6.1 for the Boards: do you agree with the staff view?

Direct Costs

Initial direct costs are included in the amount recognised in respect of lease payments if they are essential to acquiring or originating the lease. Staff note that this proposal is inconsistent with the revenue recognition proposals, where initial direct costs of negotiating a contract must be expensed.

Staff view: that the requirements for initial direct costs of acquiring or originating the lease should be consistent with the revenue recognition proposals.
Question 6.2 for the Boards: do the Boards agree with the staff view?

Residual Value Guarantees

The ED proposes that lessors include an estimate of amounts receivable from the lessee under Residual Value Guarantees (RVG). Some argue that it is not consistent to account for RVG differently depending on who the guarantee is being provided by, as the economics are the same and it makes no difference from the lessor point of view as to where the cash comes from. Therefore, either all RVG should be considered as part of the lease payments, or all should be excluded and accounted for as part of the residual asset.

Staff view: that all RVGs should be excluded from the lease payments and accounted for separately.
Question 6.3 for the Boards: do the Boards agree with the staff view?

Other Points

It is not clear how lease incentives are to be treated under the proposals, especially those that are non-monetary. Nor is it clear how or whether the lessee’s lease liability should include make good provisions if these are specific payments to be made under the lease contract. Some also have concerns with the proposal in the ED to measure lease payments at the inception of the lease and recognise them at commencement. They argue this is inconsistent and all recognition and measurement should be done simultaneously at the commencement of the lease.

Staff view: that non-monetary lease incentives should be included in the calculation of lease payments and the proposals should include guidance on how to measure these. Make good provisions should be excluded from the lease payments and hence accounted for separately under IAS *37 Provisions, Contingent Liabilities and Contingent Assets*. That initial measurement should be performed on commencement of the lease as this is simpler.
Question 6.4 for the Boards: do the Boards agree with the staff view?

7. Options (incorporating ED/2010/9 question 7)

[Note staff are not discussing purchase options again in this section, they have been discussed under section 2 ***Scope of the ED***, subheading *Sale of Leased Assets*.] Some constituents argue that they should be allowed to account for options arising in a lease contract separately, as they think that their systems are sufficiently sophisticated to handle valuing these options. Staff note that this may be the more conceptually correct approach. These constituents would prefer that the inclusion of options in the lease payments be an accounting policy choice. Staff note that this approach may reduce comparability between entities and may be more complex and costly. Staff also note that the accounting for options under the lease proposals, is inconsistent with the revenue proposals, where material options are accounted for as a separate performance obligation.

Staff view: that entities should be allowed to separate options in a lease contract and account for them under IAS 39/IFRS9 as an accounting policy choice.

Question 7 for the Boards: do the Boards agree with the staff view?

8. Recognition of items that include estimates

When recognising items that include estimates, the proposals include an additional measurement criterion within the lessor accounting that is not present in the lessee accounting, that the measurement must be 'measured reliably'. Staff have concerns with this proposal as this criterion is inherent in the conceptual framework and hence staff think that there is no need to repeat it in any specific standard. Including this within the lessor proposals but not the lessee proposals indicates bias and gives rise to inconsistencies.

Staff view: that reference to 'measured reliably' should be removed from the lessor proposals.

Question 8 for the Boards: do the Boards agree with the staff view?

9. Reassessment (incorporating ED/2010/9 question 10)

The ED proposes that estimations included in the lease payments should be reassessed if facts or circumstances indicate that there would be a significant change in the lease payments since the previous reporting period. Some constituents have commented that this approach is confusing and that entities will end up reassessing every reporting period anyway, as they will have to assess each reporting period whether facts and circumstances have changed. An alternative approach that requires entities to reassess estimations included in lease payments if there has been a change in management's expectations, on which those estimates were based and that would give rise to significant changes in the lease payments, would be less onerous and simpler to apply. This approach is consistent with the approach to reassessment of useful lives under IAS 16, where the reassessment is based on a change in estimation rather than a change in facts

or circumstances. If the proposals proceed, it should be clearer as to what this proposal means and some examples should be given of what is a changed fact or circumstance.

Some reassessments result in an adjustment to the profit and loss for lessees/lessors, but it is not clear how this adjustment should be classified – as depreciation/interest, revenue etc.

Staff view: that (i) reassessment should occur when there has been a change in management's expectations, on which initial lease estimates were based and that would give rise to significant changes in the lease payments; and (ii) the proposals should identify how adjustments to the profit and loss account arising from reassessment should be classified.

Question 9 for the Boards: do the Boards agree with the staff view?

10. Presentation and disclosure (incorporating ED/2010/9 questions 12, 13, 14 and 15)

Some concerns have been raised about how the assets and liabilities are to be presented in the balance sheet of the lessor under the performance obligation approach. Most support a net presentation, and would rather see gross amounts in the notes, rather than on the face of the balance sheet. There is also concern that not all three amounts recognised (the lease receivable, the underlying asset and performance obligation) should be net and that the lease receivable should be shown separately as a gross amount.

Some have commented that the disclosures are excessive, especially with regards to paragraph 77 and 80, which require reconciliation disclosures for all assets and liabilities recognised by lessees and lessors.

Staff view: if the performance obligation approach remains in the proposals then we would prefer a net presentation of the underlying asset and the lease liability shown on the balance sheet, with gross amounts detailed in the notes. The reconciliation disclosures should be removed.

Question 10 for the Boards: do the Boards agree with the staff view?

Question 11 for the Boards: are there any further issues that the Boards have identified with the lease proposals that they would like to discuss?

Process for finalising the submission to the IASB

The next AASB meeting is scheduled for 8 and 9 December and the next FRSB meeting 14 and 15 December. As noted above the IASB's comment date is 15 December. Given the tight timeline, we suggest that a sub-committee be formed to work with staff out-of-session to prepare a final draft for Board approval at the AASB/FRSB December meeting. If after discussion of the issues in this paper the Boards'

views are generally aligned, staff suggest that a joint sub-committee be formed. However, if the views of the Boards are varied we suggest forming a sub-committee for each Board.

Question 12 for the Boards: Would the Boards prefer a joint sub-committee? Who would like to be on the/each sub-committee?