

May 2013

Basis for Conclusions
Exposure Draft ED/2013/6

Leases

Comments to be received by 13 September 2013

**Basis for Conclusions on
Exposure Draft
Leases**

Comments to be received by 13 September 2013

This Basis for Conclusions accompanies the Exposure Draft ED/2013/6 *Leases* (issued May 2013; see separate booklet). The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by **13 September 2013** and should be submitted in writing to the address below or electronically via our website www.ifrs.org using the 'Comment on a proposal' page.

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Background Information, Basis for Conclusions, and Alternative Views on the Revised Exposure Draft *Leases*

This Basis for Conclusions accompanies, but is not part of, the [draft] Standard.

Introduction

- BC1 This Basis for Conclusions summarises the boards' considerations in developing the proposed requirements in this Exposure Draft for leases. It includes the reasons for accepting particular views and rejecting others. Individual Board members gave greater weight to some factors than to others.
- BC2 This Basis for Conclusions discusses the following matters:
- (a) background (see paragraphs BC3–BC10);
 - (b) the lessee and lessor accounting models (see paragraphs BC11–BC78);
 - (c) scope (see paragraphs BC79–BC101);
 - (d) identifying a lease (see paragraphs BC102–BC118);
 - (e) classification of leases (see paragraphs BC119–BC127);
 - (f) recognition and date of initial measurement (see paragraphs BC128–BC133);
 - (g) measurement: lessee (see paragraphs BC134–BC189);
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 - (l) measurement: lessor–Type B leases (see paragraphs BC273–BC278);
 - (m) disclosure: lessor (see paragraphs BC279–BC284);
 - (n) sale and leaseback transactions (see paragraphs BC285–BC292);
 - (o) related party leases (FASB-only) (see paragraph BC293);
 - (p) short-term leases (see paragraphs BC294–BC298);
 - (q) effective date (see paragraphs BC299–BC300);
 - (r) transition (see paragraphs BC301–BC317); and
 - (s) consequential amendments (see paragraphs BC318–BC328).

Background

Why the need to change existing accounting?

- BC3 The existing accounting model for leases under IFRS and US GAAP requires lessees and lessors to classify their leases as either finance leases or operating leases and account for those leases differently. For example, it does not require lessees to recognise assets and liabilities arising from operating leases, but it

does require lessees to recognise assets and liabilities arising from finance leases. The IASB and the FASB initiated a joint project to improve the financial reporting of leasing activities under IFRS and US GAAP in the light of criticisms that the existing accounting model for leases fails to meet the needs of users of financial statements. In particular:

- (a) many, including the US Securities and Exchange Commission (SEC) in its report on off-balance-sheet activities issued in 2005 and a number of academic studies published over the past 15 years, have recommended that changes be made to the existing lease accounting requirements to ensure greater transparency in financial reporting and to better address the needs of users of financial statements. Many users often adjust the financial statements to capitalise a lessee's operating leases. However, the information available in the notes to the financial statements is often insufficient for users to make reliable adjustments to a lessee's financial statements. The adjustments made can vary significantly depending on the assumptions made by different users.
- (b) the existence of two very different accounting models for leases in which assets and liabilities associated with leases are not recognised for most leases, but are recognised for others, means that transactions that are economically similar can be accounted for very differently. That reduces comparability for users and provides opportunities to structure transactions to achieve a particular accounting outcome.
- (c) some users have also criticised the existing requirements for lessors because they do not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from its retained interest in the underlying asset), particularly for leases of assets other than property that are currently classified as operating leases.

BC4 The boards decided to address those criticisms by developing a new approach to lease accounting that requires an entity to recognise assets and liabilities for the rights and obligations created by leases. The new approach would require a lessee to recognise assets and liabilities for all leases with a maximum possible term (including any options to extend) of more than 12 months. This approach should result in a more faithful representation of a lessee's financial position and, together with enhanced disclosures, greater transparency of a lessee's financial leverage. The new approach also proposes changes to lessor accounting that, in the boards' view, would more accurately reflect the leasing activities of different lessors.

The project to date

BC5 In March 2009 the boards published a joint Discussion Paper *Leases: Preliminary Views*. The Discussion Paper set out the boards' preliminary views on lessee accounting, proposing a 'right-of-use' accounting model. Feedback on the Discussion Paper was generally supportive of the 'right-of-use' model for lessees, in which a lessee would recognise a right-of-use asset and a lease liability at the commencement date of the lease. The Discussion Paper did not discuss lessor accounting in any detail.

BASIS FOR CONCLUSIONS ON LEASES

- BC6 In August 2010 the boards published a joint Exposure Draft *Leases* (the '2010 Exposure Draft'). The boards developed their 2010 Exposure Draft after considering the 302 comment letters received on the Discussion Paper, as well as input obtained from their International Working Group on Lease Accounting and from others who were interested in the financial reporting of leases. The 2010 Exposure Draft further developed the 'right-of-use' accounting model proposed for lessees in the Discussion Paper. The 2010 Exposure Draft also set out changes to lessor accounting by proposing a dual lessor accounting model, in which a lessor would recognise a lease receivable and derecognise a portion of the underlying asset for some leases, and would continue to recognise the underlying asset for others. The boards decided to include lessor accounting in the proposals in response to comments from respondents to the Discussion Paper. Those respondents recommended that the boards develop accounting models for lessees and lessors on the basis of a consistent rationale. The boards also saw merit in developing lessor accounting proposals at the same time as developing proposals on the recognition of revenue.
- BC7 The boards received 786 comment letters in response to the 2010 Exposure Draft from entities and organisations from a range of industries, including nonpublic entities. Concerns raised about the application of the proposed model to nonpublic entities were discussed separately by the FASB.
- BC8 The boards also consulted extensively on the proposals in the 2010 Exposure Draft. Round-table discussions were held in Hong Kong, the United Kingdom and the United States. Workshops were organised in Australia, Brazil, Canada, Japan, South Korea, the United Kingdom and the United States. Members of the boards also participated in conferences, working group meetings, discussion forums, and one-to-one discussions that were held across all major geographical regions. While redeliberating the proposals in the 2010 Exposure Draft in 2011 and 2012, the boards conducted targeted outreach on specific issues with more than 100 organisations. The purpose of the targeted outreach was to obtain additional feedback to assist the boards in developing particular aspects of the revised proposals. The targeted outreach meetings involved working group members, representatives from accounting firms, local standard-setters, users of financial statements, and preparers, particularly those from industries most affected by the lease accounting proposals.
- BC9 The main feedback received on the proposals included in the 2010 Exposure Draft was as follows:
- (a) there was general support for the recognition of the assets and liabilities arising from a lease by lessees. That was consistent with comments received on the Discussion Paper.
 - (b) some respondents supported the effects of the proposed right-of-use model on a lessee's profit or loss in which a lessee would recognise separately amortisation of the right-of-use asset and interest on the lease liability. They noted that leases are a source of financing for a lessee and should be accounted for accordingly. However, others disagreed because they said that the approach did not properly reflect the economics of all lease transactions. In particular, some respondents referred to

shorter-term property leases as examples of leases that, in their view, were not financing transactions from either the lessee's or lessor's perspective.

- (c) many respondents disagreed with the lessor accounting proposals:
- (i) some were concerned that the dual accounting model proposed for lessors was not consistent with the single accounting model proposed for lessees.
 - (ii) many did not support the performance obligation approach. According to that approach, a lessor would recognise a lease receivable and a liability at the commencement date, and would also continue to recognise the underlying asset. Those respondents indicated that, in their view, the approach would artificially inflate a lessor's assets and liabilities.
 - (iii) some supported applying the derecognition approach to all leases. According to that approach, a lessor would derecognise the underlying asset, and recognise a lease receivable and a retained interest in the underlying asset (referred to as a residual asset) at the commencement date. However, many disagreed with the proposal to prevent a lessor from accounting for the effects of the time value of money on the residual asset.
 - (iv) others said that the existing lessor accounting requirements work well in practice and supported retaining those requirements.
- (d) almost all respondents were concerned about the costs and complexity of the proposals, in particular the proposals on measurement of the lessee's lease liability and the lessor's lease receivable. The 2010 Exposure Draft had proposed that an entity would make an estimate of all variable lease payments to be made, not only during the non-cancellable period of a lease but also during any optional extension periods that the entity considered more likely than not to occur. Some questioned whether lease payments to be made during optional extension periods would meet the definition of an asset (for the lessor) or a liability (for the lessee). Others indicated that it would be extremely difficult in many cases to make a reliable estimate of variable lease payments if the amounts to be paid were dependent on future sales or use of the underlying asset. Because of the amount of judgement involved, many indicated that the cost of including variable lease payments and payments to be made during extension periods in the measurement of lease assets and lease liabilities would outweigh the benefit for users of financial statements.
- (e) many respondents also were concerned about the breadth of the scope of the proposals, indicating that the proposed definition of a lease had the potential to capture some service contracts.

BC10 The boards addressed those concerns during the redeliberations of the proposals in the 2010 Exposure Draft. A summary of the changes that the boards have made to the 2010 proposals is presented in Appendix E to this Basis for Conclusions. The changes have resulted in revised proposals in this Exposure

Draft on the lessee accounting model, the lessor accounting model, measurement of lease assets and lease liabilities and the scope of the proposals. The boards concluded that the revised proposals are sufficiently different from those published in the 2010 Exposure Draft to warrant re-exposure.

The lessee and lessor accounting models

- BC11 All contracts create rights and obligations for the parties to the contract. The model proposed in this Exposure Draft considers the rights and obligations created by a lease (defined as a ‘contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration’—see paragraphs BC102–BC106 for more information on the proposed definition of a lease). The model reflects that, at the commencement date, a lessee obtains a right to use the underlying asset for a period of time, and the lessor has provided or delivered that right. Consequently, the boards have referred to the model as a ‘right-of-use’ model.
- BC12 A lessee has a right to use the underlying asset during the lease term and an obligation to make payments to the lessor for providing the right to use the asset. The lessee also has an obligation to return the underlying asset in a particular condition to the lessor at the end of the lease term. Similarly, the lessor has a right to receive payments from the lessee for providing the right to use the underlying asset. The lessor also retains rights associated with the underlying asset. Having identified the rights and obligations that arise from a lease for the lessee and lessor, the boards then considered which of those rights and obligations should be recognised as assets and liabilities by the lessee and lessor.

Rights and obligations arising from a lease that create assets and liabilities for the lessee

Right to use the underlying asset

- BC13 The IASB’s *Conceptual Framework for Financial Reporting (Conceptual Framework)* defines an asset as “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.” FASB Concepts Statement No. 6, *Elements of Financial Statements*, states that “[a]ssets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” The main characteristics of both definitions of an asset are that the entity controls an economic resource or benefit, the resource or benefit arises from a past event and future economic benefits are expected to flow to the entity. The boards concluded that a lessee’s right to use the underlying asset meets the definition of an asset for the following reasons:
- (a) the lessee controls the right to use the underlying asset during the lease term because the lessor is unable to have access to the resource without the consent of the lessee (or breach of contract). Once the asset is delivered, the lessor is unable to retrieve or otherwise use the underlying asset during the lease term, despite being the legal owner of the underlying asset.

- (b) the lessee's control of the right of use is also demonstrated by its ability to determine how and when it uses the underlying asset and, thus, how it generates future economic benefits from that right of use. For example, assume a lessee leases a truck for four years, for up to a maximum of 160,000 miles over the lease term. Embedded in the right to use the truck is a particular volume of economic benefits or service potential that is used up over the period of time that the truck is driven by the lessee. Upon delivery of the truck to the lessee, the lessee can decide how it wishes to use up or consume the economic benefits embedded in its right of use. It could decide to drive the truck constantly during the first two years of the lease, using up all of the economic benefits in those first two years. Alternatively, it could use the truck only during particular months in each year or decide to use it evenly over the four-year lease term.
- (c) in some leases, a lessee's right to use an asset includes some restrictions on its use. For example, in the truck example in (b) above, the lessee cannot drive the truck for more than 160,000 miles over the four-year lease term. Some may think that those restrictions result in the lessee not having control of the right to use the underlying asset. However, the boards have concluded that, although those restrictions may affect the value of and payments for the right-of-use asset, they do not affect the recognition of the right-of-use asset. That is consistent with the recognition of other assets. It is not unusual for particular restrictions to be placed on the use of owned assets as well as leased assets. For example, assets that are used as security for particular borrowings may have restrictions placed on their use by the lender, or a government may place restrictions on the use or transfer of assets in a particular region for environmental or security reasons. Those restrictions do not necessarily result in the owner of such assets losing control of those assets—the restrictions may simply affect the economic benefits that will flow to the entity from the asset and that will be reflected in the price that the entity is willing to pay for those economic benefits.
- (d) the lessee's control of the right of use arises from a past event—the signing of the lease and the underlying asset being made available for use by the lessee. Some have suggested that the lessee's right to use an asset is conditional on the lessee making payments during the lease term. In other words, if the lessee does not make payments, it may forfeit its right to use the asset (which is similar to the situation that would arise if an entity failed to make payments on an instalment purchase). However, unless the lessee breaches the contract, the lessee has an unconditional right to use the underlying asset.

BC14 Consequently, the boards concluded that the lessee's right to use the underlying asset meets the definition of an asset in the IASB's *Conceptual Framework* and in Concepts Statement 6.

Obligation to make lease payments

BC15 The *Conceptual Framework* defines a liability as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.” Concepts Statement 6 states that “liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.” The main characteristics of both definitions of a liability are that the entity has a present obligation that arises from a past event, and the obligation is expected to result in an outflow of economic benefits. The boards concluded that the lessee’s obligation to make lease payments meets the definition of a liability for the following reasons:

- (a) the lessee has a present obligation to make lease payments once the underlying asset has been delivered (or made available) to the lessee. That obligation arises from a past event—the signing of the lease and the underlying asset being delivered (or made available) for use by the lessee. The lessee has no contractual right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term. In addition, unless the lessee breaches the contract, the lessor has no contractual right to take possession of, or prevent the lessee from using, the underlying asset until the end of the lease term.
- (b) the obligation results in a future outflow of economic benefits from the lessee—typically contractual cash payments in accordance with the terms and conditions of the lease.

BC16 Consequently, the boards concluded that a lessee’s obligation to make lease payments meets the definition of a liability in the *Conceptual Framework* and in Concepts Statement 6.

Obligation to return the underlying asset to the lessor

BC17 The lessee controls the use of the underlying asset during the lease term, and has an obligation to return the underlying asset to the lessor at the end of the lease term. That is a present obligation that arises from a past event (the signing of the lease and the underlying asset being made available for use by the lessee).

BC18 It might appear that there is an outflow of economic benefits at the end of the lease term because the lessee must surrender the underlying asset, which often still will have some economic potential. However, the boards concluded that there is no outflow of economic benefits from the lessee when it returns the leased item, other than incidental costs, because the lessee does not control the economic benefits associated with the asset that it returns to the lessor. Even if the lessee has physical possession of the underlying asset, it has no right to obtain the remaining economic benefits associated with the underlying asset once the lease term expires (ignoring any options to extend the lease or purchase the underlying asset). In that case, the position of the lessee at the end of the lease term is like that of an asset custodian. The lessee is holding an asset on behalf of a third party, the lessor, but has no right to the economic benefits embodied in that asset at the end of the lease term.

- BC19 Consequently, the boards concluded that the lessee's obligation to return the underlying asset does not meet the definition of a liability in the *Conceptual Framework* and in Concepts Statement 6.

Why leases are different from service contracts for the lessee

- BC20 The boards have concluded that leases create rights and obligations that are different from those that arise from service contracts. That is because the lessee obtains and controls the right-of-use asset at the time that the underlying asset is delivered to (or made available for use by) the lessee, as described in paragraph BC13.
- BC21 When the lessor delivers (or makes available) the underlying asset for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee now controls that right of use. Consequently, the lessee has an unconditional obligation to pay for that right of use. After the lessor makes the underlying asset available for use by the lessee, the lessee cannot return the underlying asset to the lessor before the end of the lease without breaching the contract (or incurring termination penalties). Similarly, unless the lessee breaches the contract, the lessor cannot retrieve the underlying asset from the lessee before the end of the lease.
- BC22 In contrast, in a typical service contract, the customer does not obtain an asset that it controls at commencement of the contract. Instead, the customer obtains the service only at the time that the service is performed. The vendor has remaining obligations until it has provided the services to its customer. Consequently, the customer typically has an unconditional obligation to pay only for the services provided to date. In addition, although fulfilment of a service contract may require the use of assets, fulfilment typically does not require the delivery of an identified asset.
- BC23 Accordingly, the boards have concluded that the nature of the rights and obligations that arise at commencement of a typical service contract is different from the nature of the rights and obligations that arise at commencement of a lease.

Rights and obligations arising from a lease that create assets and liabilities for the lessor

Lease receivable

- BC24 When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee controls the right of use. Accordingly, the lessor has an unconditional lease receivable. The lessor controls that right—for example, it can decide to sell or securitise that right. The right arises from a past event (the signing of the lease and the underlying asset being made available for use by the lessee) and is expected to result in future economic benefits (typically cash from the lessee) flowing to the lessor.
- BC25 Consequently, the boards concluded that the lessor's lease receivable meets the definition of an asset in the *Conceptual Framework* and in Concepts Statement 6.

See paragraphs BC64–BC74 for a discussion of the boards’ conclusions on the recognition of lease receivables by a lessor.

Rights retained in the underlying asset

- BC26 Although the lessor transfers the right to use the underlying asset to the lessee at the commencement date, the lessor has the right to the underlying asset at the end of the lease term (and retains some rights to the underlying asset during the lease term, for example the lessor retains title to the asset). Consequently, the lessor retains some of the potential economic benefits embedded in the underlying asset.
- BC27 The lessor controls the rights it retains in the underlying asset. A lessor can often, for example, sell the underlying asset (with the lease attached) or agree at any time during the initial lease term to sell or re-lease the underlying asset at the end of the lease term. The lessor’s rights to the underlying asset arise from a past event—the purchase of the underlying asset or signing of the head lease, if the lessor is a sub-lessor. Future economic benefits from the lessor’s retained rights in the underlying asset are expected to flow to the lessor, assuming that the lease is for anything other than the full economic life of the asset. The lessor would expect to obtain economic benefits either from the sale, re-lease or use of the underlying asset at the end of the lease term.
- BC28 Consequently, the boards concluded that the lessor’s rights retained in the underlying asset meet the definition of an asset in the *Conceptual Framework* and in Concepts Statement 6. See paragraphs BC64–BC74 for a discussion of the boards’ conclusions on the recognition of a lessor’s rights retained in the underlying asset.

The lessee accounting model

- BC29 Having concluded that the lessee’s right to use the underlying asset meets the definition of an asset and the lessee’s obligation to make lease payments meets the definition of a liability, the boards considered whether requiring a lessee to recognise that asset and liability for all leases would improve financial reporting to such an extent that the benefits from the improvements would outweigh the costs associated with such a change.
- BC30 On the basis of comments from respondents to both the Discussion Paper and the 2010 Exposure Draft, and from participants at consultation meetings (including meetings with users of financial statements) as described in paragraph BC9, the boards concluded that there would be significant benefits from requiring a lessee to recognise a right-of-use asset and a lease liability for all leases (except short-term leases), particularly for users of financial statements and others who have raised concerns about the extent of off-balance-sheet financing for operating leases. The boards have considered the costs associated with that proposed change throughout their redeliberations, and have simplified the proposals included in the 2010 Exposure Draft to address concerns about costs (see paragraphs BC136–BC143, BC148–BC155 and BC294–BC298 on the lease term, variable lease payments, and short-term leases). The costs and benefits of the lease accounting proposals are discussed in paragraphs BC329–BC466.

Amounts recognised in profit or loss

- BC31 The right-of-use asset is a non-financial asset that the boards are proposing to measure at cost. Cost for a right-of-use asset is the present value of lease payments, plus any initial direct costs incurred by the lessee.
- BC32 Accordingly, a lessee subsequently measures the right-of-use asset at cost, less accumulated amortisation and any impairment. The Discussion Paper and the 2010 Exposure Draft proposed that a lessee amortise the right-of-use asset similarly to other non-financial assets, ie on a systematic basis reflecting the pattern in which the lessee is expected to consume the right-of-use asset's future economic benefits. That would typically result in the lessee recognising amortisation of the right-of-use asset on a straight-line basis over the lease term.
- BC33 The lease liability is a financial liability that the boards are proposing to measure at cost. Cost for a lease liability is the present value of lease payments. Interest (or the unwinding of the discount) would be allocated to each period to produce a constant periodic rate of interest on the remaining balance of the liability. That measurement is similar to the measurement of other similar financial liabilities. The Discussion Paper and the 2010 Exposure Draft also proposed this measurement basis for the lessee's lease liability which would typically result in the lessee recognising decreasing interest costs over the lease term as the lessee makes lease payments reducing the liability balance.
- BC34 The boards received differing views on the effects of the proposed right-of-use model on a lessee's profit or loss:
- (a) some agreed with the boards' proposals in the 2010 Exposure Draft. They noted that every lessee obtains an asset (the right to use the underlying asset) at the commencement date, and has an obligation to pay for that right. Accordingly, a lessee should account for the transaction no differently from acquiring any other non-financial asset and separately financing that purchase, which would result in the recognition of interest on the liability and amortisation of the asset.
 - (b) others disagreed with the boards' proposals. They noted that, in a typical lease, the lessee receives equal benefits from use of the underlying asset and pays equal amounts in each period. The result of separately recognising interest on the lease liability and amortisation of the right-of-use asset, which would typically result in higher total lease expense in the earlier years of the lease and lower total lease expense in the later years of the lease, does not, in their view, reflect the economics of receiving equal benefits for equal payments over the life of the lease. They suggested a single lessee accounting model (excluding contracts that transfer control of the underlying asset to the lessee) that would allocate the total cost of the lease to each period to reflect the pattern in which the lessee consumes benefits from use of the underlying asset.
 - (c) others said that because leases vary widely ranging from those for almost all of the life of the underlying asset to those for a very short portion of the life of the underlying asset, a single expense recognition pattern

would not best reflect the economics of all lease transactions. They suggested that the boards propose different accounting models for different populations of leases.

- (d) others said that a single expense recognition pattern may not best reflect the economics of all lease transactions. Nonetheless, they supported the lessee accounting model proposed in the 2010 Exposure Draft because they thought it would be less complex and less costly to apply than multiple models. They noted the benefits of removing the need for a lease classification test and having only one method of accounting for all leases from an administrative perspective. They also questioned whether multiple expense recognition patterns would increase the usefulness of information provided to users of financial statements.
- BC35 On the basis of that feedback, the boards first concluded that it would be inappropriate to measure the lease liability for any lease on a different basis from that used to measure other similar financial liabilities. Users of financial statements confirmed that the recognition of the lease liability would be most beneficial to their analyses if measured on a basis similar to that used for other financial liabilities (ie on a basis similar to the effective interest method).
- BC36 The boards then considered various ways of amortising the right-of-use asset, and presenting that amortisation, to address concerns raised about the effects on profit or loss as proposed in the 2010 Exposure Draft. The approaches considered included the following:
- (a) interest-based amortisation (often referred to as annuity amortisation) in which the right-of-use asset would be amortised taking into account the time value of money. If a lessee expects to derive the same level of benefits from the right-of-use asset over the lease term, this approach views those same benefits to be worth relatively more in the later years of a lease as a result of the time value of money. Consequently, the amortisation charge would typically increase over the lease term. This approach would result in a lessee recognising a total lease expense, consisting of interest on the liability and amortisation of the right-of-use asset, on a straight-line basis if lease payments were even or relatively even over the lease term. The total lease expense would vary, however, in each period if lease payments were uneven. The boards rejected this approach for a number of reasons:
- (i) such an amortisation or depreciation method is currently prohibited in US GAAP and is not generally permitted to be applied under IFRS, although not specifically prohibited. The boards were concerned about the consequences of requiring such a method only for right-of-use assets when the method is not applied to other non-financial assets including property, plant and equipment.
- (ii) some users of financial statements expressed concern about a model that would result in a lack of comparability between the lease and purchase of an asset. For example, some airline

analysts were concerned that a 20-year lease of an aircraft would be accounted for differently from the purchase of a similar aircraft.

- (iii) some preparers expressed concerns about the costs associated with applying such an approach. They thought that this approach would be more costly to apply than the proposals in the 2010 Exposure Draft because it would require more extensive systems changes. Some thought that they could account for right-of-use assets within their existing systems for property, plant and equipment if the right-of-use asset were amortised similarly to other non-financial assets.
- (b) an amortisation approach that looked through to consumption of the underlying asset. This approach was based on the ‘whole asset’ approach as described in the Discussion Paper. The whole asset approach is based on the premise that, during the lease term, the leased item is under the control of the lessee. Accordingly, a lessee would recognise the leased item as its asset and recognise an obligation to return the item to the lessor at the end of the lease term, in addition to an obligation to make lease payments. If the lease was for substantially all of the leased item’s expected economic life, the obligation to return the item would be relatively insignificant. In contrast, if the lease was for a short portion of the leased item’s life (and the item was expected to retain virtually all of its value over the lease term), the obligation to return the item would be significant. Under the approach considered by the boards during their deliberations in 2012, the lessee would consider the right-of-use asset to be a combination of the underlying asset less an obligation to return that asset to the lessor. The pattern of the amortisation charge, and consequently the lease expense recognised by the lessee in each reporting period, would vary depending on the extent to which the economic benefits embedded in the underlying asset would be consumed by the lessee. For instance, if a lessee was expected to consume almost all of the economic benefits embedded in the underlying asset (for example, because the lease term is for almost all of the economic life of the asset), the approach would produce a lease expense similar to the expense recognised under current lessee accounting for finance leases. In contrast, if the lessee was expected to consume very little, if any, of the economic benefits embedded in the underlying asset (for example, because the underlying asset would retain virtually all of its value over the lease term), the approach would produce a lease expense similar to the expense recognised under current lessee accounting for operating leases (when lease payments are relatively even over the lease term). Although some board members favoured this approach because it would reflect the way in which many leases are priced, the boards rejected the approach on the basis of feedback from preparers that indicated that the approach would be prohibitively costly to apply because of the judgement required and the volume of leases that exist.

- (c) an approach that would result in the recognition of a single lease expense recognised on a straight-line basis over the lease term. Virtually all lessees that predominantly lease property (ie land and/or buildings) supported this approach, as did some users of financial statements that analyse entities that predominantly lease property. In their view, recognising lease expenses for property leases on a straight-line basis reflects the nature of the transaction. For example, when entering into a typical five-year lease of retail space, some noted that the lessee was simply paying rent to use the retail space, which should be recognised on a straight-line basis. Although the boards were persuaded by this argument in the context of most leases of property (as described in paragraphs BC40–BC63), the boards rejected this approach for *all* leases. If applied to all leases, the approach would fail to address concerns raised by some users about the comparability of accounting when leasing or purchasing assets. For example, under this approach, it would be unlikely for a lessee to account for the financing inherent in a 20-year lease of an aircraft in its statement of profit or loss and other comprehensive income.

- BC37 During redeliberations, the boards consulted extensively on the approach to lease expense recognition and took into account comments made on that issue by respondents to the 2010 Exposure Draft. That consultation emphasised that different stakeholders have very different views about the economics of lease transactions. Some view all leases as financing transactions. Others view almost no leases as financing transactions. Finally, in others' view, the economics are different for different leases.
- BC38 Some board members expressed a preference to retain a single lessee accounting model that would require a lessee to amortise the right-of-use asset consistent with other non-financial assets and measure the lease liability consistently with other similar financial liabilities. Because it would be impossible to develop lessee accounting proposals to which all stakeholders would agree, the boards noted that such an approach would provide a coherent accounting model that would be easy to understand and that the approach would reduce complexity by removing the need for a lease classification test and systems that could deal with two lessee accounting approaches.
- BC39 However, in the light of all of the feedback received, and because of the wide variety of leases (which range from those that provide the underlying asset to the lessee for almost all of the underlying asset's economic life to those that provide the underlying asset to the lessee for very little of the underlying asset's economic life), the boards concluded that amortising the right-of-use asset consistently with other non-financial assets would not provide the best reflection of the nature of *all* leases. At the same time, the boards were also aware that a single approach that attempted to capture the differing economics embedded in all leases would be impracticable (as explained in paragraph BC36(b)).

Determining whether and how to classify leases

- BC40 When considering whether and how to distinguish between different leases, the boards focused on identifying when, if ever, presenting a single lease expense (recognised on a straight-line basis) would provide better information to users of financial statements than separately presenting amortisation of the right-of-use asset and interest on the lease liability. The boards concluded that this would be the case when such an expense recognition pattern would better reflect the economics of the lease.
- BC41 The terms and conditions of the lease and the nature of the underlying asset play an important role in understanding the economics of a lease. Although a lessee is accounting for the right-of-use asset and not the whole underlying asset, the rights the lessee obtains in a lease are inevitably linked to the underlying asset. A lessor often prices, and assesses the returns it generates from its leasing activities, with reference to the value of the underlying asset.
- BC42 The boards concluded that a single lease expense would provide better information about leases for which the lessee pays only for the use of the underlying asset and is expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset itself. Consequently, the boards decided that the factor that would be used to distinguish between different leases is the level of the lessee's consumption of the economic benefits embedded in the underlying asset.
- BC43 The rationale for the classification principle proposed to distinguish between different leases is based on the fact that the lessee has the right to use *all* of the underlying asset during the period of the lease—ie by definition, the lessee controls the use of the underlying asset during the lease term. Accordingly, from an economic perspective, and subject to market constraints, a lessor would generally price a lease to ensure that it obtains a desired return on its total investment in the underlying asset and also to recover an amount representing the portion of the underlying asset that the lessee is expected to consume during the lease term.
- BC44 When there is no expected decline in the value or service potential of the asset (ie when the lessee is not expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset), the lease payments made by the lessee would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, ie a charge for the use of the asset by the lessee. That return or charge would be expected to be even, or relatively even, over the lease term. In many respects for such a lease, the payments made by the lessee could be viewed as somewhat similar to an entity paying interest on an interest-only loan. That is because the lessee 'borrows' the underlying asset, uses it during the lease term while paying the lessor even (or relatively even) lease payments for that use (providing the lessor with a constant return on its investment in the asset), and returns the underlying asset to the lessor with virtually the same value or service potential as it had at the commencement date. In the case of a lease, however, the asset 'loaned' to the lessee is a tangible asset rather than a financial asset.

- BC45 In contrast, when the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, the lessor would charge the lessee for recovery of that portion of the underlying asset that the lessee is expected to consume during the lease term, as well as obtaining a return on its investment in the asset. The lease payments, and thus the right-of-use asset, would incorporate the acquisition of the portion of the underlying asset that the lessee is expected to consume. When that is the case, the boards concluded that accounting for the right-of-use asset similarly to other non-financial assets (such as property, plant and equipment) would provide the most useful information to users of financial statements about the nature of such leases.
- BC46 For example, if a lessee leases a car for three years, and that car has an economic life of seven years, the lessee would be expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset during the three-year lease term. From an economic perspective (and subject to market constraints), the lessor would be expected to charge the lessee to recover (a) an amount representing the portion of the car expected to be consumed by the lessee over the three-year lease term, and (b) an amount providing the lessor with a return on its investment in the portion of the car that is not consumed by the lessee. For that reason, the lease payments made, and the right-of-use asset acquired, by the lessee would effectively incorporate the acquisition of the portion of the car that the lessee consumes during the lease term.
- BC47 In contrast, if a lessee leases two floors of an office building for two years, and that building has an economic life of 50 years, the lessee is consuming an insignificant portion of the economic benefits embedded in the underlying asset. That is because the office building would be expected to lose very little, if any, of its overall service potential during the two-year lease term. From an economic perspective (and subject to market constraints), the lessor would be expected to charge the lessee only to use the office space over the lease term (providing the lessor with a return on its investment in the building); the lessor would not require recovery of any of its investment in the building because the building would be expected to retain virtually all of its value or service potential over the lease term.
- BC48 Using this rationale, the boards are proposing two approaches to the recognition and measurement of expenses arising from a lease:
- (a) for some leases (Type A leases), a lessee would be required to recognise and present amortisation of the right-of-use asset consistently with depreciation and amortisation of other non-financial assets, and the unwinding of the discount on the lease liability consistently with interest or the unwinding of the discount on other financial liabilities measured on a discounted basis.
 - (b) for other leases (Type B leases), a lessee would be required to amortise the right-of-use asset so that the lessee recognises a *single lease expense* (combining amortisation of the right-of-use asset and the unwinding of the discount on the lease liability) on a straight-line basis.

BC49 The principle for deciding which of the two approaches applies is similar to the principle behind the whole asset approach described in paragraph BC36(b). However, whereas the whole asset approach would have resulted in a range of expense recognition profiles depending on the level of consumption of the underlying asset, the approach proposed by the boards would only result in two expense recognition profiles.

Application of the classification principle

BC50 As described in paragraphs BC40–BC49, the classification principle based on consumption refers to the expected decline in the economic benefits embedded in the underlying asset during the lease term. Applying that principle without additional requirements might have forced entities to obtain information about or estimate the market value of assets being leased, not only at the commencement date but possibly also at the end of the lease term for some leases. In response to requests to reduce complexity and the cost of implementing the proposals where possible, the boards decided to simplify the requirements in this Exposure Draft by proposing to apply the classification principle largely on the basis of the nature of the underlying asset (ie property (land and/or a building) and assets other than property (for example, equipment or vehicles)).

BC51 In the boards' view, applying the classification principle based on the nature of the underlying asset would make the classification proposals much simpler to apply. Although the boards acknowledge that applying the principle in the manner proposed would not always result in conclusions that are consistent with the principle (ie there may be some leases of property classified as Type B leases for which the lessee expects to consume more than an insignificant portion of the property), in the boards' view, the proposed approach will result in most leases being classified according to that principle. That is because property typically has a relatively long life, and a large proportion of the lease payments for some property leases relates to the land element inherent in property leases. That land element has an indefinite life and the economic benefits embedded in the land would not be expected to be consumed over the period of a lease.

BC52 In contrast, the boards concluded that the opposite is true for most leases of assets other than property, such as equipment and vehicles. Equipment and vehicles are depreciating assets, whose value not only declines over their economic lives but generally declines faster in the early years of their lives than in the later years. Accordingly, in the boards' view, a lessee will generally consume more than an insignificant portion of the economic benefits embedded in the underlying asset for most equipment and vehicle leases.

BC53 The boards decided, however, that an entity should not classify leases by considering only the nature of the underlying asset. That is to ensure that the conclusions reached more closely reflect the classification principle. For leases of property, the boards decided to include classification criteria that are based on the indicators that exist in IAS 17 *Leases* for finance leases—ie those indicators that refer to the economic life and fair value of the underlying asset when assessing whether a lease transfers substantially all the risks and rewards

incidental to ownership of the underlying asset to the lessee. For leases of assets other than property, an entity would also classify a lease with reference to the economic life and fair value of the underlying asset. However, the criteria proposed directly relate to the classification principle based on insignificant consumption of the underlying asset.

- BC54 Using the economic life and fair value indicators that exist in IAS 17 as the basis for determining when a lease of property is a Type A lease captures those leases of property for which it is clear that recognising amortisation of the right-of-use asset and interest on the lease liability would provide better information about the nature of the lease. For example, a manufacturer may enter into a 20-year lease of a manufacturing plant with a financial institution lessor in which the lessee is expected to consume substantially all of the economic benefits embedded in the plant, and the purpose of the transaction for both the lessee and the lessor is the provision of finance to the lessee. In addition, many stakeholders are familiar with applying those indicators, which would reduce costs and complexity when implementing the leases proposals.
- BC55 Some have questioned why the approach proposed for classifying property leases is based on such high thresholds when assessing the lease relative to the economic life and fair value of the underlying asset. They note that the IAS 17 principle—ie transfer of substantially all the risks and rewards incidental to ownership—would appear to relate to leases for which the lessee consumes almost all of the economic benefits embedded in the underlying asset, rather than leases for which the lessee consumes more than an insignificant portion of the underlying asset. The boards note, however, that when classifying property leases, the economic life of the property is considered to be the remaining economic life of the building. For a property lease for which a significant part of that property's value is derived from its location, a lessee is unlikely to consume more than an insignificant portion of the economic benefits embedded in the entire property (including the land) unless the lease term is for at least a major part of the remaining economic life of the building. Accordingly, although the wording of the classification criteria for property leases (ie major part of the remaining economic life and substantially all of the fair value) would appear to establish a line that is different from the classification principle (ie 'more than an insignificant portion'), applying the economic life criterion on the basis of the major part of the remaining economic life of the building in a property lease and the fair value criterion on the basis of substantially all of the fair value of the underlying asset is expected to result in conclusions that are consistent with the classification principle in most instances.
- BC56 For example, assume a lessee leases a new office building for 15 years. The lease also incorporates the land on which the building is constructed and the location (ie the land element of the lease) represents a substantial proportion of the fair value of the property. The economic life of the building is estimated to be 50 years. When applying the requirements in paragraph 30 of this Exposure Draft, an entity would conclude that the lease of the office building should be classified as a Type B lease (ie the lease term is not a major part of the remaining economic life of the building and the lease payments would not represent substantially all of the fair value of the property). Even though 15 years would

be more than an insignificant portion of the life of the building (when considered in isolation), the conclusion that the lease is classified as a Type B lease would be consistent with the consumption principle. That is because the lessee would not be expected to consume more than an insignificant portion of the economic benefits embedded in the property over the 15-year lease term—the land element would be expected to retain all of its service potential over the lease term and the service potential of the building would be expected to decline more rapidly nearing the end of its life rather than in the early years of its life.

- BC57 The boards are not proposing to classify leases of assets other than property on the basis of the indicators in IAS 17. That is because, when applied to equipment and vehicle leases, those indicators would *not* reflect the consumption principle proposed by the boards (as described in paragraphs BC61–BC62 below).

Other approaches considered for classifying leases

- BC58 The boards also considered classifying leases on the basis of:
- (a) the lessee's business purpose for entering into a lease; or
 - (b) the principle in IAS 17 (ie identifying when a lessor transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee).
- BC59 Using the lessee's business purpose would have the advantage of reflecting a lease in a lessee's financial statements on the basis of how the lessee views its business purpose for entering into the lease. However, the boards rejected this approach for comparability reasons. Because leases would be classified based on each lessee's assessment of its business purpose, the judgement applied by management might vary by lessee. That would make it more difficult for users of financial statements to understand when and how management has applied its judgement when classifying leases, both within the same entity and between entities.
- BC60 Some board members supported the use of the principle in IAS 17. They view the primary improvement in this Exposure Draft to be the recognition of lease assets and lease liabilities. Those board members note that in the face of diverse views about the effects of the proposed right-of-use model on a lessee's profit or loss, a practical solution would be to retain the existing lease classifications. That approach would be familiar to preparers and would distinguish the effects of the model on a lessee's profit or loss based on the extent of the risks and rewards relating to the underlying asset conveyed through the lease.
- BC61 However, the boards decided against this approach, noting that the risks and rewards principle in IAS 17 was intended to distinguish between leases that are considered to be economically similar to the purchase of the underlying asset by the lessee and those that are not. The objective of this project is not to distinguish between leases that are economically similar to purchases and other leases.
- BC62 In addition, when determining how to classify leases, the boards wanted to identify leases for which presenting a single lease expense, recognised on a straight-line basis, would provide better information to users of financial

statements. The boards concluded that using the principle in IAS 17 would not achieve that objective for assets other than property. For example, if a lessee was to classify all leases that are operating leases in IAS 17 as Type B leases, a lessee would be likely to present a single lease expense for a 20-year lease of a vessel or an aircraft rather than presenting amortisation and interest on those transactions. In those situations, users of financial statements have indicated that it would improve financial reporting to not only recognise assets and liabilities for such leases, but also account for the leases on a basis similar to the purchase of property, plant and equipment that is financed. Accordingly, those users supported the presentation of amortisation and interest relating to those leases. Consequently, the boards rejected using the IAS 17 risks and rewards principle to classify all leases.

- BC63 Nonetheless, the boards decided to use some of the indicators supporting the principle in IAS 17 when classifying property leases because that would, in most cases, result in lease classification conclusions that reflect the consumption principle proposed by the boards when applied to leases of property (as described in paragraphs BC51–BC56).

The lessor accounting model

- BC64 Having concluded that the lessor's lease receivable and rights retained in the underlying asset both meet the definition of an asset (as described in paragraphs BC24–BC28), the boards considered whether requiring a lessor to recognise those assets for all leases would improve financial reporting to such an extent that the benefits from the improvements would outweigh the costs associated with such a change.
- BC65 When considering lessor accounting, the boards noted the importance of considering the accounting for the underlying asset. In contrast to the lessee accounting model, which needs to address only the lessee's rights and obligations arising from the lease, the lessor accounting model needs to address the accounting for the underlying asset as well as the lessor's rights and obligations arising from the lease. The accounting for the underlying asset could affect the assessment of the rights and obligations that should be recognised by the lessor.
- BC66 In the 2010 Exposure Draft, the boards proposed that a lessor would recognise a lease receivable for all leases. That is consistent with a lessee recognising a lease liability for all leases.
- BC67 If the lessor retained exposure to significant risks or benefits associated with the underlying asset, the boards proposed that a lessor would continue to recognise the underlying asset as its asset, as well as recognise a lease receivable. The lessor would also recognise a liability. This approach was described as the performance obligation approach in the 2010 Exposure Draft. Under this approach, the lease was considered to create an asset, the lease receivable, and a liability, the obligation to permit the lessee to use the underlying asset over the lease term. The asset and the liability created by the lease would be separate from the underlying asset itself. The lessor would retain control of the underlying asset and would continue to recognise it.

- BC68 If the lessor did not retain exposure to significant risks or benefits associated with the underlying asset, the boards proposed that a lessor would derecognise the portion of the underlying asset relating to the right-of-use asset transferred to the lessee and recognise the lease receivable. The rights retained in the underlying asset would be reclassified as a residual asset. That approach was described as the derecognition approach in the 2010 Exposure Draft.
- BC69 There was very little support for the performance obligation approach from respondents to the 2010 Exposure Draft or from participants at outreach meetings. Many viewed the approach as inappropriately inflating a lessor's assets and liabilities. Many questioned how one set of cash flows—the cash flows to be received from the lessee—could relate to both the lease receivable and the underlying asset. Many also questioned how the obligation to permit the lessee to use the asset would meet the definition of a liability. Having delivered the underlying asset to the lessee, the lessor would typically have nothing further to do in relation to the right-of-use asset other than comply with the terms and conditions of the contract. For many leases, the lessor must give the lessee 'quiet enjoyment' of the underlying asset, unless the lessee breaches the contract. Many respondents did not view complying with the terms and conditions of a contract as an obligation that should give rise to a liability. There would appear to be no expected outflow of future economic benefits from the lessor, which is an essential component of the definition of a liability.
- BC70 Some supported applying the derecognition approach to all leases. Others thought that the existing lessor accounting requirements were not 'broken' and questioned whether the benefit of changing lessor accounting would outweigh any costs associated with that change. Others were concerned about the lack of consistency between the lessee accounting proposals (a single lessee accounting model) and the lessor accounting proposals (a dual lessor accounting model) as proposed in the 2010 Exposure Draft. Many suggested that the boards make the lessor proposals consistent with the revenue recognition proposals, the lessee accounting proposals or, ideally, both.
- BC71 On the basis of this feedback, the boards decided to change the lessor accounting proposals as follows:
- (a) a lessor would determine the appropriate lessor accounting approach using the same classification requirements as are proposed for lessee accounting. The rationale used for having two different expense recognition patterns for the lessee would be the same as that used for having two different lessor accounting approaches (as described in paragraphs BC40–BC63).
 - (b) if a lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, the lessor would account for the transfer of the right-of-use asset to the lessee as the sale of that portion of the underlying asset that the lessee is expected to consume. Accordingly, the lessor would derecognise the underlying asset and recognise a lease receivable and a residual asset, which would be measured on a cost basis. The lessor would also recognise any profit relating to the lease at the commencement date.

- (c) if a lessee is not expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, the lessor would account for the lease similarly to existing operating lease accounting. Accordingly, the lessor would not derecognise the underlying asset and would recognise rental income over the lease term, typically on a straight-line basis.

BC72 As noted in paragraph BC24, at the commencement date, the lessor transfers the right to use the underlying asset to the lessee, which the lessee recognises as an asset. Although the lessor may have an obligation to provide other services to the lessee (for example, to maintain or service the asset), those obligations are separate from the lease itself and are accounted for separately (as described in paragraphs BC112–BC116). After making the underlying asset available for use by the lessee, the lessor has performed its obligation under the contract and has an unconditional right to receive lease payments from the lessee. Accordingly, to be consistent with the right-of-use model, a lessor would recognise a lease receivable.

BC73 However, the boards decided not to propose the recognition of a lease receivable and derecognition of a portion of the underlying asset for all leases, and in particular not for most property leases, for a number of reasons:

- (a) when the lessee is expected to consume very little, if any, of the economic benefits embedded in the underlying asset, the right-of-use asset transferred to the lessee does not represent the sale of any significant portion of the underlying asset (as described in paragraphs BC43–BC47). The lessor ‘loans’ the underlying asset to the lessee, allowing the lessee to use its asset during the lease term, subject to market constraints, and charges the lessee for that use on the basis of a desired return on its investment in the asset. The lessee then returns the asset to the lessor in virtually the same condition as it was at the commencement date. In that circumstance, the economic benefits embedded in the underlying asset are not expected to change to any real extent over the lease term because the lessor is expected to get back virtually the same asset that it gave up at the commencement date. Accordingly, the boards have concluded that when there is little or no consumption of the underlying asset (ie when the economic benefits embedded in the underlying asset are not expected to change significantly over the lease term), more useful information would be provided by continuing to recognise the underlying asset rather than by recognising a lease receivable and a residual asset, which would result in accounting for the lease as the sale of a portion of the underlying asset. A lessor would reflect better the economics of the transaction by recognising rental income over the lease term.
- (b) discussions with lessors indicate that there are two different lessor business models:
 - (i) the leasing activities of some lessors are primarily about providing finance to lessees. Such lessors would typically have no ongoing involvement with the underlying asset while it is the subject of a lease or, if they do, that involvement is priced

separately from the lease. Most equipment and vehicle lessors tend to have such a business model. The boards concluded that accounting for a lease as the sale of a portion of the underlying asset with financing would appropriately reflect such a lessor's business model.

- (ii) other lessors manage the underlying asset throughout the lease term and over the economic life of the asset. In those lessors' view, they are not primarily in the business of providing finance to lessees. Instead, their aim is to generate cash flows from the underlying asset on an ongoing basis by managing the asset over a period typically longer than any one lease term. Most property lessors tend to have such a business model. The boards concluded that accounting for a lease by recognising the lease payments received as rental income over the lease term would appropriately reflect such a lessor's business model.
- (c) the underlying asset in most property leases meets the definition of investment property in IAS 40 *Investment Property*. Lessors of investment property applying IFRS must either measure their investment property at fair value or, if measured at cost, disclose the fair value of the investment property. Some users of financial statements have confirmed that the fair value of an entire investment property gives them more useful information than other measurements. Rental income and changes in fair value are inextricably linked as integral components of the performance of the lessor and having both pieces of information (ie rental income and fair value changes) results in a lessor reporting performance in a meaningful way. Consequently, the boards concluded that the recognition of a lease receivable and a residual asset (measured on a cost basis), for each portion of an investment property leased to a different tenant, would not provide more useful information for investment property than what is provided under existing requirements.
- (d) the approach would be extremely complicated to apply when one asset is leased to multiple parties concurrently.

BC74 For those reasons, the boards decided not to propose any significant changes to the existing lessor accounting requirements for property leases.

Other approaches considered for lessor accounting

BC75 When developing the lessor accounting proposals, the boards considered a number of alternatives.

BC76 In the 2010 Exposure Draft, the boards proposed a performance obligation approach for some leases. On the basis of the feedback received from respondents (summarised in paragraph BC69), the boards rejected this approach when redeliberating those proposals.

BC77 The boards also considered a net asset and liability approach, in which the lessor would recognise a lease receivable and an obligation to permit the lessee to use the underlying asset, and present those amounts together on a net basis in the lessor's statement of financial position. Such an approach would address the

main concern raised by respondents about the performance obligation approach, namely that it would artificially inflate a lessor's assets and liabilities. However, the boards concluded that the benefits of applying such an approach did not outweigh the costs when compared with existing operating lease accounting. That is because the net asset and liability approach and operating lease accounting would result in a lessor recognising the same amounts in its statement of financial position and in profit or loss for virtually all leases currently classified as operating leases. However, the net asset and liability approach would be more complex and costly to apply.

BC78 The boards also considered whether to retain the existing lessor accounting requirements, ie operating lease accounting and finance lease accounting. Some respondents to the 2010 Exposure Draft had suggested that the existing lessor accounting requirements were not fundamentally flawed and would result in useful information. However, the boards concluded that proposing changes to the accounting for leases would improve financial reporting in the light of the changes being proposed to lessee accounting because of the following:

- (a) in the boards' view, the changes being proposed for lessors with leases of assets other than property will improve financial reporting. For example, a financial institution lessor (leasing equipment or vehicles) would be expected to recognise interest income over the lease term of all of its leases over 12 months, reflecting that the lessor is primarily engaged in providing finance to lessees. According to existing requirements, that lessor is likely to account for some of those leases as financing transactions (ie finance leases) and some as operating leases (recognising rental income on a straight-line basis, rather than interest income). In addition to recognising interest income, a manufacturer lessor (leasing equipment or vehicles) is likely to recognise revenue and cost of sales at the commencement date, similar to how the lessor recognises revenue and cost of sales on sales of similar assets. The manufacturer lessor would, however, only recognise revenue and profit relating to the right-of-use asset transferred to the lessee, rather than revenue and profit on the entire leased asset. That accounting would reflect that a manufacturer lessor often uses leasing as an alternative means of realising value from assets that it would otherwise sell. According to existing requirements, that lessor is likely to account for some of its leases as finance leases and some as operating leases resulting in very different accounting outcomes, even though it is likely to price all of its leases in a similar way.
- (b) without any change to lessor accounting, an entirely different rationale would be used to support the lessee and the lessor accounting proposals. Respondents to both the Discussion Paper and the 2010 Exposure Draft had requested consistency in the rationale supporting both the lessee and lessor models, with many noting subleases as a reason for this request.
- (c) it would be difficult, if not impossible, not to make *any* changes to lessor accounting in the light of the changes being made to lessee accounting, for example changes to variable lease payments and the definition of a

lease. Consequently, if any improvements could be made to lessor accounting, it would be appropriate to make those improvements at this time.

Scope (paragraphs 4–5)

- BC79 The Discussion Paper and the 2010 Exposure Draft set out the boards' preliminary view that the scope of the proposed requirements should be based on the scope of the existing leases requirements. For the FASB, that is Topic 840 in the Codification and for the IASB, it is IAS 17. Topic 840 applies to leases of property, plant and equipment. IAS 17 applies to all leases, with specified exclusions. Those exclusions result in a similar scope to that of Topic 840.
- BC80 In this Exposure Draft, the boards propose the following scope exceptions:
- (a) leases to explore for or use natural resources, such as minerals, oil and natural gas. That is because accounting practices for assets relating to exploration and evaluation are diverse and differ from the accounting for other types of assets. Furthermore, the accounting for assets related to the exploration and use of natural resources is specified in IFRS 6 *Exploration for and Evaluation of Mineral Resources* or Topic 930, Extractive Activities—Mining, and Topic 932, Extractive Activities—Oil and Gas.
 - (b) leases of biological assets (including plants and living animals), to ensure that requirements relating to biological assets are found in a single standard. Leases of timber are specifically excluded from the FASB's Exposure Draft to be consistent with the scope exclusion that currently exists in Topic 840. The scope exclusion for leases of timber is not necessary in the IASB's Exposure Draft because IAS 41 *Agriculture*, defines biological assets to include trees in a forest, which encompasses timber (before it is harvested).
 - (c) under IFRS, service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*. The IASB decided to clarify that service concessions are not within the scope of this Exposure Draft, consistent with the conclusions in IFRIC 12 that such arrangements do not meet the definition of a lease.

Intangible assets

- BC81 Consistently with the 2010 Exposure Draft, the FASB Exposure Draft proposes to exclude leases of intangible assets from its scope. The IASB Exposure Draft does not permit lessors, or require lessees, to apply the lease accounting proposals to leases of intangible assets. The boards acknowledged that there is no conceptual basis for excluding leases of intangible assets. However, the boards concluded that a separate and comprehensive review of the accounting for intangible assets should be performed before requiring leases of intangible assets to be accounted for under the proposed leases requirements. Many respondents to the 2010 Exposure Draft agreed with this proposal.
- BC82 IAS 17 excludes licensing agreements from its scope, rather than all leases of intangible assets. A few respondents to the 2010 Exposure Draft who apply IAS 17 to leases of intangible assets raised concerns about that scope exclusion,

which they interpreted as preventing the application of the proposed leases requirements to leases of intangible assets. They were of the view that applying the lease proposals would provide users of financial statements with better information about those types of transactions in the absence of any other requirements that specifically address the accounting for such leases.

- BC83 In response to that feedback, the IASB decided to clarify that a lessee need not apply the lease proposals to leases of intangible assets, rather than stating that such leases are excluded from the scope of this Exposure Draft. That is because the IASB did not want to prevent a lessee from applying the proposals to leases of intangible assets. In the IASB's view, a lessee could apply the proposals to leases of intangible assets by applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, in the absence of another standard that includes specific requirements on leases of intangible assets. That would not be the case for a lessor, because the revenue recognition proposals specifically address the accounting for leases of intangible assets from a lessor's perspective.

Onerous contracts

- BC84 The IASB's 2010 Exposure Draft proposed that a lessee should apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to leases between the date of inception and the commencement date, if the lease meets the definition of an onerous contract in IAS 37. The IASB did not consider it necessary to develop separate requirements for such contracts, and directed entities to apply IAS 37 if the contract is onerous. Except for short-term leases, after the commencement date, the costs of meeting an obligation under the lease and the economic benefits expected from the lease would be accounted for according to the proposals in this Exposure Draft. Accordingly, the lease proposals, and not IAS 37, would apply to a lease from the commencement date.
- BC85 On reconsideration, the boards confirmed those conclusions that, if a lease is onerous between the date of inception and the commencement date, an entity should account for it in accordance with IAS 37 or Topic 450, *Contingencies*. The boards decided not to include any particular exclusion for such onerous contracts in the scope section of this Exposure Draft because it would potentially be misleading. The proposals include a requirement to disclose information about leases before the commencement date if they create significant rights and obligations for the lessee. In addition, the boards noted that an entity would be required to apply the requirements in other IFRSs or US GAAP in any event, without the need to mention it specifically in this Exposure Draft.

Subleases

- BC86 In the boards' view, leases of right-of-use assets (ie a sublease) should be accounted for in the same way as other leases. Accordingly, this Exposure Draft proposes that subleases are within its scope.
- BC87 In addition, the boards decided that an entity should account for a head lease and a sublease as two separate contracts. Even if entered into at close to the same date, each contract is generally negotiated separately, with the counterparty to the sublease being a different entity from the counterparty to

the head lease. Because of this, the obligations that arise from the head lease for the lessee are generally not extinguished by the terms and conditions of the sublease.

- BC88 The boards decided that, when classifying a sublease, an entity should evaluate the lease with reference to the underlying asset, rather than the right-of-use asset arising from the head lease. A lessee in a sublease may not know the terms and conditions of the head lease and, accordingly, the proposed approach should be easier to apply than referring to the right-of-use asset arising from the head lease. In addition, the boards noted that it may be difficult to understand and explain why a lessor would account for similar leases differently. That could occur if an entity were required to refer to the right-of-use asset when classifying a sublease. For example, if subleases were classified with reference to the right-of-use asset, a lessor that leases two similar properties on similar terms for five years could account for those leases differently if the lessor owned one of the properties and leased the other.

Inventory

- BC89 The 2010 Exposure Draft did not specifically exclude leases of inventory from its scope. Some respondents questioned whether what is sometimes referred to as 'leased inventory' would be within the scope of the lease proposals. 'Leased inventory' is sometimes used to describe purchases of non-depreciating spare parts, operating materials, and supplies that are associated with leasing another underlying asset. The boards decided not to specifically exclude leases of inventory from the scope of this Exposure Draft. The boards note that few of these transactions, if any, would meet the definition of a lease and therefore a scope exception would not be necessary. In addition, in the boards' view, it is unlikely that an asset will simultaneously meet the definition of an underlying asset and inventory from a lessee's perspective. That is because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by another party) for sale in the ordinary course of business, or for consumption in the process of production for sale in the ordinary course of business.

Non-core assets

- BC90 Assets that are not essential to the operations of an entity are sometimes of less interest to users of financial statements because those assets are often less material to the entity. Accordingly, the costs associated with recognising and measuring the assets and liabilities arising from leases of non-core assets could outweigh the benefits to users. For example, information about assets and liabilities arising from the lease of a delivery van is important to assess the operations of a delivery company, but it may not be important in assessing the operations of a financial institution which uses the van to deliver stationery to its retail banking locations. Consequently, the boards considered whether to exclude leases of non-core assets from this Exposure Draft.
- BC91 Although some board members favoured such an approach, the boards noted the following difficulties with excluding leases of non-core assets from the scope of the proposals:

- (a) defining 'core' and 'non-core' would be extremely difficult. For example, would office buildings used by a financial institution be a core asset, and would the conclusion be different if the financial institution has retail banking operations? Would an entity consider some offices or cars to be core assets and others non-core? If core assets were defined as those essential or crucial to the operations of an entity, it could be argued that every lease would be a lease of a core asset. Otherwise, why would an entity enter into the lease?
- (b) different entities might interpret the meaning of non-core assets differently, thereby reducing comparability for users of financial statements.
- (c) neither IFRS nor US GAAP distinguish core and non-core purchased assets for the purposes of recognition. Because of that, it would be difficult to justify distinguishing a right-of-use asset relating to a core asset from one that relates to a non-core asset.

BC92 Consequently, the boards are not proposing any distinction in accounting on the basis of whether the underlying asset is core to an entity's operations.

Long-term leases of land

BC93 A long-term lease of land is sometimes regarded as being economically similar to the purchase or sale of the land and, therefore, some suggested that such leases should be excluded from the scope of this Exposure Draft. However, the boards are not proposing to specifically exclude long-term leases of land from the scope of this Exposure Draft for the following reasons:

- (a) there is no conceptual basis for differentiating long-term leases of land from other leases. If the contract does not transfer control of the land to the lessee but gives the lessee the right to control the *use* of the land throughout the lease term, the contract is a lease and should be accounted for as such;
- (b) inevitably, any definition of a long-term lease of land would be arbitrary; and
- (c) a very long term lease of land (for example, a 99-year or 999-year lease) could be classified as a Type A lease because the present value of the lease payments could represent substantially all of the fair value of the land. In this case, the accounting applied by the lessee and lessor would be similar to accounting for the purchase or sale of the land.

Leases of investment property at fair value (IASB-only)

BC94 The IASB's 2010 Exposure Draft proposed to exclude leases of investment property measured at fair value from its scope. That was because investment property analysts had informed the IASB that the requirements in IAS 40 provide useful information about the leasing activities of a lessor, especially when the fair value model is used. In particular, analysts said that both total rental income and fair value changes are important measures of performance of the lessor. Analysts would no longer have obtained total rental income information under the lessor accounting proposals in the 2010 Exposure Draft.

- BC95 This Exposure Draft, however, does not exclude leases of investment property from its scope because of the changes proposed to the lessor accounting model, and because most leases of investment property are expected to be classified as Type B leases. For Type B leases, the IASB proposes that a lessor of investment property applying IFRS would apply IAS 40 when accounting for its investment property, and apply the proposed leases requirements when accounting for the lease. That is similar to how IAS 17 and IAS 40 currently interact. Accordingly, a user of financial statements would obtain fair value information about the investment property, which is required by IAS 40, and information about rental income earned by the lessor, which is required by this Exposure Draft.

Embedded derivatives

- BC96 The boards considered whether an entity should be required to account for embedded derivatives within a lease separately, as it does in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* or Topic 815, *Derivatives and Hedging*. The boards noted that some variable lease payments that depend on an index or a rate, which the boards propose to include in the measurement of lease payments, could meet the definition of an embedded derivative.
- BC97 The proposals would not, in themselves, require variable lease payments that depend on an index or a rate to be measured at fair value. If the boards did not retain the current requirements to account for embedded derivatives separately, unrelated derivative contracts could be bundled with leases to avoid measuring such embedded derivatives at fair value. Consequently, the boards decided to retain the requirement to assess leases for embedded derivatives and, if they exist, to require the embedded derivatives to be separated from the lease and accounted for in accordance with IAS 39, IFRS 9 or Topic 815.

Costs incurred relating to the construction or design of an underlying asset

- BC98 The 2010 Exposure Draft did not address issues specific to contracts often referred to as 'build-to-suit' leases. Some respondents to the 2010 Exposure Draft questioned whether requirements on build-to-suit leases should be included in the leases proposals.
- BC99 Existing US GAAP provides requirements relating to a lessee's involvement in the construction of an asset that the lessee will lease when constructed (such contracts are typically build-to-suit leases). Those requirements were initially written to address situations in which a lessee might attempt to keep assets 'off balance sheet' by leasing an asset that it had constructed but avoiding applying the sale and leaseback requirements that would typically require the lessee to recognise the asset. In such transactions, the lessor would sometimes be a variable interest entity.
- BC100 The boards considered but decided not to carry forward the requirements in US GAAP to this Exposure Draft on how to account for costs incurred by a lessee relating to the construction or design of an asset for the following reasons:

- (a) costs incurred relating to the construction or design of an asset would not meet the definition of lease payments or initial direct costs. Consequently, in the absence of specific requirements relating to a lessee's involvement in the construction of an asset, the lessee would apply other applicable IFRSs or US GAAP to determine how to account for those costs. For example, the lessee would consider whether to apply the requirements on inventory or property, plant or equipment or financial instruments when accounting for the costs incurred. In turn, the lessee may consider whether the lessor is a customer and, consequently, whether to apply the revenue recognition requirements. If the lessee controls the underlying asset before the commencement date, the lessee would then apply the sale and leaseback requirements when accounting for the transaction. The boards noted that this approach would result in a lessee accounting for costs incurred relating to the construction of an asset consistently with how other entities account for similar costs, and consistently with how the lessee accounts for similar costs not associated with a lease.
- (b) the existing requirements were written to address 'off balance sheet' concerns at a time when leases classified as operating leases were not recognised in a lessee's statement of financial position. The boards noted that the changes proposed in this project to require a lessee to recognise lease assets and lease liabilities and the changes proposed to sale and leaseback accounting, together with more recent changes to the consolidation requirements for variable interest entities in both IFRS and US GAAP, would reduce the need for specific requirements in this area. For example, regardless of whether the lessee is considered to control the asset during construction, the lessee will recognise a right-of-use asset at the commencement date.
- (c) this decision is consistent with the boards' proposals on sale and leaseback transactions, which would eliminate the requirements in US GAAP that would often prevent sale and leaseback accounting for many real estate transactions. Instead, an entity would apply the revenue recognition proposals to sale and leaseback transactions to determine whether a sale has occurred (as described in paragraphs BC285–BC292).

BC101 Nonetheless, on the basis of the feedback received from some respondents, the boards decided that it would be helpful to specifically state in this Exposure Draft that a lessee would apply other applicable IFRSs or US GAAP when accounting for costs incurred relating to the construction or design of an underlying asset.

Identifying a lease

Definition of a lease (paragraphs 6–19)

BC102 The 2010 Exposure Draft retained the existing definition of a lease and the requirements included in IFRIC 4 *Determining whether an Arrangement contains a Lease* and in Topic 840, but with some minor changes to the wording of those

requirements. Those requirements require an entity to determine whether a contract contains a lease by assessing whether the fulfilment of the contract depends on the use of a specific asset (the underlying asset), and the contract conveys the right to control the use of the underlying asset to the lessee.

BC103 Respondents to the 2010 Exposure Draft, as well as participants at workshops in 2010, expressed the following concerns about the proposed definition of a lease:

- (a) although respondents generally agreed with the definition of a lease as the right to use an asset, many were concerned that the requirements supporting the definition would capture contracts that they perceived to be service contracts.
- (b) some common contracts were identified as being difficult to assess under the existing requirements (for example, season tickets for sporting events, outsourcing contracts, charter arrangements in the shipping and oil and gas industries and power purchase arrangements). Respondents noted that the distinction between a lease and a service is not so critical under existing requirements because the accounting for operating leases and services is the same. That would change, however, under the proposals for which meeting the definition of a lease results in a lessee recognising lease assets and lease liabilities.
- (c) questions were raised about how to apply some of the existing requirements. For example, could the underlying asset be a portion of a larger asset and, if so, when? How would one interpret 'output' when there were outputs that had economic value but were not physical (for example, renewable energy credits)? There are difficulties in applying the pricing criteria in IFRIC 4 and in Topic 840 in a number of situations.
- (d) some questioned why the control criteria used to define a lease were different from the control principle being proposed in the Revenue Recognition project.

BC104 The boards decided to retain the definition of a lease in IFRIC 4 and Topic 840. They also affirmed that considering whether the customer (lessee) obtains the right to control the use of an underlying asset would be an appropriate way to determine whether a contract contains a lease. However, the boards decided to change the proposed application guidance supporting the definition to align the concept of control more closely with the control principle in the Revenue Recognition project and in consolidation requirements and to address practice issues that were raised about the definition of a lease in IFRIC 4 and Topic 840.

BC105 More specifically, the boards decided the following about the definition of a lease:

- (a) to retain the requirement that fulfilment of the contract must depend on a specified or an identified asset. The boards considered whether the requirement should be changed to widen the definition to incorporate the right to use an asset of a particular specification. However, having considered feedback from participants at targeted outreach meetings, the boards decided to retain the current requirement for the following reasons:

- (i) being able to identify *an* asset, rather than one of a number of assets of a particular specification, is fundamental to the definition of a lease. It is necessary to know what the asset is to assess whether the customer has the right to control the use of that asset, classify the lease and determine which asset to derecognise for lessors with Type A leases.
 - (ii) in most contracts for which there is no identified asset, the customer does not have the right to control the use of an asset. Consequently, widening the definition in that respect would possibly have forced some entities to go through the process of assessing whether the customer obtains the right to control the use of an asset, only to conclude that it does not. That would potentially have increased costs for little benefit.
 - (iii) the boards were informed that the current requirements on specified assets work well in practice.
- (b) to enhance the requirements on the substitutability of an asset. If a supplier has a substantive right to substitute the underlying asset at any time during the term of the contract, in the boards' view, the contract does not contain a lease. That is because a customer would be unable to control the use of an asset if the supplier can replace the asset without requiring the customer's consent (requiring the customer's consent to enter the customer's premises would not, however, prevent the supplier from having substantive substitution rights). The boards have included additional language to help determine when substitution rights are substantive. Their intention in doing so is to discourage the insertion of a substitution clause in a contract which does not change the substance or character of the contract, solely to achieve a particular accounting outcome. If a substitution clause is not substantive because it does not, for all intents and purposes, change the substance of the contract, that substitution clause should not affect an entity's assessment of whether a contract contains a lease.
- (c) to clarify that an underlying asset must be physically distinct. Consequently, an underlying asset can be a physically distinct portion of a larger asset. It cannot, however, be a capacity portion of a larger asset because that capacity portion is not physically distinct from the remaining capacity of that asset. The boards concluded that it would be unlikely that a customer would have the right to control the use of a capacity portion of a larger asset (for example, a 20 per cent capacity portion of a pipeline). That is because decisions about the use of the asset are typically made at the larger asset level. For example, a customer taking only 20 per cent of the capacity of an asset would be unlikely to have the ability to make those decisions. Widening the definition to possibly capture portions of a larger asset that are not physically distinct might have forced entities to consider whether they lease assets used to fulfil any contract for services, only to conclude that they do not. Consequently, the boards concluded that widening the definition to include capacity portions of a larger asset would increase

complexity with little benefit. Nonetheless, the boards noted that if a customer has the ability to obtain substantially all of the economic benefits from use of an asset, the larger asset is then considered to be an identified asset and the contract would contain a lease if the customer has the right to control the use of that asset.

- (d) to change the application guidance for ‘the right to control the use of an asset’ to be more consistent with the concept of control applied in other requirements and projects (ie the consolidation requirements and revenue recognition proposals). According to the existing requirements on the definition of a lease, a customer can have the right to control the use of an asset solely on the basis of obtaining substantially all of the output from an asset, assuming that the contract is priced in a particular way. This defines ‘control’ based on a ‘benefits’ element only. The revenue recognition proposals and consolidation requirements, however, define control to require both a ‘power’ element as well as a ‘benefits’ element. The boards decided to change the application guidance to require a customer to have not only the right to obtain substantially all of the economic benefits from use of an asset during the lease term (a ‘benefits’ element) but also the ability to direct the use of that asset (a ‘power’ element). The boards concluded that, to have the right to control the use of an asset, a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from the use of the asset. Without any such decision-making rights, the customer would have no more control over the use of the asset than any customer purchasing services. If this were the case, the customer would not control the use of the asset. The change to control will narrow the scope of the proposals. Some contracts that were previously considered to be leases would no longer meet the definition. The change also removes the need to have pricing criteria, which had proved difficult to apply in practice.
- (e) to clarify that only the benefits arising from *use* of an asset, rather than the benefits arising from *ownership* of that asset, should be considered when assessing whether a customer has the ability to derive the benefits from use of an asset. That is because a lease does not convey ownership of an underlying asset; it conveys only the right to use that underlying asset. Accordingly, the boards concluded that a customer should not consider benefits relating to ownership of an asset (for example, tax benefits as a result of owning an asset), when considering whether a contract contains a lease. However, the boards concluded that a customer should consider benefits relating to the use of the asset (for example, renewable energy credits received from the use of an asset) when considering whether a contract contains a lease.
- (f) to include additional language addressing assets that are incidental to the delivery of services. Respondents to the 2010 Exposure Draft were concerned that the definition of a lease might capture service contracts when the delivery of the service involves the use of particular assets that could be viewed as being under the control of the customer (for example, a season ticket at sporting venues and a contract for cable television

services). The boards decided to clarify that when the use of an asset is an inseparable or non-distinct part of the overall services being provided to a customer, the customer does not obtain the right to control the use of the asset—ie the customer is unable to derive benefits from the use of the asset when the asset has no value or use to the customer without the other deliverables in the contract. Instead, the customer receives services over the term of the contract that require the use of the asset. The boards note that this is consistent with the proposals in the Revenue Recognition project. In that project, the boards concluded that, for example, a seller would not generally recognise revenue relating to the delivery of a good that is not distinct from other services in the contract.

- (g) to make some other minor modifications to the requirements to address practice issues raised relating to the existing requirements.

BC106 In the boards' view, the proposed changes about the definition of a lease provide a sound basis on which to determine whether a contract contains a lease. The boards decided to include guidance and examples to help entities apply the proposed principle.

Cancellable leases

BC107 The 2010 Exposure Draft stated that a lease is a contract. However, it did not include a definition of a contract. In addition, in the light of the boards' proposals on lease term and short-term leases, some stakeholders raised questions about how to account for leases that are often referred to as 'cancellable', 'month-to-month', 'at-will', 'evergreen', 'perpetual' or 'rolling'. Examples of such contracts include (a) a lease that runs from the date of signing until further notice and in which both the lessee and lessor have the right to cancel with one month's notice, and (b) a lease that has an initial non-cancellable period of one year but that can be extended for another year if that is agreed to by both the lessee and the lessor before the end of the initial non-cancellable period.

BC108 For the purposes of defining the scope of the leases proposals, the boards decided that a contract would exist only when it creates rights and obligations that are *enforceable*. Any initial non-cancellable period or notice period in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. To meet the proposed definition of a contract, any options to extend or terminate the lease that are included in the lease term must also be enforceable, for example the lessee must be able to enforce the extension of the lease beyond the non-cancellable period. If optional periods are not enforceable, for example if the lessee cannot enforce the extension of the lease without the agreement of the lessor, the lessee does not have the right to use the asset beyond the non-cancellable period. Consequently, by definition, there is no contract beyond the initial non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. Nonetheless, when assessing the enforceability of a contract, an entity should consider whether the lessor can, by law, refuse to agree to a request from the lessee to extend the lease.

- BC109 For leases for which both the lessee and lessor must agree to extend the lease beyond the non-cancellable period, the maximum term of the lease would be the non-cancellable period plus any notice period. Accordingly, if the non-cancellable period plus any notice period is less than 12 months, that lease would meet the definition of a short-term lease. In contrast, if only one of the parties to the lease has the right to terminate the lease, or if the lessee has the right to extend the lease without the agreement of the lessor, there are enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease would be required to include those optional periods in their assessment of the term.
- BC110 The boards considered whether applying enforceability to leases in this way might encourage entities to add a clause to a lease stating that the lease could be cancelled at any point, knowing that, in practice, it would not. However, the boards are of the view that this will not be the case because there often is an economic disincentive for the lessor or lessee to agree to do so. That is because the inclusion of such a clause is likely to affect the pricing of a lease. For example, if a lessor has priced a contract assuming that the lessee will not cancel the contract, including such a clause would put the lessor at risk of being exposed to higher residual asset risk than has been anticipated when pricing the contract. In contrast, if the lessor has priced the contract assuming that the lessee will cancel the contract, the lessee would be likely to have to pay higher rentals to compensate the lessor for taking on more residual asset risk, and there would be no economic incentive to do so if the lessee does not intend to cancel the contract.
- BC111 In the light of the questions raised, the boards decided to include the definition of a contract and requirements on cancellable leases in this Exposure Draft.

Separating components of a contract (paragraphs 20–24)

- BC112 Many contracts contain both lease and non-lease (service) components, such as a contract for a car lease that is combined with maintenance services. In addition, there are contracts that contain multiple lease components, such as a lease of a port that can incorporate the lease of land, buildings and equipment.
- BC113 Existing leases requirements provide limited guidance on how to separate lease components and non-lease (service) components of a contract, even though that separation is required. Because the boards' proposals result in lease components of a contract being accounted for differently from non-lease components, the boards decided to provide expanded guidance on how entities should account for contracts that contain both lease components and non-lease components.
- BC114 The 2010 Exposure Draft proposed that an entity should separately account for non-lease components of a contract if those components are distinct and the entity is able to separate those components, although the IASB's and the FASB's proposals were different for lessors in particular situations. That Exposure Draft included guidance to help determine when the non-lease components of a contract would be distinct.
- BC115 Almost all respondents agreed that an entity should separate lease components of a contract from non-lease components, noting that the boards' proposals

should be applied only to the lease components of a contract. However, many of those respondents found the proposals confusing or they disagreed with some aspects of those proposals. Some were concerned that, although similar, the notion of distinct in the leases proposals was not the same as the notion of distinct in the revenue recognition proposals. Others disagreed with the proposal to account for the entire contract as a lease if non-lease components were not distinct. In particular, some were concerned that property-related costs, such as maintenance, property tax, utilities and insurance, would be considered to be non-distinct and would be included as part of the cost of the right-of-use asset. Others thought it was not helpful to have differing proposals under IFRS and US GAAP in this respect.

BC116 Consequently, the boards have changed the proposals on lease components and non-lease components in the following way and for the following reasons:

- (a) the objective of the project is to propose changes to the accounting for leases; it is not to propose changes to the accounting for services. The new proposals should, therefore, apply only to the lease component(s) of any contract. The accounting for services (or the service component of a contract) should be the same, regardless of whether the contract is only for services or includes the purchase, or lease, of an asset as well as services. Accordingly, the boards are proposing that both a lessee and a lessor should separate each lease component from non-lease components of a contract. That is consistent with the boards' proposals in the Revenue Recognition project to allocate the consideration in a contract to separate performance obligations.
- (b) this Exposure Draft includes requirements for determining whether a contract that contains a lease has only one lease component or multiple lease components. Those requirements are based on the requirements included in the Revenue Recognition project on the identification of separate performance obligations. The boards noted that the identification of separate lease components in a lease contract is similar to the identification of separate performance obligations in a revenue contract—in both circumstances, an entity is trying to identify whether a customer or a lessee is contracting for a number of separate deliverables or contracting for one deliverable that may incorporate a number of different assets. Accordingly, rather than developing new requirements addressing how to identify separate lease components, the boards decided that providing requirements similar to those in the revenue recognition proposals on the identification of separate performance obligations would work well in this respect within the leases proposals.
- (c) in the boards' view, it is not necessary to distinguish between distinct and non-distinct components when separating lease and non-lease components of a contract in the light of the changes proposed to the definition of a lease. A contract is unlikely to contain a lease if non-lease or service components of a contract are not distinct (as defined in the 2011 Exposure Draft *Revenue Recognition*). That is because, when service components are not distinct, a customer is unlikely to have the right to control the use of an asset. In that situation, the supplier would typically

control the use of any assets used to deliver the overall service contract to the customer (as described in paragraph BC105(f)).

- (d) lessors are required to separate lease components and non-lease components of a contract. In the boards' view, a lessor should always be able to separate payments made for lease and non-lease components because it would need to have information about the value of each component, or a reasonable estimate of it, when pricing the contract. In addition, many lessors indicated in response to the 2010 Exposure Draft that they would be able to do so. The boards decided to require a lessor to allocate the consideration in a contract to lease components and non-lease components in accordance with the revenue recognition proposals to ensure consistency for entities that are both a lessor and a seller of goods or services in the same contract. The boards concluded that the approach applied by a lessor should be no different from how a seller would allocate consideration in a revenue contract with separate performance obligations.
- (e) the boards are proposing a hierarchy of requirements that a lessee would follow when allocating consideration to different components of a contract. According to these requirements, a lessee would be required to obtain observable stand-alone prices for each component if possible, and allocate any remaining consideration to components without observable prices. In setting a threshold that must be met to separate lease components and non-lease components, the boards did not wish the threshold to be so high that a lessee would find it too difficult, or could choose whether, to separate lease components and non-lease components. Accordingly, observable is not limited to being lessor-specific, and obtaining the price of similar leases, goods or services is sufficient (ie observable does not mean that a lessee is required to obtain the stand-alone price of an identical lease, good or service component). Nonetheless, the boards concluded that it would not be appropriate to always require a lessee to separate lease components and non-lease components. In the boards' view, the cost of obtaining the information required to separate non-lease components that do not have observable prices would outweigh the benefit for the lessee.

Distinguishing between a lease and a sale

- BC117 The 2010 Exposure Draft proposed some guidance to allow entities to distinguish a sale from a lease. There was little support for the guidance from respondents, with many finding it confusing and noting that it would not be necessary if the boards defined a lease appropriately.
- BC118 In the light of those comments, the boards decided that this Exposure Draft would not provide requirements for distinguishing a lease from the sale of an asset. The proposals apply to any contract that conveys the right to use an underlying asset for a period of time. They do not apply to transactions for which control of the underlying asset is transferred to the lessee—such transactions are sales within the scope of other IFRSs or US GAAP (for example, the requirements for property, plant and equipment and revenue recognition).

Distinguishing between a lease and the sale of an asset is less critical in the light of the boards' proposals on lessee and lessor accounting. Those decisions mean that the accounting for leases that are economically similar to the sale of the underlying asset would be accounted for in a similar way to the sale of that asset; ie when a lease is such that the lessee consumes substantially all of the underlying asset, the lessee would account for it similarly to the purchase of an asset that is financed, and the lessor would account for it similarly to the sale of an asset for which the consideration is paid over time.

Classification of leases

BC119 As discussed in paragraphs BC50–BC63, the boards decided that an entity should apply the classification principle on a lessee's expected consumption of the economic benefits embedded in the underlying asset on the basis of the nature of the underlying asset (ie property or assets other than property). In order to achieve classification conclusions that more closely reflect the classification principle, this Exposure Draft proposes, however, that an entity would also assess the lease relative to the economic life and fair value of the underlying asset.

Determining whether the underlying asset is property or an asset other than property

BC120 Some leases, either directly or indirectly, convey the right to use more than one asset, for example, the lease of a turbine that is housed inside a building. When one lease component contains the lease of property (ie land or a building), as well as the lease of assets other than property, it can be difficult to determine whether the lease should be considered to be a property lease or a lease of an asset other than property. That distinction is important for lease classification.

BC121 In discussing the classification of leases, the boards first decided that an entity should not be required to subdivide one lease component into multiple elements. Such a requirement could be very onerous to apply and thus would increase costs. In addition, any subdivision within one lease component could be artificial because a lessee can benefit only from the use of the assets within the component as a whole and not individually.

BC122 Second, the boards decided that an entity should determine whether the underlying asset is property or an asset other than property on the basis of the nature of the primary asset within a lease component. The primary asset within a lease component is the predominant asset for which the lessee has contracted for the right to use. The main purpose of any other assets that form part of the lease component is often to facilitate the lessee obtaining benefits from the use of the primary asset. The boards note that, for most leases, this would be a relatively straight-forward assessment—ie it is a qualitative assessment that would require entities to conclude on the most important element of a lease, which should be relatively clear for most leases. The boards also noted that if an entity is unable to identify the primary asset, it may indicate that there is more than one lease component in the contract, which should each be classified and accounted for separately.

The economic life of the underlying asset

- BC123 When classifying both property leases and leases of assets other than property, this Exposure Draft proposes that an entity should assess the lease term relative to the economic life of the underlying asset.
- BC124 When classifying leases of property, the boards decided that an entity would assess whether the lease term is for a major part of the *remaining* economic life of the underlying asset at the commencement date. The boards decided to do so to ensure that longer-term leases of property that are entered into primarily for financing purposes would be classified as Type A leases. Without requiring the assessment of the lease term relative to the remaining economic life of the property, an entity may have classified a lease that is economically similar to purchasing the building as a Type B lease. That could have been the case if, for example, the lease were to include significant variable lease payments. The boards concluded that it would be inappropriate for a lease of a building that is economically similar to the lessee purchasing the building to be classified as a Type B lease.
- BC125 The boards decided, however, that when classifying leases of assets other than property, an entity should assess whether the lease term is for more than an insignificant part of the *total* economic life of the underlying asset (ie the expected economic life of the underlying asset at lease commencement assuming the asset was new at that date) for the following reasons:
- (a) one of the benefits of the proposed changes to lessor accounting is that the accounting would more closely reflect the business model of many lessors. Some lessors of equipment, such as a lessor of the rail cars described in (b) below, manage the assets that they lease over the economic life of the equipment, leasing the asset for relatively short periods to different lessees numerous times over the life of the asset. Such lessors are of the view that they are not primarily in the business of providing finance to lessees. Instead, their aim is to generate cash flows from the equipment on an ongoing basis by managing the asset over a period typically longer than any one lease term, similarly to many property lessors. Accordingly, if the lease is not for more than an insignificant part of the total economic life of the asset, the lessor would apply accounting that more closely reflects its business model by continuing to recognise the underlying asset and recognising rental income over the lease term, regardless of the age of the asset being leased.
 - (b) when the underlying asset is equipment or vehicles, a lessee would be expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset for a large proportion of leases of such assets, for example a four-year lease of a truck that has a 10-year economic life. However, there are some leases of longer-lived equipment or vehicles for which that would not be the case, for example, a four-year lease of a rail car that has a 50-year economic life. If the economic life criterion referred to the remaining economic life of the asset, a lessee would be required to know how old the rail car is at the commencement date, and may be required to account for a four-year

lease of a new rail car differently from a four-year lease of, for example, a 25-year old rail car. The boards concluded that a lessee should account for leases of equipment or vehicles with the same lease term consistently because it would provide more useful information in these situations.

- BC126 The boards considered whether interpreting 'economic life' to be the total, and not the remaining, economic life of the underlying asset that is not property would create opportunities to classify a lease as a Type B lease (and achieve a straight-line income statement recognition pattern) when it would be inappropriate to do so. In the boards' view, this is not a significant risk because for leases of equipment and vehicles, the lease still needs to be for an insignificant part of the total economic life of the leased equipment or vehicle to be classified as a Type B lease. An 'insignificant part' is a relatively small portion of the life of such an asset and relatively few leases of equipment or vehicles would be expected to be for an insignificant part of the life of such assets.

Reassessment of the classification of leases

- BC127 The boards decided that, after classifying a lease at the commencement date, an entity would not reassess that classification. Even though the lease term can change after lease commencement, the boards do not expect it to change frequently because it would require a change (from factors other than changes in market conditions) in whether the lessee has or does not have a 'significant economic incentive' to exercise an option to extend a lease, which is a relatively high hurdle. In addition, a change in the lease term may not result in a change to the classification of a lease even if an entity was required to reassess the classification of leases. For example, changing the lease term of a property lease from 10 years to 15 years may not change the classification of that lease even if reassessment of the classification was required. Accordingly, the boards concluded that there would be little benefit in adding complexity to the requirements that, in practice, would be expected to have little effect.

Recognition and the date of initial measurement

Inception versus commencement of a lease

- BC128 The 2010 Exposure Draft proposed that a lessee and a lessor recognise lease assets and lease liabilities at the commencement date of a lease but initially measure those assets and liabilities at the date of inception of the lease.
- BC129 Respondents to the 2010 Exposure Draft generally agreed that the commencement date is the appropriate date on which to recognise lease assets and lease liabilities. Although for most leases, the time between the date of inception and the commencement date is usually short, some respondents noted that there are contracts for which that is not the case (for example, some leases are signed before the underlying asset is constructed). When that is the case, the proposals raised a number of questions:
- (a) how should an entity account for any changes to the terms and conditions of the lease between the date of inception and the commencement date?

- (b) should an entity account for the time value of money, changes in indexes, and changes in the fair value of the underlying asset between the date of inception and the commencement date? If so, how?

- BC130 Recognising assets and liabilities arising from a lease at the commencement date is consistent with the proposed right-of-use model, in which a lessee recognises an asset representing its right to use an underlying asset for the period of the lease and a liability representing its obligation to make lease payments. A lessee does not obtain and control its right to use the underlying asset until the commencement date, ie the date on which the lessor makes the underlying asset available for the lessee's use. Before that date, the lessor has not yet performed under the contract. Although a lessee may have an obligation to stand ready to make lease payments if the lessor performs under the contract, the lessee is unlikely to have an obligation to make lease payments before the asset is made available for its use. Similarly from the lessor's perspective, although the lessor may have an obligation to stand ready to deliver the right to use the underlying asset from the date of inception, the lessor is unlikely to have a right to receive lease payments before the asset is made available for the lessee's use. Nonetheless, an entity could have an onerous contract liability before the commencement date, which should be accounted for consistently with other onerous contracts.
- BC131 On the basis of the feedback received, the boards decided to change the date of initial measurement to the commencement date so that entities would initially recognise and measure lease assets and lease liabilities at that date. The boards noted that their intentions for initial measurement of lease assets and lease liabilities were that the measurement would reflect the nature of the transaction and the terms and conditions of the lease. That would require an entity to look to the terms and conditions agreed to in the contract at the date of inception. However, the boards had not intended that an entity would recognise a gain or loss relating to changes between the dates of inception and commencement when recognising lease assets and lease liabilities at the commencement date.
- BC132 In reaching that decision, the boards noted that aligning the date of recognition with the date of initial measurement has the following benefits:
- (a) it clarifies that, other than any gain or loss to be recognised by a lessor with Type A leases, a gain or loss should not arise on initial recognition of lease assets and lease liabilities by a lessee or a lessor.
- (b) it removes the need to add requirements (and thus potentially reduces complexity) on how to account for changes to the terms and conditions of a lease, or assumptions used in measuring lease assets and lease liabilities, between the date of inception and the commencement date. Any changes to a lease that occur after the date of inception are taken into account when initially measuring the asset and liability at the commencement date.
- (c) it clarifies that an entity would capitalise initial direct costs incurred before the commencement date. Some respondents to the 2010 Exposure Draft had noted that the previous proposals on initial

measurement implied that an entity would not be permitted to capitalise any initial direct costs incurred after the date of inception.

- (d) it is more consistent with the measurement date for other transactions, such as business combinations and the acquisition of property, plant and equipment.

BC133 Despite the changes to the proposed date of initial measurement, the boards noted that for some leases the rights and obligations that arise from signing a lease could be significant. Without any disclosure, a user of financial statements would have no information about those rights and obligations before the commencement date (assuming that the entity did not have an onerous contract liability). Accordingly, this Exposure Draft proposes that a lessee should disclose information about leases that create significant rights and obligations between the date of inception and the commencement date. Those disclosures would inform users of financial statements of significant cash commitments made relating to leases for which assets and liabilities would be recognised by the lessee in future periods.

Measurement: lessee

Measurement bases of the lease liability and the right-of-use asset (paragraphs 38–53)

BC134 The boards decided to propose a cost measurement basis for the lease liability and right-of-use asset, with cost measured at the present value of the lease payments. The boards concluded that this would provide the most useful information to users of financial statements while minimising costs as compared with other approaches.

BC135 The boards considered whether to refer to existing IFRSs or US GAAP rather than specify in the lease proposals the initial and subsequent measurement of the lease liability and right-of-use asset. The boards rejected that approach for a number of reasons:

- (a) the accounting by lessees would differ in US GAAP and IFRS because the existing requirements for financial liabilities and non-financial assets differ in US GAAP and IFRS.
- (b) the approach would be inconsistent with the boards' decision not to apply a components approach to lease accounting. For example, existing requirements on financial instruments would require separate accounting for options in a lease.
- (c) leases often have unique features compared with other financial liabilities and non-financial assets and, therefore, should have accounting that reflects those unique features.
- (d) the approach would be more complex to apply, particularly when a lease contains features such as options, variable lease payments and residual value guarantees.

Initial measurement of the lease liability (paragraphs 38(a) and 39)

Lease term: options to extend or terminate a lease (paragraphs 25–27)

- BC136 Leases often grant the lessee a right to extend a lease beyond the initial non-cancellable period, or to terminate a lease before the end of the lease period. Depending on the terms and conditions of the option, a three-year lease with an option to extend for two years could be economically similar to a three-year non-cancellable lease or a five-year non-cancellable lease. However, a lease with options would never be exactly the same as a lease without any options.
- BC137 There are a number of different ways that a lessee and lessor could reflect options that exist in leases:
- (a) *a components approach*, in which options in a lease are recognised and measured as separate components of the lease. The boards rejected a components approach to lease accounting because such an approach would be complex, would ignore the interrelationship between the term of a lease and the exercise of options, and would be difficult to apply because options may be difficult to measure reliably.
 - (b) *a disclosure approach*, in which an entity recognises a lease liability or lease receivable for the non-cancellable period and discloses the existence of any options to extend the term. Although simple to apply, the boards rejected this approach because it would provide less useful information to users of financial statements. The measurement of lease assets and lease liabilities would ignore the existence of options, including those that are virtually certain of being exercised and, thus, would potentially misrepresent the assets and liabilities arising from a lease.
 - (c) *a measurement approach*, in which options in a lease are included in the measurement of lease assets and lease liabilities using a particular method. That method could be, for example:
 - (i) a probability-weighted measurement method (in which the measurement of lease assets and lease liabilities reflects the probability of each possible lease term);
 - (ii) a probability threshold method (in which an entity includes optional periods in the lease term if the exercise of the options meets a specified threshold, for example reasonably certain, virtually certain, more likely than not); or
 - (iii) an economic incentive method (in which an entity includes optional periods in the lease term if an entity has an economic incentive to exercise the option).
- BC138 The Discussion Paper and the 2010 Exposure Draft proposed determining the lease term on the basis of a ‘most likely’ measurement approach, ie the lease term would be the longest possible term that is more likely than not to occur. That is because the boards thought that the lease term should reflect an entity’s reasonable expectation of what the term would be. The 2010 Exposure Draft

also proposed that, at each reporting date, the lessee or lessor should reassess which outcome it considered to be most likely to occur on the basis of any new facts or circumstances that indicate that there would be a significant change in the recognised lease liability or lease receivable since the previous reporting period.

BC139 Many respondents to the Discussion Paper and the 2010 Exposure Draft disagreed with the proposals:

- (a) some said that determining the present value of lease payments on the basis of the most likely lease term might result in the recognition of a liability (for the lessee) and an asset (for the lessor) that does not meet the definition of a liability or an asset in the boards' respective conceptual frameworks. That is because the lessee is not obliged to make lease payments, and the lessor does not have a right to receive lease payments, beyond the initial non-cancellable period until the lessee has exercised the option.
- (b) some disagreed because the approach would not distinguish between a five-year, non-cancellable lease and a three-year lease with an option to extend for two years that is likely to be exercised. In their view, a lessee (and a lessor) is in a different economic position when it has a five-year non-cancellable lease compared with a three-year lease with an option to extend that it may or may not exercise, and that difference should be reflected in the measurement of lease assets and lease liabilities.
- (c) some suggested increasing the threshold at which an entity would include options to extend in the measurement of lease assets and lease liabilities. They suggested thresholds such as 'reasonably assured' (used in existing US GAAP), 'reasonably certain' (used in existing IFRS) and 'virtually certain' (which would be a higher threshold that would almost equate to including only contractual minimum lease payments in the measurement of lease assets and lease liabilities).
- (d) others suggested including options in the measurement of lease assets and lease liabilities only when a lease includes economic incentives for an entity to exercise an option.
- (e) most preparers highlighted the cost and complexity of not only determining the lease term at the commencement date but also reassessing the lease term at each reporting date. Preparers reiterated this message at workshops held in 2010 to discuss the proposals.

BC140 On reconsideration, the boards affirmed their view that the lease term should reflect an entity's reasonable expectation of what the term would be. However, on the basis of the feedback received, they have changed the proposals so that the basis of that reasonable expectation of the lease term is linked to a lessee having a significant economic incentive to exercise an option. The boards note that applying the concept of 'significant economic incentive' would provide a threshold that is similar to the concepts of 'reasonably assured' and 'reasonably certain' in existing US GAAP and IFRS, which the boards understand work well in practice. However, there would need to be a significant *economic* incentive for the lessee to exercise the option in order to include optional periods in the lease

term. An expectation of exercise alone (and without any economic incentive to do so) would not be sufficient. The boards concluded that requiring an economic incentive provides a threshold that can be applied more easily because it is more objective than a threshold based solely on management's estimates or intent.

- BC141 The boards note that including optional periods in the lease term on the basis of an entity having a significant economic incentive to exercise an option addresses the concerns that other approaches would be complex and costly to apply.
- BC142 The boards considered which factors should be considered when determining the lease term at the commencement date. The boards concluded that, at the commencement date, an entity should take into account all relevant factors (contractual, asset, entity and market-based factors) when assessing whether an entity has a significant economic incentive to exercise an option to extend a lease. That is because many of the factors are interlinked and it would be both difficult and illogical to require an entity to consider any one factor in isolation. The factors to consider when reassessing the lease term are discussed in paragraphs BC168–BC172.
- BC143 The boards also concluded that options to extend a lease and options to terminate a lease should be accounted for in the same way. Accordingly, payments to be made during the period after which a lessee can terminate a lease are included when measuring lease assets and lease liabilities if the lessee has a significant economic incentive not to exercise the option to terminate the lease.

Discount rate (paragraph 38(a))

- BC144 The Discussion Paper proposed that the discount rate used to determine the lessee's lease liability should be the lessee's incremental borrowing rate; in other words, the rate that takes into account the credit standing of the lessee, the length of the lease, the nature and quality of the security provided and the economic environment in which the transaction occurs.
- BC145 In theory, the rate implicit in the lease should be similar to the lessee's incremental borrowing rate. However, the rate implicit in the lease is affected by differences between the lessee's estimate and the lessor's estimate of the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor. Thus it may be difficult for lessees to determine the rate implicit in the lease for some leases, particularly those in which the underlying asset has a significant residual value at the end of the lease.
- BC146 Some respondents to the Discussion Paper commented that the rate implicit in the lease is often relatively easy to determine and has the advantage of being specific to the transaction. In addition, some respondents said that using the lessee's incremental borrowing rate for the lease liability would not necessarily reduce complexity because the incremental borrowing rate should reflect the credit standing of the lessee as well as the security provided by the underlying asset. The degree of security could be different from lease to lease and from

period to period, depending on the fair value of the underlying asset. The incremental borrowing rate may also not be readily obtainable when the lease term is long.

- BC147 The boards agreed with respondents that the rate implicit in the lease could be readily determined in some circumstances. However, there would be circumstances in which the rate implicit in the lease would be difficult for a lessee to determine. Accordingly, consistently with the 2010 Exposure Draft, this Exposure Draft proposes that a lessee should discount the lease liability using the rate the lessor charges the lessee (which would often be the rate implicit in the lease), if that rate can be readily determined. If the rate the lessor charges the lessee cannot be readily determined, the lessee would use its incremental borrowing rate.

Lease payments

Variable lease payments (paragraphs 39(b) and 39(c))

- BC148 Some or all of the lease payments for the right to use an asset can be variable. That variability can arise because lease payments are linked to the following:
- (a) price changes due to changes in an external market rate or the value of an index. For example, lease payments might be adjusted for changes in a benchmark interest rate or the Consumer Price Index;
 - (b) the lessee's performance derived from the underlying asset. For example, a lease of retail property may specify that lease payments are based on a specified percentage of sales made from that property; and
 - (c) the use of the underlying asset. For example, a car lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.
- BC149 There are different views on whether variable payments linked to future performance or use of an asset meet the definition of a liability. Some are of the view that a lessee's liability to make, and a lessor's right to receive, variable lease payments do not exist until the future event requiring the payment occurs (ie when the underlying asset is used, or a sale is made). Accordingly, some are of the view that entities should only provide disclosure about variable lease payments linked to performance or use and should not include those payments in the measurement of lease assets and lease liabilities.
- BC150 However, some note that a lessee's obligation to make, and a lessor's right to receive, variable lease payments exist at the commencement date by virtue of the lease contract. Consequently, they are of the view that all variable lease payments meet the definition of a liability for the lessee and an asset for the lessor. It is the amount of the liability or asset that is uncertain, rather than the existence of the liability or asset. Accordingly, some would suggest that lessees and lessors should estimate variable lease payments and include that estimate in the measurement of lease assets and lease liabilities.
- BC151 The 2010 Exposure Draft proposed a probability-weighted estimation approach in which a lessee and lessor would include estimated variable lease payments in

the measurement of lease assets and lease liabilities at the commencement date. That Exposure Draft would also have required the reassessment of estimates if there was a significant change in the measurement of the lease liability. Many respondents to that Exposure Draft disagreed with those proposals. Preparers stated that, and demonstrated at workshops why, this approach would be extremely costly to apply, especially for longer-term leases with payments linked to the lessee's performance or use of the underlying asset. They noted that the reason that they often enter into leases with variable lease payments based on performance or use is because of the uncertainty associated with that future performance or use, ie they wish to share the risks of the uncertainty about the economic benefits to be derived from using an underlying asset with the lessor. Accordingly, it often would be difficult for a lessee to estimate variable lease payments reliably. Similarly, it often would be difficult for the lessor to estimate the future performance from or use of an asset reliably when it has little, or no, control over that use. Consequently, respondents, including some users of financial statements, questioned the reliability of the information that would be included in the measurement of lease assets and lease liabilities.

- BC152 On the basis of that feedback, the boards agreed that the cost and complexity of estimating and measuring all variable lease payments would outweigh the benefit. This Exposure Draft, therefore, proposes to include in the measurement of lease assets and lease liabilities only those variable lease payments that are in-substance fixed payments or that depend on an index or a rate. For some board members, the decision about variable lease payments linked to future performance or use was made solely for cost-benefit reasons, ie they are of the view that all variable lease payments meet the definition of an asset (for the lessor) and a liability (for the lessee). However, those board members were convinced by the responses to the 2010 Exposure Draft that the costs of those proposals would outweigh the benefits, particularly because of the reliability concerns expressed about the measurement that would result from the proposals. Other board members do not think that variable lease payments linked to future performance or use meet the definition of an asset (for the lessor) or a liability (for the lessee) until the performance or use occurs. They consider those payments to be avoidable by the lessee and, accordingly, would conclude that the lessee does not have a present obligation to make those payments. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future profits to be derived from the use of the asset. Accordingly, those variable lease payments would not be included in the measurement of lease assets and lease liabilities.
- BC153 The boards decided to include variable lease payments that are in-substance fixed lease payments in the measurement of lease assets and lease liabilities because those payments are unavoidable and, thus, economically are indistinguishable from fixed lease payments. The boards discussed whether to leave this as a principle or provide further requirements. They concluded that providing a principle was sufficient, rather than a list of possible scenarios, which would never capture every situation. However, the boards decided to include some examples of the types of payments that would be considered to be in-substance fixed payments to help in applying the principle.

- BC154 For similar reasons, the boards decided to include variable lease payments that depend on an index or a rate in the measurement of lease assets and lease liabilities. Those payments meet the definition of assets (for the lessor) and liabilities (for the lessee) because they are unavoidable (ie a lessee has a present obligation to make, and the lessor has a present right to receive, those lease payments). Any uncertainty, therefore, relates to the measurement of the asset or liability that arises from those payments and not to the existence of the asset or liability.
- BC155 In the boards' view, in principle, forecasting techniques should be used to determine the effect of changes in an index or a rate on the measurement of lease assets and liabilities. However, forecasting changes in an index or a rate requires macroeconomic information that entities may not have readily available, and forecasts can often be unreliable. In the boards' view, the usefulness of the additional information obtained using such a forecast would not justify the costs of obtaining it. The 2010 Exposure Draft proposed using forward rates when measuring lease assets and liabilities if they are readily available. However, respondents commented that this would reduce comparability between those using forward rates and those not doing so and that determining whether a rate would be 'readily available' requires judgement. Consequently, the boards decided to require an entity to determine payments that depend on an index or a rate using the index or rate that exists at the commencement date. Subsequent measurement of variable lease payments that depend on an index or a rate is discussed in paragraphs BC173–BC175.

Residual value guarantees (paragraph 39(d))

- BC156 The 2010 Exposure Draft proposed that a lessee should estimate the amount payable to the lessor under residual value guarantees and account for that amount as a lease payment. Many respondents supported those proposals, noting that the amounts payable under residual value guarantees should be included in the measurement of lease assets and lease liabilities because they are unconditional and meet the definition of a liability.
- BC157 Similarly, this Exposure Draft proposes that a lessee should include the expected amount payable under residual value guarantees in the measurement of the lease liability (and the right-of-use asset). In the boards' view, payments to be made under residual value guarantees meet the definition of a liability and are part of the cost of the right-of-use asset and, thus, should be recognised and measured as part of the lease liability and the right-of-use asset. That is because those payments cannot be avoided by the lessee—the lessee has an unconditional obligation to pay the lessor if the market price of the underlying asset moves in a particular way. Accordingly, any uncertainty does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary on the basis of movements in the market price for the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee.
- BC158 The boards considered whether a lessee should account for residual value guarantees separately because they are linked to the value of the underlying asset and may meet the definition of a derivative. However, the boards note that

residual value guarantees are often so interlinked with other terms and conditions in a lease that it could be misleading and potentially costly to recognise such guarantees separately. That is also consistent with the boards' decision not to adopt a components approach to lease accounting.

Options to purchase the underlying asset (paragraph 39(e))

- BC159 The boards considered whether a purchase option is:
- (a) the ultimate renewal option and, thus, should be accounted for similarly to other options to extend or terminate a lease. This approach would include the exercise price of a purchase option in the determination of lease payments on a basis similar to the inclusion of lease payments to be made during optional periods.
 - (b) a means of terminating the lease that should be accounted for only when it is exercised as a sale or purchase of the underlying asset. This approach would exclude the price of a purchase option from the determination of lease payments.
- BC160 The 2010 Exposure Draft viewed a purchase option as a means of terminating the lease and, thus, proposed that the price of a purchase option is not a lease payment. Respondents had mixed views about the proposal to account for purchase options only when they are exercised. Some respondents agreed with the proposals, but others proposed that the accounting for purchase options should be consistent with the accounting for options to extend or terminate a lease.
- BC161 On reconsideration, the boards decided that purchase options should be accounted for in the same way as options to extend the term of a lease (ie the exercise price of a purchase option would be included in the measurement of lease assets and lease liabilities if the lessee has a significant economic incentive to exercise that option). That is because the boards view a purchase option as the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the boards decided that those two options should be accounted for in the same way.

**Initial measurement of the right-of-use asset
(paragraphs 38(b) and 40)**

- BC162 Consistently with the 2010 Exposure Draft, this Exposure Draft proposes that a lessee should measure the right-of-use asset at cost, which is the present value of the lease payments.
- BC163 The boards considered whether a lessee should initially measure the right-of-use asset at fair value because that may provide more relevant information about the economic benefits to be derived from the use of the underlying asset. However, initial measurement of a right-of-use asset at cost is consistent with the measurement of many other non-financial assets, such as assets within the scope of IAS 16 *Property, Plant and Equipment*, and Topic 360, *Property, Plant, and Equipment* and IAS 38 *Intangible Assets*, and Topic 350, *Intangibles—Goodwill and*

Other. Measuring right-of-use assets on a basis similar to that of the underlying asset would increase comparability of leased and owned assets and, thus, improve the information provided to users of financial statements. Furthermore, initial measurement of the right-of-use asset at cost is less complex and less costly for entities to apply than fair value measurement because there is rarely an active market for right-of-use assets. For many leases, a cost measurement basis also would provide a reasonable approximation of the fair value of the right-of-use asset at the commencement date.

Initial direct costs (paragraph 40(c))

- BC164 Initial direct costs for a lessee are costs directly attributable to negotiating and arranging a lease and would not have been incurred without entering into the lease. This Exposure Draft proposes that a lessee should capitalise those costs by adding them to the carrying amount of the right-of-use asset. Capitalising initial direct costs is consistent with the treatment of costs associated with acquiring other non-financial assets (for example, property, plant and equipment and intangible assets). Maintaining consistency in the accounting for leased and owned assets increases comparability, thereby providing better information for users of financial statements.
- BC165 The boards considered whether initial direct costs incurred by lessees should be allocated between the asset and liability arising from a lease at the commencement date. However, the boards concluded that such an approach could be costly for entities to apply with little incremental benefit for users of financial statements.

Subsequent measurement of the lease liability (paragraphs 41(a) and 42–46)

- BC166 Consistently with the 2010 Exposure Draft, this Exposure Draft proposes that a lessee should measure lease liabilities similarly to other similar financial liabilities on an amortised cost basis, ie the carrying amount of the lease liability is adjusted each period to reflect the unwinding of the discount on the lease liability and the payment of lease payments.
- BC167 The boards have not proposed that a lessee would be required or permitted to measure lease liabilities at fair value after initial measurement because it would be:
- (a) inconsistent with the subsequent measurement of many other non-derivative financial liabilities, thus decreasing comparability for users of financial statements;
 - (b) more complex and costly for entities to apply than a cost-based approach because it requires the use of both current expected cash flows and current interest rates; and
 - (c) inconsistent with the proposal that the initial measurement of assets and liabilities arising from a lease should not be at fair value.

Reassessment of options (paragraphs 44(a) and 44(b))

- BC168 In principle, the boards are of the view that users of financial statements receive more relevant information when entities reassess options on a regular basis because reassessment reflects current economic conditions and using a lease term established at initial recognition throughout the lease could be misleading.
- BC169 However, requiring reassessment at each reporting date would be costly for an entity with many leases. To address that concern, the 2010 Exposure Draft proposed that an entity would be required to reassess the lease term only when there has been a change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability.
- BC170 Respondents to the 2010 Exposure Draft expressed concern about the costs associated with such reassessment. They noted that it could be difficult to interpret when a change would be significant. Many interpreted the proposals as requiring an entity to demonstrate that there had not been a change in facts and circumstances that would indicate a significant change in the lease asset or lease liability in order to avoid having to reassess options. The costs of demonstrating that any change would not be significant could be as costly as reassessing options at each reporting date.
- BC171 This Exposure Draft requires an entity to reassess options only when a lessee has, or no longer has, a significant economic incentive to exercise an option. Because the 'significant economic incentive' threshold is higher than the 'more likely than not' threshold proposed in the 2010 Exposure Draft, an entity should be required to remeasure lease assets and lease liabilities as a result of changes relating to options relatively infrequently, thus reducing costs associated with reassessment. In addition, the boards decided that a change in market conditions alone (for example, an option moving in or out of the money) would not trigger reassessment because of concerns about the possibility of frequent changes to the lease term as market prices increased or decreased. The boards concluded that such an outcome would add unnecessary complexity and cost to the accounting and may not provide useful information to users of financial statements.
- BC172 Although entities recognise changes in most other liabilities in profit or loss, this Exposure Draft proposes that a lessee should adjust the carrying amount of the right-of-use asset to reflect changes in the measurement of the related lease liability arising from the reassessment of the lease term or purchase options. That is because (a) a change in the lease term or the assessment of purchase options reflects the lessee's expectation that it has acquired more or less of the right to use the underlying asset and (b) in the boards' view, the adjustments are made to measure the total costs of the asset accurately.

Reassessment of variable lease payments that depend on an index or a rate (paragraph 44(d))

- BC173 Paragraph BC154 describes the boards' reasons for requiring both lessees and lessors to include variable lease payments that depend on an index or a rate in the measurement of lease assets and liabilities.

- BC174 Consistently with the 2010 Exposure Draft, this Exposure Draft proposes that an entity should reassess the measurement of lease assets and lease liabilities to reflect changes in the index or rate that is used to determine variable lease payments. In the boards' view, reassessment is necessary to provide relevant information to users of financial statements about a lessee's lease liabilities at the reporting date. For example, without remeasurement of lease liabilities for changes in an index or a rate, the measurement of the lease liability for a 20-year property lease, for which lease payments are linked to a price index, may not provide users of financial statements with useful information about the entity's future cash outflows relating to that lease throughout the lease term.
- BC175 Some of the feedback from the 2010 Exposure Draft indicated concerns about the cost of performing reassessments and questioned whether the benefits for users of financial statements would outweigh the costs for preparers. For example, some respondents noted that the total lease-related expenses recognised in profit or loss by a lessee would be substantially the same, regardless of whether the lessee remeasures the lease liability for changes to an index or a rate. However, the boards noted that they have made significant changes to the proposals on the measurement of variable lease payments in this Exposure Draft, which are expected to reduce the costs and complexity of the proposals, as described in more detail in paragraphs BC148-BC155 (for example an entity is not required to measure (or remeasure) variable lease payments that do not depend on an index or a rate). Consequently, the costs associated with remeasuring lease liabilities should be lower than the costs that would have arisen from the proposals in the 2010 Exposure Draft.

**Reassessment of residual value guarantees
(paragraph 44(c))**

- BC176 The boards decided that lessees should reassess the expected amounts payable under residual value guarantees because that provides more relevant information to users of financial statements, reflecting current economic conditions.
- BC177 An increase or a decrease in the amount expected to be payable under a residual value guarantee can arise from a decrease or an increase in the expected value of the underlying asset at the end of the lease term. Accordingly, some might view adjusting the carrying amount of the right-of-use asset for any such increase or decrease as counter-intuitive. However, in the boards' view, changes in the expected amounts payable under residual value guarantees are changes to the cost of the right-of-use asset, which is consistent with including the expected amounts payable under residual value guarantees as part of the initial measurement of the right-of-use asset. The boards noted that the proposed requirement for lessees to review right-of-use assets for impairment would ensure that assets arising from leases are not overstated.

Reassessment of the discount rate (paragraph 45)

- BC178 The 2010 Exposure Draft proposed that neither the lessee nor the lessor would change the rate used to discount lease payments, except to reflect changes in reference interest rates when variable lease payments are determined using those reference interest rates.

- BC179 Respondents to the 2010 Exposure Draft had mixed views on those proposals:
- (a) some agreed that the discount rate should not be reassessed, which would be consistent with amortised cost accounting in the financial instruments and revenue recognition requirements. Many also expressed concern about the added cost and complexity of requiring the discount rate to be reassessed.
 - (b) others questioned why the discount rate would not be reassessed, noting that the proposals were inconsistent with requirements in other IFRSs or US GAAP that require discount rates to be adjusted, such as the accounting for pensions, insurance, decommissioning liabilities and asset retirement obligations. It might also prevent an entity from properly reflecting the change in the economics of a transaction.
 - (c) users of financial statements generally supported reassessment to ensure that financial information reflects management's most recent evaluation of economic circumstances and their effect on committed cash flows.
- BC180 The boards decided that, in most cases, an entity should not reassess the discount rate during the lease term. That is generally consistent with amortised cost accounting. In other IFRSs or US GAAP in which the discount rate is required to be reassessed, it is usually because the liability to which the discount rate relates is measured on a current measurement basis.
- BC181 Nonetheless, in the boards' view, there are some circumstances in which an entity should reassess the discount rate, for example when there is a change in the lease term or the assessment of whether the lessee has a significant economic incentive to exercise an option to purchase the underlying asset. In the boards' view, in those circumstances, the economics of the lease have changed and those changes should be reflected in the discount rate. For example, if an entity previously accounted for a lease on the basis that it has a remaining term of five years, and that remaining lease term changes to 10 years, it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of lease assets and lease liabilities. However, the boards decided that such a change to the discount rate would be required only if an entity had not taken into account the optionality in the contract when determining the discount rate at the commencement date. It is not necessary to update the discount rate if that rate already reflects that an entity has an option to extend or terminate the lease, or to purchase the underlying asset.

Foreign currency exchange

- BC182 The 2010 Exposure Draft did not provide specific requirements on how an entity should account for the effects of foreign currency exchange differences relating to lease liabilities (for a lessee) and lease receivables (for a lessor) that are denominated in a foreign currency. A lessee's lease liability and a lessor's lease receivable are monetary items that are required to be remeasured using exchange rates at the end of each reporting period if denominated in a foreign currency.

- BC183 Some respondents suggested that an entity should recognise any foreign currency exchange differences as an adjustment to the carrying amount of the right-of-use asset. This approach would treat translation adjustments as a correction of, or update to, the cost of the right-of-use asset, which is initially measured on the basis of the initial measurement of the lease liability. Those respondents were of the view that lease payments denominated in a foreign currency are in effect another form of variable lease payments, and should be accounted for similarly to variable lease payments that are determined using an index. Those respondents also questioned whether useful information would be provided as a result of the profit or loss volatility created by recognising foreign currency exchange differences on a lessee's lease liability in profit or loss (profit or loss volatility might arise because any foreign currency denominated lease liability is remeasured to reflect the rate of exchange at the end of each reporting period, whereas the carrying amount of the right-of-use asset, being a non-monetary asset, is not remeasured to reflect movements in exchange rates).
- BC184 The boards decided that any foreign currency exchange gains and losses relating to lease liabilities (for the lessee) and lease receivables (for the lessor) denominated in a foreign currency should be recognised in profit or loss. That is because this approach is consistent with existing requirements on foreign currency exchange differences. In the boards' view, subsequent changes to a foreign exchange rate should not have any effect on the cost of a non-monetary item, and thus it would be inappropriate to include such changes in the remeasurement of the right-of-use asset. Although the approach could result in volatility in profit or loss from the recognition of foreign currency exchange differences, those changes would be disclosed separately as foreign currency exchange gains or losses. Accordingly, it would be clear to users of financial statements that the gain or loss results solely from movements in exchange rates. Because the boards' conclusion is consistent with the existing requirements for foreign currency exchange, the boards concluded that it was unnecessary to include any specific requirements in this Exposure Draft.

Subsequent measurement of the right-of-use asset (paragraphs 41(b) and 47–53)

- BC185 This Exposure Draft proposes that after the commencement date, a lessee should measure the right-of-use asset at cost less accumulated amortisation and impairment. For Type A leases, a lessee would determine the amortisation in each period consistently with existing IFRSs and US GAAP for non-financial assets that are measured at cost. For Type B leases, a lessee would determine the amortisation in each period as the difference between the periodic lease cost, which is recognised on a straight-line basis, and the periodic unwinding of the discount on the lease liability. That approach is the result of concerns raised about the effects of the proposals in the 2010 Exposure Draft on a lessee's profit or loss. Paragraphs BC29–BC63 include a detailed discussion of the feedback received on the lessee accounting model and the basis for the boards' proposals on the subsequent measurement of a lessee's right-of-use asset. In some circumstances, the lease cost may be initially capitalised as part of the cost to acquire or construct another asset, such as inventory, in accordance with other IFRSs or US GAAP and later recognised in the income statement when that asset

is disposed of or consumed. This Exposure Draft refers to recognising lease cost rather than lease expense because any lease cost that is capitalised as part of the cost to acquire or construct an asset would not be recognised as lease expense in the statement of profit or loss and other comprehensive income.

BC186 The boards did not propose that a lessee should measure the right-of-use asset at fair value after initial measurement because it would be:

- (a) inconsistent with the subsequent measurement of many other non-financial assets.
- (b) more complex and costly for entities to apply than a cost-based approach because it requires the use of both current expected cash flows and current interest rates. There is rarely an active market for right-of-use assets, which would add to the complexity.
- (c) inconsistent with the proposal that initial measurement of assets and liabilities arising from a lease should not be at fair value.

Impairment of the right-of-use asset (paragraph 51)

BC187 Consistently with the 2010 Exposure Draft, this Exposure Draft proposes that entities apply the impairment requirements of IAS 36 *Impairment of Assets* and Topic 350.

BC188 Respondents to the 2010 Exposure Draft generally agreed with that proposal. The boards acknowledge that this approach could result in a different measurement of right-of-use assets under IFRS and US GAAP because requirements on impairment in IFRS and US GAAP differ. In the boards' view, the benefits for users of financial statements of better comparability between assets that an entity owns and those that it leases outweigh this disadvantage. In addition, it could be difficult for entities to implement an impairment model for right-of-use assets that is different from other non-financial assets, particularly if an entity is required to assess a group of assets (comprising both leased and owned assets) for impairment together.

Fair value measurement of the right-of-use asset (paragraphs 52–53)

BC189 IFRS permits the revaluation of non-financial assets, such as property, plant and equipment, and also permits investment properties to be measured at fair value. US GAAP does not permit the revaluation of property, plant and equipment or fair value measurement for investment property. In the boards' view, an entity should be permitted to measure a right-of-use asset on the same basis that it measures owned assets. Consequently, this Exposure Draft proposes the following:

- (a) lessees applying IFRS would have the option to revalue right-of-use assets and the option to measure right-of-use assets that meet the definition of investment property at fair value.
- (b) lessees applying US GAAP would not be permitted to revalue right-of-use assets.

Presentation: lessee (paragraphs 54–57)

Statement of financial position (paragraphs 54–55)

- BC190 The boards discussed how to present the right-of-use asset in the statement of financial position.
- BC191 The boards concluded that presenting leased and owned assets in a similar way would provide useful information to users of financial statements about the function of the underlying asset. That presentation is useful because a lessee often uses owned assets and leased assets for the same purpose and derives similar economic benefits from the use of owned assets and leased assets.
- BC192 However, the boards noted that there are differences between a right-of-use asset and an owned asset and that users of financial statements may want to know the carrying amount of each separately. For example, right-of-use assets may be viewed as being (a) less risky than owned assets because a right-of-use asset may not embed residual asset risk or (b) more risky than owned assets because the lessee may need to replace the right-of-use asset at the end of the lease term, but may not be able to secure a favourable rate for the replacement lease. Accordingly, either in the statement of financial position or in the notes, this Exposure Draft proposes that a lessee should provide information about the carrying amount of right-of-use assets separately from assets that are owned.
- BC193 Similarly, this Exposure Draft proposes that a lessee should present the carrying amount of the lease liability separately from other financial liabilities either in the statement of financial position or in the notes. In the boards' view, a lease liability is a unique class of liability that is linked to a corresponding asset and may have features, such as options and variable lease payments, that differ from those in other liabilities. Thus, disclosing information about lease liabilities provides users of financial statements with information that is important to understanding the extent to which an entity uses lease arrangements and highlights the relationship between the lease liability and the right-of-use asset.
- BC194 The boards also decided to require the presentation or disclosure of right-of-use assets arising from Type A leases separately from right-of-use assets arising from Type B leases, either in the statement of financial position or in the notes. The boards concluded that separate presentation or disclosure would be useful because those assets are measured in a different way after the commencement date.
- BC195 Similarly, the boards decided to require the presentation or disclosure of lease liabilities arising from Type A leases separately from lease liabilities arising from Type B leases. Although all lease liabilities are measured in the same way, separate presentation or disclosure would help a user to understand the liability balance to which lease expenses recognised in the statement of profit or loss and other comprehensive income relate.

Statement of profit or loss and other comprehensive income (paragraph 56)

- BC196 This Exposure Draft proposes that, for Type B leases, a lessee should recognise a single lease cost that combines the amortisation of the right-of-use asset and the

unwinding of the discount on the lease liability. That cost would be presented as a single amount in the statement of profit or loss and other comprehensive income. In the boards' view, when a lessee is not expected to consume more than an insignificant portion of the underlying asset, presenting a single lease expense provides more useful information than presenting amortisation and the unwinding of the discount separately. That is because, for such leases, the lessee is paying to use the underlying asset and does not acquire a significant portion of the underlying asset itself. Accordingly, the payments for use are presented as one amount and recognised on a straight-line basis (see paragraphs BC29–BC63 for further information about the basis for the boards' decisions on the lessee accounting model).

- BC197 In contrast, for Type A leases, a lessee should present amortisation of the right-of-use asset and the unwinding of the discount on the lease liability (presented as interest) in separate line items, in accordance with other IFRSs or US GAAP. When a lessee is expected to consume more than an insignificant portion of the underlying asset, the lessee in effect acquires a portion of the underlying asset that it is expected to consume. Accordingly, the boards concluded that a lessee would provide more useful information by presenting amortisation of the right-of-use asset in the same line item as other similar expenses (for example depreciation on property, plant and equipment), and interest on the lease liability in the same line item as interest on other financial liabilities.

Statement of cash flows (paragraph 57)

- BC198 The proposals on the presentation of cash outflows in the statement of cash flows are linked to the presentation of expenses arising from a lease in the statement of profit or loss and other comprehensive income. In the boards' view, it would be misleading to present payments in one manner in the statement of profit or loss and other comprehensive income and in another in the statement of cash flows.
- BC199 Consequently, this Exposure Draft proposes that a lessee should classify cash repayments of the principal portion of the lease liability for Type A leases as financing activities in the statement of cash flows. Cash paid relating to interest should be classified in accordance with the existing requirements on the statement of cash flows, which is not the same in this respect in IFRS and US GAAP. This approach provides comparability between interest paid for Type A leases and interest paid on other financial liabilities.
- BC200 In addition, the boards decided that cash flows from Type B leases and variable lease payments that are not included in the lease liability should be classified as operating activities, because the corresponding lease expenses would be presented in line items above finance costs in profit or loss.

Disclosure: lessee (paragraphs 58–67)

- BC201 In determining the disclosures for leases, the boards considered the following:
- (a) the existing requirements in IAS 17 and Topic 840; and

- (b) IFRS 7 *Financial Instruments: Disclosures* (IAS 17 requires a lessee to comply with the disclosure requirements in IFRS 7).

BC202 When selecting the disclosure objective, the boards considered work in other related projects. As a result, the boards proposed that disclosures about leases should enable users of financial statements to evaluate the amount, timing and uncertainty of cash flows arising from leases.

Reconciliation of opening and closing balances (paragraphs 61–64)

BC203 This Exposure Draft proposes that a lessee should provide a reconciliation of opening and closing balances of the lease liability because that reconciliation informs users of financial statements about changes to the liability during the reporting period. Users have indicated that such a reconciliation would provide them with information that is useful to their analyses.

BC204 The 2010 Exposure Draft proposed that the reconciliation of opening and closing balances of lease liabilities should be provided by class of underlying asset. Many respondents disagreed with the proposals for cost-benefit reasons. In response to those comments, the boards are no longer proposing to require the reconciliation of lease liabilities by class of underlying asset because the nature of the liability does not differ on the basis of the nature of the underlying asset to which it relates.

BC205 The IASB's Exposure Draft also proposes that a lessee should provide a reconciliation of opening and closing balances of the right-of-use asset. IAS 16 requires similar information for property, plant and equipment. Again, users of financial statements have indicated that such a reconciliation would provide them with information that is useful to their analyses. In the IASB's view, providing a reconciliation of right-of-use assets by class of underlying asset provides information about changes to the right-of-use asset that is comparable to information provided about changes in owned assets.

BC206 The FASB's Exposure Draft does not have a similar requirement for right-of-use assets because there is no requirement to provide such information for property, plant and equipment in US GAAP and, in the FASB's view, the benefits of the information would not justify the costs of providing it.

Maturity analyses (paragraph 67)

BC207 This Exposure Draft proposes that a lessee should disclose a maturity analysis of the contractual lease payments included in lease liabilities to assist users of financial statements in understanding and evaluating the nature and extent of liquidity risks. A lessee should disclose, at a minimum, the amounts due on an annual basis for each of the first five years after the reporting date, plus a lump sum for the remaining years. Those maturity analyses are similar to the maturity analyses currently required by Topic 840 and are somewhat more detailed than the maturity analyses required by IAS 17. This proposal may result in a lessee disclosing the maturities of lease liabilities differently from the maturities of other financial liabilities (for which an entity has discretion in determining the appropriate maturity categories). However, the boards have been informed that the detail that is currently provided about the maturities of

lease payments is useful to users of financial statements, and the comparability of maturity analyses for leases is more important than the comparability of disclosures about lease liabilities and other financial liabilities.

- BC208 The FASB decided to require the disclosure of a maturity analysis of non-lease (for example, service) components of a contract that also contains a lease. That would provide information about the committed future cash flows of the entity based on the total future payments arising from contracts that contain a lease. For example, if an entity has an unconditional obligation to make payments of CU100 each month (CU70 for the lease and CU30 for non-lease components) for the next five years, then, in the FASB's view, it is more useful to provide a maturity analysis of all of those payments rather than to provide a maturity analysis relating only to lease payments of CU70 each month.
- BC209 The IASB decided not to propose the disclosure of a maturity analysis of non-lease components. The IASB concluded that users of financial statements would find information about the maturities of any contractual commitments of an entity useful, regardless of what the commitments relate to. However, the IASB noted that it could be misleading to require the disclosure of contractual commitments for services only when those services are embedded within a contract that contains a lease. Similar contractual commitments relating to services that are provided as part of other contracts would not be disclosed.

Other disclosures

- BC210 The boards also discussed, but decided not to require, the following possible disclosures because, in their view, the cost of providing these disclosures would outweigh the benefit:
- (a) the discount rate (or range or weighted average discount rates) used to calculate the lease liability;
 - (b) the fair value of the lease liability because doing so would reintroduce the costs and complexity that the boards intended to avoid by not requiring such liabilities to be measured at fair value;
 - (c) the existence, and principal terms and conditions, of any options for the lessee to purchase the underlying asset;
 - (d) the amount of initial direct costs capitalised as part of the right-of-use asset;
 - (e) information about arrangements that on transition are no longer a lease; and
 - (f) disclosure of various lease expense components and corresponding cash flows.

Measurement: lessor—Type A leases

Initial measurement of the lease receivable (paragraphs 69(a) and 70)

- BC211 The boards decided that a lessor should initially measure a lease receivable at the present value of future lease payments, consistently with how a lessee measures a lease liability. Respondents to the 2010 Exposure Draft generally supported that approach.

Lease term: options to extend or terminate a lease (paragraphs 25–27)

- BC212 The boards decided that a lessor should determine the lease term in the same way as does a lessee. Although assessing the likelihood of exercise of an option may be easier for the lessee than the lessor (because the decision to extend or terminate is made by the lessee), the boards decided that it would complicate the proposals to propose different requirements for lessees and lessors in this respect. In addition, the feedback received on the proposals in the 2010 Exposure Draft about the lease term was similar for both lessees and lessors. The reasons for the boards' decisions on the lease term are set out in paragraphs BC136–BC143.

Discount rate (paragraph 69(a))

- BC213 The boards considered whether the discount rate applied by a lessor should be the rate implicit in the lease, the lessee's incremental borrowing rate, or another rate if the lessor is unable to determine the rate implicit in the lease. The boards rejected requiring the use of the lessee's incremental borrowing rate by the lessor because in some cases, it could result in recognising a lease receivable and a residual asset, the sum of which could be higher than the known fair value of the underlying asset at the commencement date. Nonetheless, a lessor is likely to consider the lessee's incremental borrowing rate when determining the rate it charges the lessee.
- BC214 In the boards' view, the rate implicit in the lease (ie the rate at which the sum of the present value of lease payments plus the present value of the expected residual value of the underlying asset at the end of the lease term would equal the fair value of the underlying asset) would typically be the most appropriate rate to use for Type A leases. Using the rate implicit in the lease is consistent with the lessor accounting approach for Type A leases, which requires the lessor to recognise a lease receivable and a residual asset separately for each lease. However, the rate implicit in the lease might not always be available. For example, that might be the case for some property leases. Although relatively few property leases are likely to be classified as Type A leases, there are other Type A leases for which it may not be possible for the lessor to calculate the rate implicit in the lease.
- BC215 Consequently, the boards retained the requirement for a lessor to use the rate the lessor charges the lessee when discounting lease payments. That rate could be the rate implicit in the lease or, for example, a property yield for a property lease. However, in response to questions raised by respondents to the 2010

Exposure Draft, the boards decided to clarify that a lessor should use the rate implicit in the lease whenever that rate is available.

Lease payments

Variable lease payments (paragraphs 70(b) and 70(c))

- BC216 The boards decided that a lessor should apply the same requirements when determining which variable lease payments to include in the measurement of the lease receivable as a lessee does when measuring the lease liability. Accordingly, a lessor would include in the measurement of the lease receivable only those variable lease payments that depend on an index or a rate or that are in-substance fixed payments. Although the estimation of variable lease payments to be paid in the future may be easier, or more difficult, for the lessor than the lessee in particular situations, the boards decided that it would complicate the proposals to propose different lessee and lessor accounting for variable lease payments, ie it would be difficult to understand why variable lease payments would represent a liability for the lessee and not an asset for the lessor, or vice versa. In addition, the feedback received on the proposals in the 2010 Exposure Draft about variable lease payments was similar for both lessees and lessors. The reasons for the boards' decisions on variable lease payments are set out in paragraphs BC148–BC155.

Residual value guarantees (paragraphs 70(d) and 85)

- BC217 The 2010 Exposure Draft considered a residual value guarantee to be a variable lease payment if the guarantor was the lessee. That Exposure Draft, therefore, proposed that a lessor should account for a residual value guarantee from the lessee in a similar way to other variable lease payments, ie an estimate of the amounts to be received would be included within the measurement of the lease receivable. The 2010 Exposure Draft did not address the accounting for residual value guarantees provided by a third party because they do not form part of the lease contract between the lessee and the lessor. Accordingly, under those proposals, a lessor might have been required to account for those guarantees separately under the financial instruments requirements, potentially treating them as a derivative instrument.
- BC218 Respondents to the 2010 Exposure Draft disagreed with the boards' proposals to provide requirements only for residual value guarantees provided by lessees. Many thought it would be misleading for users of financial statements if economically similar residual value guarantees were accounted for in a different way, solely because the guarantee contract had a different counterparty. Respondents noted that existing leases requirements address the accounting for all residual value guarantees, regardless of the counterparty.
- BC219 In response to this concern, this Exposure Draft now addresses accounting for all residual value guarantees, including guarantees provided by parties other than the lessee.
- BC220 When considering how a lessor should account for residual value guarantees, the boards first identified residual value guarantees that are in-substance equivalents to fixed lease payments. When a lessor enters into a contract in

which any difference between a specified amount and the market value of an underlying asset at the end of the lease term is paid to, or received from, the counterparty (which would typically be the lessee in these circumstances), that specified amount is economically the same as a fixed 'balloon' lease payment that is a feature of some leases. Consequently, the boards decided that such payments, often referred to as residual value guarantees, should be accounted for similarly to other fixed lease payments.

- BC221 All other residual value guarantees would be excluded from the measurement of the lease receivable. Those residual value guarantees would be considered when a lessor assesses the residual asset for impairment. The boards noted that this approach is consistent with the lessor accounting approach for Type A leases. According to that approach, a lessor should not recognise any profit relating to the residual asset until the underlying asset has been sold or re-leased at the end of the lease term because the residual asset has not been sold when entering into the lease. Similarly, when a lessor obtains a guarantee providing protection against any decline in the market value of the underlying asset but for which the lessor has retained exposure to any upside potential, the lessor is not in the same economic position as it would be if it had sold the underlying asset or leased the asset for a longer term. Accordingly, on entering into the guarantee contract, the lessor has not sold the residual asset. Instead, the lessor has obtained more assurance about the cash flows that it will derive from the residual asset, which is relevant when assessing whether the residual asset is impaired but is not part of the lease receivable. The boards concluded that it would be inappropriate for the lessor to recognise any profit associated with the residual asset at the time of obtaining the guarantee, which could occur if the residual value guarantee was included as part of the lease receivable. In reaching that decision, the boards also noted that if an estimate of the residual value guarantee was to be included in the measurement of the lease receivable, a decline in the value of the underlying asset could result in the lessor recognising a gain, which would be counter-intuitive and misleading.

- BC222 The boards also considered but rejected accounting for residual value guarantees separately from a lease. The boards noted that residual value guarantees are often so interlinked with lease payments, particularly when the guarantor is the lessee, that it could be misleading to recognise such guarantees separately.

Options to purchase the underlying asset (paragraph 70(e))

- BC223 The boards decided that a lessor should account for options provided to the lessee to purchase the underlying asset by applying the same requirements as are applied by a lessee when accounting for those options. The reasons for the boards' decisions on options to purchase the underlying asset are set out in paragraphs BC159–BC161.

Initial direct costs (paragraph 69(a))

- BC224 This Exposure Draft proposes that a lessor should capitalise initial direct costs at the commencement date, which is consistent with the proposals in the 2010 Exposure Draft. That approach is consistent with the accounting for costs associated with similar financial assets and with the accounting for initial direct costs proposed for lessees.

- BC225 In reaching this decision, however, the boards noted that the calculation of the rate the lessor charges the lessee should not include initial direct costs because doing so could result in those costs being reflected twice in the initial measurement of the lease receivable.

**Initial measurement of the residual asset
(paragraphs 69(b) and 71–75)**

- BC226 When a lessor recognises a lease receivable and a residual asset at the commencement date, the boards considered whether the lessor should initially measure the residual asset on a current measurement basis (ie at the present value of the estimated residual value at the end of the lease) or on a cost basis (ie as an allocation of the previous carrying amount of the underlying asset). A difference between those two measurement bases would arise when the carrying amount of the underlying asset is different from its fair value immediately before the commencement date. The derecognition approach in the 2010 Exposure Draft had proposed that the residual asset should be initially measured on a cost basis.
- BC227 The proposal to measure the residual asset on a current measurement basis might imply that the boards considered entering into a lease to be equivalent to the sale of the underlying asset. That is because under this approach, when the carrying amount of the underlying asset is lower than its fair value, the lessor would recognise profit at the commencement date relating to both the lease receivable and the residual asset, which would be the same as (or very similar to) the profit recognised if the lessor was to sell the underlying asset.
- BC228 Such an approach would have the benefit of more accurately reflecting the way in which many equipment and vehicle lessors price their leases because in such leases, many lessors price the contract by estimating the residual value of the underlying asset at the end of the lease term and then factoring in a specified return to achieve on their investment in the underlying asset. The periodic lease payments are a function of those inputs, together with the fair value of the underlying asset at the commencement date, subject to market constraints. Measuring the residual asset on a current measurement basis would also have the potential to provide better information to users of financial statements about the residual asset because, for many leases, it would be measured at an amount that is close to fair value.
- BC229 However, the boards decided that a lessor should measure the residual asset on a cost basis. They concluded that entering into a lease is not equivalent to the sale of the underlying asset, particularly if the lease is for a short portion of the life of the underlying asset. At the commencement date, the lessor transfers the right-of-use asset to the lessee and it is appropriate to recognise any profit relating to that right-of-use asset. It would, however, be inappropriate to recognise profit associated with the residual asset before that asset is either sold or re-leased at the end of the lease term. The boards were also concerned about the structuring opportunities that a current measurement basis for the residual asset might create. For example, they were concerned that a lessor could arrange to enter into a lease for only a few months, recognising all of the profit associated with the underlying asset at the commencement date.

Subsequent measurement of the lease receivable (paragraphs 76(a) and 78–81)

BC230 Consistently with the 2010 Exposure Draft, this Exposure Draft proposes that a lessor should measure lease receivables on an amortised cost basis after initial measurement. That measurement basis is similar to, but not exactly the same as, the measurement basis applied to other financial assets within the scope of existing financial instruments requirements. For example, there are some differences in the measurement of variable lease payments under the leases proposals and how similar features would be measured for a financial asset measured at amortised cost in accordance with the financial instruments requirements. Nonetheless, this approach would result in accounting for lease receivables on a basis similar to that applied to other similar receivables. Respondents to the 2010 Exposure Draft generally agreed with this approach.

Sale of the lease receivable

BC231 The boards considered whether lease receivables held for sale (or securitisation) should be measured at fair value. Fair value measurement of such receivables would be consistent with the principles in existing financial instruments requirements on the measurement of financial assets held for the purposes of sale. Fair value measurement would also eliminate the recognition of gains or losses upon sale (assuming the transfer occurs at fair value) because the asset being transferred would be recognised at fair value immediately before sale.

BC232 However, the boards decided not to require or permit a lessor to measure lease receivables held for sale at fair value for the following reasons:

- (a) there would be two measurement bases for lease receivables in this Exposure Draft, thus increasing complexity and reducing comparability.
- (b) the measurement requirements would need to specify whether a lessor would be required to measure at fair value only the part of the lease receivable being transferred, or all of the cash flows included in the lease receivable, including those relating to variable lease payments and options that meet the recognition criteria according to the leases proposals. That would be relevant, for example, if a lease contains an extension option for which there is a significant economic incentive to exercise the option, however the cash flows to be sold relate only to lease payments to be received during the non-cancellable period of the lease. In that case, a part of the lease receivable (ie the lease payments to be received during the extension period) would not be held for sale. Both alternatives (ie measuring the entire lease receivable or only the part to be transferred at fair value) would be complicated in this situation. Measuring only the part of the lease receivable to be transferred at fair value would require splitting the lease receivable into two parts with two different measurement bases for the same receivable. Alternatively, measuring all of the lease receivable at fair value would result in a lessor measuring lease payments not held for sale at fair value, which would be inconsistent with the boards' other decisions on the measurement of lease payments.

- (c) if the fair value requirement was a 'held for sale' requirement, it would not be perfectly consistent with the existing financial instruments requirements in IFRS 9 or the proposed requirements in the FASB's project on accounting for financial instruments.
- (d) applying different measurement bases to different parts of a lease receivable could also introduce opportunities for structuring.

BC233 The boards then considered whether the derecognition requirements in the financial instruments standards could be applied to lease receivables or whether proposals specific to lease receivables would need to be developed.

BC234 The boards concluded that a lessor should apply the derecognition requirements in IAS 39 or IFRS 9, or Topic 860, Transfers and Servicing, to lease receivables. Developing derecognition requirements for lease receivables would add complexity to the proposals, and reduce comparability between lease receivables and other similar financial assets. The boards did not identify any particular feature of lease receivables that would suggest that the financial instruments derecognition requirements would be inappropriate. In particular, IAS 39, IFRS 9 and Topic 860 include requirements that address the sale of only a part of a larger financial asset.

Impairment of the lease receivable (paragraph 84)

BC235 Consistently with the 2010 Exposure Draft, this Exposure Draft proposes that a lessor should evaluate the lease receivable for impairment in accordance with the respective impairment models for financial assets within IFRS and US GAAP.

BC236 A lease receivable meets the definition of a financial asset in IAS 39 and a loan in Topic 310, Receivables. The boards noted that subsequently measuring the lease receivable on an amortised cost basis, and assessing it for impairment in accordance with the financial asset impairment model, would result in the lease receivable being measured on a similar basis to other financial instruments, particularly other similar receivables. The few respondents to the 2010 Exposure Draft that commented on the impairment proposals on the lease receivable generally supported using the financial asset impairment model when testing the lease receivable for impairment.

BC237 The boards considered including impairment requirements for the lease receivable within this Exposure Draft. The advantage of such an approach would be that IFRS and US GAAP preparers would subsequently measure lease receivables using the same requirements, increasing the consistency in application of lessor accounting in accordance with IFRS and US GAAP. However, the boards are both working on developing a new impairment model for financial assets, specifically addressing how that model would be applied to lease receivables. Including impairment requirements within this Exposure Draft would likely result in differences between the impairment model applied to lease receivables and the impairment model being developed for all other financial assets, which the boards consider to be inappropriate.

BC238 As part of the impairment project, the boards discussed how the new impairment model being developed would be applied to lease receivables. The boards noted that the tentative decisions made in the leases project result in

lease receivables being measured similarly to, but not in the same way as, financial assets at amortised cost, including some differences in the application of the effective interest method. The cash flows included in leases could also include features such as variable lease payments that would not be present in other financial assets measured at amortised cost.

BC239 Although the measurement of some lease receivables would be different from other financial assets measured at amortised cost, the boards concluded that this was not a reason to apply a different impairment model. In the boards' view, the same impairment model could be applied to lease receivables as long as:

- (a) the cash flows assessed for impairment are consistent with those included in the measurement of the lease receivable; and
- (b) the rate used to discount the expected cash shortfalls is consistent with the rate proposed in the impairment model.

BC240 Consequently, the boards are proposing that the new impairment models should be applied to lease receivables when those models are complete. The IASB decided, as part of the impairment project, that a lessor would be permitted to use either the full impairment model or a simplified approach (which always requires a lessor to measure lifetime expected credit losses relating to lease receivables) when measuring the impairment allowance for lease receivables. The impairment model being proposed by the FASB would always require a lessor to measure all expected losses relating to lease receivables. Additional information is available within the bases for conclusions on the IASB's Exposure Draft *Financial Instruments: Expected Credit Losses*, and the proposed FASB Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)*.

Reassessment of options (paragraphs 79(a)–79(b))

BC241 This Exposure Draft proposes that an entity reassess options only when there is a change in whether a lessee has, or does not have, a significant economic incentive to exercise an option. The reasons for that decision are set out in paragraphs BC168–BC172.

BC242 The boards propose that a lessor should adjust the lease receivable and the carrying amount of the residual asset for changes arising from the reassessment of options so that the carrying amounts of the lease receivable and the residual asset reflect the relative value of what has been transferred (the lease receivable) and what has been retained (the residual asset) based on the revised assessment of the lease term or purchase options. For example, if the lease term is increased so that it represents almost all of the economic life of the underlying asset, the carrying amount of the lease receivable would increase to include the lease payments in the optional period. At the same time, the residual asset would be reduced to reflect that the carrying amount of the residual asset (ie the underlying asset at the end of the new lease term) is now expected to be small, assuming that the residual asset is expected to have any value at the end of the new lease term. Similarly, if the lease term is shortened, the carrying amount of

the lease receivable would decrease and the residual asset would increase to reflect that the lease is now expected to expire sooner than was originally anticipated.

Reassessment of variable lease payments that depend on an index or a rate (paragraph 79(c))

- BC243 A change in variable lease payments that depend on an index or a rate represents a change in the total consideration that the lessor expects to receive for transferring the right to use an asset to the lessee. Accordingly, this Exposure Draft proposes that a lessor should remeasure the lease receivable for such changes in each period. A lessor should recognise those changes in the consideration received for the right-of-use asset in profit or loss in order to be consistent with the treatment of the consideration at the commencement date. The boards considered but rejected adjusting the carrying amount of the residual asset for changes in the lease receivable arising from changes in variable lease payments that depend on an index or a rate. That is because such changes do not represent any change in the lessor's remaining rights relating to the underlying asset. Those changes relate to the right-of-use asset already transferred to the lessee and, accordingly, should be recognised in profit or loss.

Reassessment of the discount rate (paragraphs 80–81)

- BC244 This Exposure Draft proposes that both a lessee and a lessor should reassess the discount rate in limited circumstances, such as when there is a change to the lease term, the accounting for purchase options or reference interest rates. The reasons for that decision are set out in paragraphs BC178–BC181.

Subsequent measurement of the residual asset (paragraphs 76(b), 82–83 and 85)

Unwinding of the discount embedded in the measurement of the residual asset

- BC245 As noted in paragraphs BC226–BC229, consistently with the 2010 Exposure Draft, this Exposure Draft proposes that a lessor should initially measure the residual asset as an allocation of the previous carrying amount of the underlying asset (ie the present value of the estimated residual value of the underlying asset at the end of the lease term (the gross residual asset) less any unearned profit relating to the residual asset).
- BC246 The 2010 Exposure Draft proposed that, other than for impairment, a lessor would not remeasure the residual asset during the lease term. Many respondents to the 2010 Exposure Draft did not agree with those proposals. They noted that prohibiting the unwinding of the time value of money (or discount) embedded in the initial measurement of the residual asset would not reflect the way in which many leases were priced and, thus, would not reflect the economics of those transactions. It would result in the lessor measuring the residual asset at an artificially low amount during the lease term and subsequently recognising an artificially large gain if the underlying asset were sold at the end of the lease term.

- BC247 In response to those comments, this Exposure Draft proposes that a lessor should unwind the discount embedded in the initial measurement of the gross residual asset over the lease term, and recognise the unwinding of the discount as interest income. That is because the amounts recognised are derived from the lease—they are part of the lease payments and represent interest charged by the lessor on the residual asset during the lease term. Consequently, in the boards' view, the proposal would result in accounting that better reflects how a Type A lease is typically priced and the return a lessor earns throughout the lease.
- BC248 In a Type A lease, the lessor not only charges the lessee to recover its investment in the portion of the underlying asset that the lessee is expected to consume, but it also charges the lessee for the use of the entire underlying asset over the lease term. That is because the lessor cannot generate economic benefits from the underlying asset while the asset is subject to a lease, other than those received from the lessee. Accordingly, the lessor must obtain a return on its investment in the entire underlying asset (including the residual asset) during the lease term and would be expected to include that return in the lease payments being charged to the lessee. The discount rate (typically, the rate implicit in the lease) applied to the lease receivable and the residual asset would also be calculated in a manner that was consistent with this rationale.
- BC249 In reaching this decision, the boards noted that the measurement basis proposed for the residual asset is different from the measurement basis typically applied to other non-financial assets measured at cost, ie an entity does not usually adjust the subsequent measurement of a non-financial asset for the effects of the time value of money when the non-financial asset is measured on a cost basis. However, the approach is similar to the accounting applied to the residual asset embedded in the net investment in a finance lease in IAS 17 or a direct finance or a sales-type lease in Topic 840. The boards noted that the nature of the residual asset, and its initial measurement, is somewhat different from other non-financial assets. The lessor derives economic benefits from the entire underlying asset (including the residual asset) in how it has priced the lease, and it is unable to access any other economic benefits from the asset until the end of the lease term. Accordingly, it is appropriate to recognise those economic benefits derived from the lease during the lease term.
- BC250 The boards considered whether a lessor should apply a different discount rate to the lease receivable and the residual asset. That is because the nature of the risks associated with the lease receivable (mainly credit risk associated with the lessee) is different from the nature of the risks associated with the residual asset (mainly asset risk associated with the underlying asset). However, the boards were informed that many lessors of Type A leases determine the rate they charge the lessee as a blended rate, considering the risks associated with both the lease receivable and the residual asset. Applying the same rate when measuring both assets would also be simpler to apply. Consequently, the boards decided that a lessor should apply the rate the lessor charges the lessee when measuring both the lease receivable and the residual asset.

Variable lease payments that do not depend on an index or a rate reflected in determining the rate the lessor charges the lessee

- BC251 When determining the rate charged to the lessee, the lessor is required to take into account the terms and conditions of the lease, possibly including an expectation of variable lease payments, if the lease includes such payments. If those variable lease payments do not depend on an index or a rate or are not in-substance fixed payments (for example, if payments vary on the basis of the use of an asset), a lessor does not include the payments in the measurement of the lease receivable. Excluding those variable lease payments from the measurement of the lease receivable, and reflecting them in determining the discount rate, means that a portion of the initial measurement of the residual asset relates to variable lease payments to be received during the lease term (ie the gross residual asset not only represents the present value of the expected residual value of the underlying asset at the end of the lease term, but it also represents the present value of any expected variable lease payments during the lease term). Without making any adjustments to the carrying amount of the residual asset during the lease term in this situation, the profit recognised by the lessor over the lease term would be overstated and the residual asset could possibly be impaired.
- BC252 The boards considered three ways to deal with this issue. The first approach would be to permit the lessor to include an expectation of those variable lease payments in the measurement of the lease receivable when the lessor is able to make a reliable estimate of the amounts expected to be received. That is what the 2010 Exposure Draft proposed under the derecognition approach. However, the boards rejected that approach because it would contradict their decisions on variable lease payments and the general feedback received about the inclusion of variable lease payments in the measurement of the lessee's liability and the lessor's receivable (as described in paragraphs BC148–BC155). It would also result in a lack of comparability among lessors when accounting for variable lease payments.
- BC253 The second approach would be to require a lessor to always exclude variable lease payments that do not depend on an index or a rate when determining the rate charged to the lessee. However, the boards rejected this approach because the rate calculated would no longer be the rate the lessor charges the lessee. This approach might also produce counter-intuitive results in leases that have a significant proportion of variable lease payments.
- BC254 The third approach, which was chosen by the boards, would require a lessor to derecognise a portion of the carrying amount of the residual asset during the lease term if the rate the lessor charges the lessee reflects an expectation of variable lease payments that has not been included in the lease receivable. That amount derecognised would be recognised as an expense in each period, representing the cost associated with the revenue recognised as variable lease payments are received. Because the discount rate used by the lessor already reflects the expected variable lease payments, the boards decided that a lessor should calculate the adjustment to the residual asset on the basis of the expected variable lease payments.

- BC255 To apply this approach strictly, a lessor would have been required to update its expectations of variable lease payments at the end of each reporting period and recalculate the adjustments to be made to the residual asset. However, the boards are not proposing such an approach because it would be extremely complex to apply for possibly little benefit.
- BC256 The boards also considered whether a lessor should be required to make any adjustments to the carrying amount of the residual asset in this situation from a cost-benefit perspective. Although the accounting to be applied may appear complicated, a lessor is required to adjust the carrying amount only when variable lease payments are reflected in determining the rate the lessor charges the lessee. Information obtained about Type A leases indicates that this would not be expected to occur frequently. In addition, the information required to apply the accounting would be no different from the information that the lessor uses when pricing the lease and determining the discount rate. The adjustments to be made also are determined at the commencement date, without a requirement for reassessment during the lease term. Accordingly, there should be little additional cost associated with applying these proposals.

Impairment of the residual asset (paragraph 85)

- BC257 This Exposure Draft proposes that a lessor should apply existing non-financial asset impairment requirements to the residual asset. The residual asset is a non-financial asset and its value is directly linked to the value of the underlying asset. Consequently, any impairment of the residual asset would typically be caused by a decline in the value of the underlying asset, which is a non-financial asset. Given that the indicators of impairment would typically be the same for the residual asset and the underlying asset, the boards concluded that it is appropriate to apply the same impairment models to both the residual asset and the underlying asset.
- BC258 When a lessor has received a residual value guarantee, it could be argued that the impairment model for financial assets would be more appropriate than the impairment model for non-financial assets. That is because the lessor is exposed to the credit risk of the guarantor and not directly to the risk associated with any decline in value of the underlying asset.
- BC259 However, the boards noted that the essence of any impairment model, whether it relates to financial assets or non-financial assets, is that an entity is comparing the carrying amount of an asset with the future cash flows expected to be received. Consequently, regardless of whether the lessor applies the financial asset or non-financial asset impairment model, the lessor would consider all cash flows expected to be received relating to the residual asset, including those to be received from a guarantor, when testing the asset for impairment. The main difference between the impairment models relates to the indicators of impairment, ie the factors that require a lessor to test the residual asset for impairment. When a lessor has a residual value guarantee, the guarantee becomes relevant only if the expected market value of the underlying asset falls below a specified amount. Consequently, although the lessor is exposed to the credit risk of the guarantor, that exposure would only be relevant from an impairment perspective if the value of the underlying asset has declined.

Accordingly, the boards concluded that the indicators of impairment included in the non-financial asset impairment model, which refer to a decline in value of the asset, would also be appropriate when a lessor has a residual value guarantee.

- BC260 The boards considered developing and applying a single impairment model to the residual asset that would be the same under both US GAAP and IFRS. However, for the reasons set out in paragraph BC188 they decided to refer to the existing impairment requirements within US GAAP and IFRS.

Revaluation of the residual asset (IASB-only)

- BC261 The IASB considered whether to permit, but rejected permitting, revaluation of the residual asset because it would be inconsistent with the decision to prohibit measuring the residual asset on a current measurement basis (and thereby recognising profit relating to the residual asset) at the commencement date. It would also be inconsistent with the decision to require a lessor to recognise the unwinding of the discount embedded in the measurement of the residual asset over the lease term as interest income. The IASB also questioned whether a lessor would ever choose to measure the residual asset at fair value, with changes in fair value being recognised as part of other comprehensive income. Such an approach would result in part of the income earned from a lease never being recognised in profit or loss.

- BC262 That decision could arguably be viewed as being inconsistent with the requirements of IAS 16 and IAS 38. However, as noted above, in the IASB's view, the nature of the residual asset is different from that of other non-financial assets, which is reflected in the proposal to measure the residual asset on a basis different from assets within the scopes of IAS16 and IAS 38.

Measurement of the underlying asset at the end of the lease term or termination of a lease (paragraphs 86–87)

- BC263 This Exposure Draft proposes that if the underlying asset is returned to the lessor before the end of the lease term (for example, because of a premature termination of the lease), a lessor should measure the returned asset by aggregating the carrying amount of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset at that date.
- BC264 Although a lessor would recognise the lease receivable and residual asset separately because they have different characteristics and are different in nature, both of those assets relate to the same underlying asset. Because of that, the boards are proposing to present the lease receivable and residual asset on an aggregated basis as 'lease assets' (as described in paragraph BC268). Consistently with this rationale, the boards decided that, if a lessee returns the underlying asset before the end of the lease term, the lessor should account for the returned asset as a reclassification of those two assets (ie the lease receivable and the residual asset). In reaching that decision, the boards noted that the lease receivable would be required to be assessed for impairment immediately before the underlying asset is returned to the lessor, and this approach is consistent with how that impairment assessment would be performed. The boards concluded, however, that a lessor would continue to recognise a receivable for

any amounts that it expects to receive relating to the lease. Accordingly, a lessor would initially measure the returned asset at the carrying amount of the lease receivable (after impairment) and the residual asset, excluding any amounts that the lessor expects to receive, which the lessor would continue to recognise as a receivable.

BC265 The boards considered two other alternatives for measuring the returned asset:

- (a) *fair value* – a lessor would derecognise the lease receivable and the net residual asset, and recognise the returned asset at fair value; and
- (b) *retrospective measurement* – a lessor would calculate a revised rate implicit in the lease (the rate actually earned on the shortened lease term) on the basis of the fair value of the returned asset at the time the lease terminates prematurely. According to this approach, a lessor would use the revised inputs to compute what the deferred profit on the residual asset would have been at the commencement date as if the lessor had known that the lease would terminate prematurely at the commencement date.

BC266 The boards rejected fair value because of the following:

- (a) it would result in any unearned profit on the residual asset being recognised when the asset is returned, and before the asset is sold or re-leased to another party. As explained in paragraphs BC226–BC229, the boards decided that a lessor should not recognise any profit relating to the residual asset until the asset is sold or re-leased. Applying a fair value measurement approach would be inconsistent with that requirement; and
- (b) although rare, it could potentially result in a lessor recognising a gain from a repossession of the underlying asset. The boards noted that it is counter-intuitive for a lessor to recognise a gain as a result of what most would view as an unfavourable circumstance (ie the termination of a lease before the end of the lease term).

BC267 The boards rejected retrospective measurement because of the following:

- (a) the approach would be complex to apply. It requires the use of hindsight to recalculate the transaction as if the lessor had known at the commencement date that the lease would be terminated prematurely;
- (b) the measurement methodology is not consistent with the way in which a lessor would assess the lease receivable for impairment immediately before recognition of the returned asset; and
- (c) although rare, it could potentially result in a net gain from a repossession of the underlying asset in situations in which the fair value of the asset has increased over the lease term.

Presentation: lessor—Type A leases (paragraphs 88–92)

Statement of financial position (paragraphs 88–89)

- BC268 The Exposure Draft proposes that a lessor should present lease assets (ie the sum of the carrying amounts of lease receivables and residual assets) separately from other assets in the statement of financial position. Both the lease receivable and the residual asset relate to the same underlying asset and, thus, are linked. Consequently, the boards concluded that it is useful to present those assets together.
- BC269 Although linked, the boards decided to require a lessor also to present or disclose the carrying amount of lease receivables and the carrying amount of residual assets separately because those assets have different natures, risks and liquidity. Separate disclosure of those assets will improve the transparency of information provided to users of financial statements about a lessor's exposure to credit risk (relating to the lease receivable) and asset risk (relating to the residual asset).
- BC270 The boards considered presenting the residual asset as it would be presented immediately after the expiry of the lease (for example, as inventory or property, plant and equipment). However, the boards noted that the residual asset (ie the rights retained in the underlying asset while the subject of a lease) did not share the same economic characteristics as similar assets that were not leased. Consequently, the boards concluded that it would be useful to present both assets (the lease receivable and the residual asset) that relate to the same underlying asset together. For example, a lessor cannot use an asset that it owns and generally cannot sell an asset that it owns (without the lease being attached) while the asset is the subject of a lease. In the boards' view, it would be less useful to present such an asset together with other assets that the lessor can either use in its own business or sell unencumbered at any time.

Statement of profit or loss and other comprehensive income (paragraphs 90–91)

- BC271 Business models vary among lessors with Type A leases. For example, many financial institution lessors use leasing solely as a means of providing finance to lessees. Other lessors, for example, manufacturer or dealer lessors, use leasing as an alternative means of realising value from assets they would otherwise sell and also provide finance to lessees. The boards propose to permit a lessor to present profit recognised at the commencement date either gross or net to reflect its business model or business models (if the lessor has different leasing businesses). That would enable a lessor to present the effects of leases in a way that is consistent with how the lessor generates its income.

Statement of cash flows (paragraph 92)

- BC272 The Exposure Draft proposes that, in the statement of cash flows, a lessor should classify lease payments received as operating activities because leasing is generally part of a lessor's revenue-generating activities.

Measurement: lessor—Type B leases (paragraphs 93–97)

- BC273 The boards decided that a lessor should continue to recognise the underlying asset, and recognise lease income over the lease term for Type B leases. The approach is similar to operating lease accounting in IAS 17 or Topic 840 for a lessor.
- BC274 The boards considered whether a lessor should be required to recognise a lease receivable for all leases, including Type B leases, but rejected this approach for the reasons noted in paragraphs BC72–BC74.
- BC275 The boards also decided that a lessor would recognise lease income arising from Type B leases on a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset. In reaching that decision, the boards considered two other alternatives:
- (a) recognising lease income on the basis of the contractual cash flows; or
 - (b) recognising lease income on a straight-line basis.
- BC276 Recognising lease income on the basis of the contractual cash flows might be an appropriate method of recognising lease income if the lessor measures the underlying asset at fair value, recognising changes in fair value through profit or loss. That is because the fair value of the asset would be estimated on the basis of future cash flows, taking into account both the timing and amount of contractual cash flows as well as non-contractual cash flows. However, the boards concluded that recognising lease income on a contractual cash flow basis would not be appropriate when the underlying asset is measured at cost because under such an approach, the amount of lease income recognised would be entirely dependent on the contractual timing of lease payments, rather than reflecting when the lessor has earned income.
- BC277 Although, in the boards' view, recognising rental income on a straight-line basis will often reflect the pattern in which income is earned from the underlying asset, they noted that will not always be the case. For example, the boards concluded that it would be simpler and more consistent with their proposals on variable lease payments to recognise lease income arising from variable lease payments for Type B leases in the period in which they are receivable, rather than on a straight-line basis. In addition, in the case of stepped rent increases (when those stepped rents are expected to compensate the lessor for increases in market rentals), the boards agreed with some respondents to the 2010 Exposure Draft that recognising lease income as lease payments are received would better reflect the pattern in which income is earned from the underlying asset. For such leases, although the yield that the lessor earns on the underlying asset may not change over the lease term, the amount of lease income earned in later periods may be higher, reflecting that the economic benefits derived from use of the underlying asset (which is often property in a Type B lease) have increased in value over the lease term.
- BC278 Consequently, the boards decided that a lessor would recognise rental income on a systematic basis that is not straight-line if that basis was more

representative of the pattern in which income is earned from the underlying asset. Nonetheless, a lessor would be expected to recognise uneven fixed lease payments on a straight-line basis when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (for example, when there is significant front-loading or back-loading of payments or when rent-free periods exist in a lease).

Disclosure: lessor (paragraphs 98–109)

- BC279 When determining the disclosures for leases, the boards considered the following:
- (a) the existing requirements in IAS 17 and Topic 840; and
 - (b) IFRS 7 (IAS 17 requires a lessor to comply with the disclosure requirements in IFRS 7).
- BC280 In selecting the disclosure objectives, the boards considered work in other related projects. As a result, the boards propose that disclosures about leases should enable users of financial statements to evaluate the amount, timing and uncertainty of cash flows arising from leases.

Reconciliation of opening and closing balances (paragraphs 103–104)

- BC281 This Exposure Draft proposes that a lessor should provide reconciliations of the lease receivable and residual asset for Type A leases because those reconciliations inform users of financial statements about changes to those assets during the reporting period. Users of financial statements have informed the boards that such reconciliations are useful in their analyses.

Information about exposure to residual asset risk (paragraph 107)

- BC282 This Exposure Draft proposes that a lessor of Type A leases should provide information about how it manages its exposure to residual asset risk. Some users of financial statements informed the boards that there is currently a lack of transparency on such information in a lessor's financial statements. Particularly for leases that are currently classified as operating leases, lessors can retain significant residual asset risk and very little, if any, information is available about that exposure to risk in financial statements. The boards considered proposing disclosure of the fair value of the residual asset at each reporting period to address the concern raised. However, the boards concluded that requiring fair value information at each period end could be very onerous for lessors. Although it is fundamental to a lessor's business that the lessor manage its exposure to residual asset risk, the costs associated with having to disclose, and have audited, fair value information about residual assets would potentially outweigh the benefit for users of financial statements.

Table of income (paragraph 101)

- BC283 This Exposure Draft proposes disclosure of lease income in tabular form, which will provide information about the different components of lease income

recognised during the reporting period (for example profit recognised at the commencement date and interest income). In the boards' view, the tabular display better highlights the different nature of the components of lease income.

Maturity analyses (paragraphs 106 and 109)

- BC284 This Exposure Draft also proposes that lessors should disclose a maturity analysis of the timing of the future cash flows arising from both Type A and Type B leases. In the boards' view, such disclosure would help users of financial statements to assess the expected timing and amount of future cash flows arising from leases.

Sale and leaseback transactions (paragraphs 110–117)

- BC285 In a sale and leaseback transaction, one entity (the lessee) sells an asset that it owns to another party (the lessor) and immediately leases back that same asset. Existing lease accounting requirements include specific requirements on sale and leaseback transactions to determine whether, when an asset is sold and immediately leased back, an entity should account for the transaction as a sale and leaseback, or account for the entire transaction as a financing arrangement. Those requirements are different under IFRS and US GAAP, with more transactions being accounted for as sale and leaseback transactions under IFRS than under US GAAP.
- BC286 Consistently with the 2010 Exposure Draft, this Exposure Draft proposes that a transaction should be accounted for as a sale and leaseback transaction only if there is a sale of the asset that is the subject of the contract. The 2010 Exposure Draft included a list of conditions that, if they existed, would typically preclude sale and leaseback accounting. Those conditions set a higher threshold in terms of achieving sale accounting than the revenue recognition proposals.
- BC287 Respondents to the 2010 Exposure Draft raised the following concerns about the proposals:
- (a) many questioned why there was a need for a higher threshold in relation to sale and leaseback transactions, especially in the light of the proposals in the Revenue Recognition project to remove the higher threshold that exists in US GAAP on real estate sales. Consequently, those respondents questioned why a higher threshold for revenue recognition should be retained only within the context of sale and leaseback transactions.
 - (b) many were concerned about whether the sale recognition conditions in the 2010 Exposure Draft were operational. They expected the proposals to be applied very strictly so that almost all sale and leaseback transactions would be treated as financing arrangements. Many of those respondents thought that applying sale and leaseback accounting was an appropriate way to account for those transactions.
- BC288 In response to those concerns, the boards decided that an entity would apply the control principle being developed in the Revenue Recognition project when assessing whether a sale has occurred in a sale and leaseback transaction. Applying the revenue recognition requirements to sale and leaseback

transactions would simplify the proposals and increase comparability between sales entered into as part of sale and leaseback transactions and all other sales. That would be beneficial to both preparers and users of financial statements. In addition, some of the structuring concerns relating to sale and leaseback transactions that exist under existing IFRSs and US GAAP would be reduced by the proposals in this Exposure Draft, which would require the recognition of lease assets and lease liabilities by lessees.

BC289 In applying the control principle in the revenue recognition proposals to sale and leaseback transactions, the boards decided to clarify the following in this Exposure Draft:

- (a) the control principle should be applied to the entire transaction, and not just the sales portion of the transaction. That is consistent with the proposals in the Revenue Recognition project to combine contracts that are negotiated as a package. It would also be difficult and arbitrary to bifurcate many sale and leaseback transactions into distinct sale and leaseback portions.
- (b) the existence of the leaseback does not, in isolation, prevent the buyer/lessor from obtaining control of the asset. That is because a lease is different from the purchase or sale of an asset in that a lease does not transfer control of the asset to the lessee; instead, it transfers the right to control the use of the asset for the period of the lease. Consequently, assuming that there are no features in a sale and leaseback transaction that would prevent sale accounting, the buyer/lessor would be considered to obtain control of the asset, and immediately transfer the right to control the use of that asset to the lessee for the lease term. The lease payments received by the buyer/lessor during the lease term, together with the benefits that the lessor can generate from the residual asset after the lease term, would represent substantially all of the remaining benefits from the asset immediately before the asset is leased to the seller/lessee. Consequently, in such cases, the buyer/lessor obtains control of the asset. The boards noted that the buyer/lessor in many sale and leaseback transactions is no different from many other lessors in terms of its control of the asset. Many lessors purchase an asset that will be the subject of a lease from a third party only when the terms and conditions of the lease have already been negotiated. The lessor may not receive physical possession of the asset until the end of the lease term (for example, a vehicle could be delivered directly by a manufacturer to the lessee, even though the lessor purchases the vehicle from the manufacturer). In a sale and leaseback transaction, the lessor may also not receive physical possession of the asset until the end of the lease term. However, in both of those situations, the boards concluded that it would be appropriate for the lessor to be deemed to control the asset immediately before the commencement of the lease.
- (c) a sale has not occurred if the leaseback is such that the seller/lessee obtains substantially all of the remaining benefits of the asset. In that case, the seller/lessee has, in effect, sold the asset and immediately repurchased it. Accordingly, a sale has not occurred and the entire

transaction should be accounted for as a financing arrangement. The boards decided to include requirements on how to apply that principle within the context of sale and leaseback transactions, which are the same as the requirements applied when classifying leases of property. Those requirements are familiar to many constituents, which will make them easier to apply and lead to more consistent application.

- (d) if an entity concludes that the buyer/lessor does not obtain control of the asset, the entire transaction is accounted for as a financing arrangement. On the basis of the proposals in the 2011 Exposure Draft *Revenue Recognition*, the inclusion of a call option or some put options in a sale and leaseback transaction would cause the transaction to be accounted for as a financing arrangement. In making that decision, the boards noted that the application of the proposals in that Exposure Draft on repurchase agreements could have required an entity to account for some sale and leaseback transactions as a lease and leaseback. The boards noted that applying lease and leaseback accounting in those situations would be complex and difficult to understand and, thus, the cost would outweigh any benefit. Consequently, the boards expect that the requirements on repurchase agreements within the forthcoming standard on revenue recognition will clarify that if the buyer/lessor does not obtain control of the asset in a sale and leaseback transaction, the entire transaction is accounted for as a financing arrangement.

BC290 The lease payments and the sales price in a sale and leaseback transaction can be interdependent because they are negotiated as a package. For example, the sales price might be more than the fair value of the asset because the leaseback lease payments are above a market rate; conversely the sales price might be less than the fair value because the leaseback lease payments are below a market rate. That could result in the misstatement of gains and losses on disposal of the asset for the lessee and the misstatement of the carrying amount of the asset for the lessor. Consequently, this Exposure Draft proposes that if the sale consideration or leaseback rentals are not at market rates, a lessee should adjust the carrying amount of the right-of-use asset to reflect current market lease payments for that asset, with a corresponding adjustment made to the gain or loss recognised on disposal of the asset. Similarly, a lessor would adjust the amounts recognised to reflect current market lease payments. In the boards' view, such adjustments ensure that the assets, liabilities, gains and losses recognised by both the lessee and the lessor are neither understated nor overstated. However, the FASB decided that if the transaction is between entities that are related, the lessee and the lessor should not adjust the lease assets or the lease liabilities and should make the appropriate disclosures in accordance with Topic 850, Related Party Disclosures.

BC291 The boards considered whether the transferred asset must be an entire leased asset (a 'whole asset' approach) or whether a bundle of rights and obligations associated with an asset could qualify for sale and leaseback accounting (a 'partial asset' approach). For example, under a partial asset approach, in a sale and leaseback of an office building, the lessee would continue to recognise a portion of the building representing the right to use the building during the leaseback period and derecognise that portion of the building relating to the

rights transferred to the lessor (for example ownership rights and the right to use the building after the end of the leaseback period). However, the boards decided not to propose a partial asset approach because it would be complex to apply and would not provide a proportionate benefit in improved information to users of financial statements.

- BC292 This Exposure Draft proposes that lessees should disclose the main terms and conditions of sale and leaseback transactions and any gains and losses arising from those transactions. Those disclosures would inform users of financial statements about transactions that could give rise to significant non-recurring gains and losses and cause a significant change in the capital structure of the entity.

Related party leases (FASB-only)

- BC293 The FASB decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties on the basis of legally enforceable terms and conditions of the arrangement, acknowledging that some related party transactions are not documented and/or the terms and conditions are not at arm's length. In addition, lessees and lessors would be required to apply the disclosure requirements for related party transactions in Topic 850. Under existing US GAAP, entities are required to account for leases with related parties based on the economic substance of the arrangement, which may be difficult when there are no legally enforceable terms and conditions of the arrangement. Examples of difficulties include related party leases that are month-to-month and related party leases that have payment amounts dependent upon cash availability. In these situations, it is difficult and costly for preparers to apply the recognition and measurement requirements. Even when applied, the resulting information is often not useful to users of financial statements.

Short-term leases (paragraphs 118–120)

- BC294 The 2010 Exposure Draft proposed that a lessee and lessor could elect to apply simplified accounting to leases that met the definition of a short-term lease. A lessee would not need to discount lease assets and lease liabilities arising from short-term leases. A lessor could apply an approach similar to existing operating lease accounting to short-term leases. A short-term lease was defined in the 2010 Exposure Draft as a lease that, at the commencement date, has a maximum possible lease term of 12 months or less.
- BC295 Respondents to the 2010 Exposure Draft noted that the proposals for short-term leases did not offer much relief for entities because the discount element of short-term leases is often immaterial. In addition, the proposals would still require an entity to track a possibly large volume of leases with little value and to separate non-lease components from lease components for these leases, which could be cumbersome.
- BC296 On reconsideration, the boards agreed that applying the full proposals did not justify the costs. Consequently, the boards have simplified the accounting for

short-term leases to offer more relief to lessees. This Exposure Draft proposes that both lessees and lessors need not apply the proposed recognition and measurement requirements to short-term leases.

- BC297 This Exposure Draft proposes that short-term leases should be defined as leases that, at the commencement date, have a maximum contractual term, including all options to extend, of 12 months or less. The boards considered, but rejected, increasing the short-term lease exemption beyond leases of 12 months because, for example, two-year leases and three-year leases are more likely to give rise to material assets and liabilities, and the objective of the project was to ensure greater transparency about an entity's leasing activities.
- BC298 The boards also considered defining short-term leases consistently with the definition of the lease term. According to that approach, a short-term lease would include any lease for which the lease term is 12 months or less, considering whether the lessee has a significant economic incentive to extend the lease. The boards rejected that approach because of concerns that leases could be structured to obtain short-term lease accounting. For example, a lease that ultimately extends for 10 years or more could be structured to include a series of one-year renewal options, which could result in the lease never being recognised on a lessee's statement of financial position. In addition, such an approach would require entities to apply more judgement than the contractual approach proposed by the boards and, thus, would be more complex to apply. In the light of the boards' objective in including an accounting option for short-term leases, which was to provide cost relief, the boards concluded that it would be counter-intuitive to make the practical relief more complex to apply.

Effective date (paragraph C1)

- BC299 The boards will set the effective date for the proposed requirements when they consider feedback on the proposed changes and finalise this Exposure Draft. The boards recognise that the proposals affect almost every reporting entity. Some of those entities have many leases and the proposed changes to accounting for those leases are significant. The boards will consider these and other relevant factors when setting the effective date to ensure that entities have sufficient time to implement the proposed changes. As part of that consideration, the boards will consider whether to permit early application of the leases requirements.
- BC300 Consequently, this Exposure Draft does not specify a possible effective date or whether the proposed requirements could be applied early.

Transition (paragraphs C2–C24)

- BC301 The 2010 Exposure Draft proposed that an entity should recognise and measure all outstanding contracts that exist at the beginning of the earliest comparative period as of that date using a simplified retrospective approach.
- BC302 According to that simplified approach, lessees would be required to recognise a lease liability measured at the present value of the remaining lease payments and a right-of-use asset equal to the lease liability, less any impairment

adjustments. A lessee could carry forward the carrying amounts of lease assets and lease liabilities arising from leases classified as finance leases according to existing requirements if those leases did not have options, variable lease payments, term option penalties or residual value guarantees. Transition for lessors would depend on the lessor accounting approach applied. For leases to which a lessor would apply the performance obligation approach, the lessor would measure the lease receivable and performance obligation at the present value of the remaining lease payments. For leases to which a lessor would apply the derecognition approach, the lessor would recognise a lease receivable, measured at the present value of remaining lease payments, and a residual asset, measured at fair value.

BC303 The boards received differing views on the transition approach proposed in the 2010 Exposure Draft:

- (a) some agreed with the boards' proposals in the 2010 Exposure Draft. They noted that the simplified approach helps reduce cost for preparers while continuing to provide users with useful information.
- (b) others disagreed with that approach. Many were concerned about the 'front-loading effect' of interest expense for lessees at transition. They noted that the transition proposals treated all leases as new leases on the date of transition, which would increase lease-related costs artificially in the years immediately after transition and reduce those costs artificially nearing the end of each lease. The front-loading effect that would arise from the transition proposals would be much greater than that which would arise if a lessee applied a full retrospective approach on transition. They thought that the artificial increase in interest expense immediately after transition would distort the financial information provided to users of financial statements. For that reason, many suggested that an entity should be permitted to apply a full retrospective approach.
- (c) most preparers expressed concerns about the costs associated with transition, with some favouring prospective application.
- (d) others thought there was a need for additional transition requirements for specific transactions, including sale and leaseback transactions and leveraged leases, and additional requirements on the discount rate to be used.

Modified retrospective approach

BC304 On the basis of feedback received, the boards concluded that the simplified retrospective approach that was proposed in the 2010 Exposure Draft was not the appropriate approach, mainly because of the front-loading effects for lessees that would have distorted lease-related expenses included in profit or loss in periods after transition.

BC305 The boards then considered other approaches to address the main concerns raised, including the following:

- (a) retrospective approach;
- (b) modified retrospective approach; and

- (c) prospective approach.
- BC306 The boards rejected requiring a full retrospective approach without any relief because the costs of such an approach for preparers could be significant and would be likely to outweigh the benefits. A full retrospective approach would require entities to calculate the carrying amounts of all outstanding leases at the earliest comparative period as if those leases had always been accounted for in accordance with the proposed requirements. That could be impracticable for entities that have thousands of leases. Nonetheless, the boards did not wish to prohibit entities from applying a full retrospective approach because that approach would provide better information to users of financial statements than other approaches. Consequently, the boards decided to permit entities to choose to apply the proposals retrospectively.
- BC307 The boards also rejected a prospective approach (ie applying the proposals only to leases that commence after the date of transition). Although the approach would be the least costly for preparers to apply, the information provided would not be beneficial to users of financial statements, particularly for entities that enter into longer-term operating leases. For example, some entities enter into operating leases with lease terms of 20 to 25 years. For such entities, a user would not obtain a clear picture of the true effect of the leases proposals for up to 25 years after implementing the new requirements. In addition, lease income for many lessors is central to the lessor's revenue generating activities. Consequently, it is important for users of financial statements to have information about those activities prepared on a consistent basis.
- BC308 The boards decided to propose a modified retrospective approach in this Exposure Draft because such an approach would result in an entity recognising amounts on transition that approximate a full retrospective approach without performing all of the calculations assuming that the proposals had been applied from the beginning of every lease. This approach would also address the concerns raised in response to the 2010 Exposure Draft about the front-loading effects for lessees.
- BC309 According to the modified retrospective approach, a lessee would calculate lease assets and lease liabilities in a similar manner to a full retrospective approach but would use information available to the lessee at the date of transition. A lessee may also apply hindsight on transition. To provide additional relief, the boards decided that a lessee could calculate a discount rate on a portfolio basis for leases with similar characteristics, rather than calculate a discount rate for each lease.
- BC310 Although providing some relief for lessors (for example, a lessor can also use hindsight on transition), the modified retrospective approach proposed by the boards does not provide as much relief for lessors as it does for lessees, for a number of reasons:
- (a) a lessor's leasing activities are generally a central part of the lessor's revenue generating activities and, accordingly, it is important that users of financial statements obtain information about those activities that is prepared on a consistent basis when the lessor first applies the proposed requirements.

- (b) there is little change to existing requirements for lessors of Type B leases. On transition, a lessor can carry forward its previous accounting for Type B leases. Consequently, the lessor accounting proposals affect a smaller population of leases and a smaller population of entities. In contrast, the lessee accounting proposals require significant changes for both Type A leases and Type B leases.
- (c) a lessor of Type A leases should be able to more easily obtain information about those leases than a lessee would. For example, the boards are not proposing any relief for lessors on the discount rate to be applied on transition. That is because the original rate charged to the lessee is consistent with the rate applied to new leases and that rate is also likely to be available to a lessor of Type A leases.

Uneven lease payments

- BC311 In some leases, lease payments are uneven during the lease term and there may be significant increases in payments at the beginning or end of the lease term. For such leases, the present value of the lease payments during the remaining term of the lease may not reflect the economic benefits that are available to the lessee or lessor at the date of transition. Accordingly, this Exposure Draft proposes that lessees should adjust the right-of-use asset and that lessors should adjust the carrying amount of the underlying asset derecognised for many Type A leases to reflect any adjustments for prepaid or accrued payments on transition.

Leases that are finance leases according to existing requirements

- BC312 In the 2010 Exposure Draft, the boards proposed transition relief for finance leases that do not include features such as options, residual value guarantees and variable lease payments. That was because, for those simple finance leases, there would be little difference between the accounting under the existing and proposed requirements, and thus the benefits of restating the assets and liabilities for those leases would be marginal. Some respondents to the 2010 Exposure Draft thought that the transition relief should be extended to all leases classified as finance leases. They noted that finance leases typically do not include variable lease payments or unrecognised optional lease payments and, thus, there is little difference in the accounting that would result from applying the existing and proposed requirements to all finance leases.
- BC313 This Exposure Draft proposes that an entity need not remeasure the assets and liabilities arising from leases classified as finance leases in accordance with existing requirements. The boards agreed with those respondents who noted that the cost of requiring entities to remeasure lease assets and liabilities for those leases would be likely to outweigh the benefit because the accounting under the existing and proposed requirements would be similar. In reaching that decision, the boards also noted that the changes to the proposals on options and variable lease payments would result in proposals that are more closely aligned with the existing requirements.
- BC314 The boards decided that the best way to implement this proposal would be to:

- (a) require an entity to use the carrying amounts of lease assets and liabilities under existing requirements as the carrying amounts at the date of transition to the new requirements; and
- (b) after the date of transition, apply particular requirements within the proposals that would lead to accounting that is similar to applying the existing requirements for finance leases.

Sale and leaseback transactions

- BC315 In response to requests from respondents to the 2010 Exposure Draft, the boards decided to provide transition requirements for sale and leaseback transactions that are consistent with the general transition proposals for lessees and lessors to the extent possible. Accordingly, because the boards decided to provide transition relief for leases that are classified as finance leases in accordance with existing requirements, the boards are also proposing transition relief for sale and leaseback transactions for which the entity concluded that the transaction was a sale and finance leaseback in accordance with existing requirements.
- BC316 For all other sale and leaseback transactions, an entity would be required to reassess whether a sale has occurred and, if so, to apply the general transition requirements to the leaseback. This approach would provide comparability between (a) sale and leaseback transactions entered into before and after transition and (b) leases, regardless of whether the lease is part of a sale and leaseback transaction. It should, therefore, provide better information to users of financial statements than other approaches.

Leveraged leases (FASB-only)

- BC317 The existing accounting model for leveraged leases will not be retained in this Exposure Draft, and the leases proposals for lessors will be applied to all leases currently accounted for as leveraged leases. The FASB decided that all leases should be accounted for in a consistent manner and that special rules should not exist for leases with certain characteristics.

Consequential amendments

Business combinations

- BC318 The boards decided that when the acquiree in a business combination is a lessee, the acquirer should measure the acquiree's lease liability at the present value of the remaining lease payments as if the acquired lease was a new lease at the date of acquisition. The acquiree's right-of-use asset should be measured at an amount equal to the lease liability, with an adjustment for any off-market terms present in the lease.
- BC319 The boards considered whether an acquirer should be required to follow the general principle in IFRS 3 *Business Combinations* and Topic 805, *Business Combinations*, and measure the acquiree's right-of-use assets and lease liabilities at fair value on the date of acquisition. However, in the boards' view, the costs associated with measuring lease assets and lease liabilities at fair value would outweigh the benefits because obtaining fair value information, particularly for the right-of-use asset, might be difficult and, thus, costly. The boards also noted

that when the acquiree is a lessee, the proposals on the measurement of lease assets and lease liabilities would result in recognising a net carrying amount for the lease at the date of acquisition that approximates the fair value of the lease at that date.

- BC320 The boards decided that when the acquiree in a business combination is a lessor of Type A leases, an acquirer should recognise the acquiree's lease receivable at the present value of the remaining lease payments, as if the acquired lease were a new lease at the date of acquisition. The acquiree's residual asset should be measured as the difference between the fair value of the underlying asset at the date of acquisition and the carrying amount of the lease receivable. The boards considered requiring the measurement of both the lease receivable and the residual asset at fair value at the date of acquisition. However, the boards noted that there would be costs associated with measuring each of those assets at fair value and that they had decided not to require such a measurement basis for the lease receivable and the residual asset more generally because of those costs. In addition, although the proposed initial measurement of the lease receivable and the residual asset may not represent the fair value of those assets, the sum of the initial measurement of those assets would equal the fair value of the underlying asset, which is consistent with the principles in IFRS 3 and Topic 805. Consequently, the boards concluded that the costs of requiring an acquirer to measure the lease receivable and the residual asset at fair value would outweigh the benefits.

Transition for first-time adopters of IFRS (IASB-only)

- BC321 The IASB considered whether the transitional relief in paragraphs C2–C18 should also apply to entities applying IFRS 1 *First-time Adoption of International Financial Reporting Standards*.
- BC322 The IASB decided that a first-time adopter of IFRS should be permitted to apply the transition reliefs available to an IFRS preparer to leases currently classified as operating leases in accordance with IAS 17. This is because those first-time adopters would face issues similar to those faced by existing IFRS preparers, and the transition requirements provide some relief when first applying the new requirements.
- BC323 The IASB, however, decided against permitting a first-time adopter of IFRS to apply the transitional relief in paragraphs C10–C12 and C16–C18 to leases currently classified as finance leases. As noted above in paragraph BC312, the accounting for leases classified as finance leases in accordance with IAS 17 is similar to the proposed accounting to be applied by both lessees and lessors to those leases. For this reason, when a lease is classified as a finance lease in accordance with IAS 17, the IASB decided to permit an IFRS preparer to measure lease assets and lease liabilities at the beginning of the earliest comparative period presented at the amounts that they were previously measured in accordance with IAS 17.
- BC324 However, the IASB is not aware of, nor is it possible to consider, the accounting required by every other GAAP for leases that are classified as finance leases in accordance with IAS 17. The amounts recognised in accordance with other GAAPs could be significantly different from the amounts recognised in

accordance with IAS 17 and the proposals in this Exposure Draft. For example, some other GAAPs may require or permit some leases classified as finance leases in IAS 17 to be accounted for as off-balance-sheet transactions. If this is the case, the IASB concluded that carrying forward that previous accounting could be misleading to users of financial statements, and result in a lack of comparability with other IFRS preparers, perhaps for many years after first implementing IFRS.

Investment property (IASB-only)

- BC325 Under existing requirements, a lessee is permitted to account for property that the lessee holds under an operating lease using the fair value model in IAS 40 if that property meets the definition of investment property. Such an election is available on a property-by-property basis.
- BC326 The consequential amendments to IAS 40 in this Exposure Draft, however, propose that investment property held under any lease should be within the scope of IAS 40. This represents a change from the existing scope of IAS 40. The IASB decided to eliminate the option for investment property held under an operating lease because of the changes proposed to the lessee accounting model. The IASB has concluded that every lease creates an asset for the lessee. Accordingly, the IASB decided that any right-of-use asset arising from a lease of property that meets the definition of investment property should be accounted for as investment property. The IASB concluded that such an approach would result in greater consistency in accounting for investment property and, thus, would provide better information to users of financial statements.

Licenses of internal-use software (FASB-only)

- BC327 The FASB decided to remove the requirements in paragraph 350-40-25-16, which require entities to analogise to Topic 840 on leases when determining the asset acquired in a license of internal-use software. Although entities currently apply Topic 840 by analogy, that Topic is expected to change as a result of this Exposure Draft. Because licenses of internal-use software are just one of many types of licenses and this Exposure Draft does not address leases of intangible assets, the FASB decided not to develop accounting requirements for only one type of license as part of the leases project.

Variable interests (FASB-only)

- BC328 The FASB decided to amend the requirements in paragraph 810-10-55-39 because the operating lease classification is not retained in this Exposure Draft. The FASB does not intend to change current US GAAP on variable interests. Regardless of lease classification under this Exposure Draft, in the FASB's view, certain features of leases, such as guarantees of residual values of leased assets and purchase options, may create a variable interest. Although the FASB notes that the lease accounting model in this Exposure Draft better reflects the rights and obligations that arise from leases than current US GAAP, the objectives of variable interest entity consolidation requirements differ from the objectives of the leases proposals.

Effects analysis for leases (IASB-only)¹

BC329 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely ongoing associated costs and benefits of each proposed IFRS—the costs and benefits are collectively referred to as ‘effects’. The IASB gains insight on the likely effects of the proposals for new or revised IFRSs through its formal exposure of proposals, analysis and consultations with relevant parties.

BC330 The following sections describe those considerations. There are separate sections discussing effects on lessees and lessors, respectively.

Summary

Changes being proposed to the accounting requirements

BC331 Lease accounting (ie IAS 17 *Leases* within IFRS) has historically focused on identifying when a lease is economically similar to purchasing the asset being leased (the ‘underlying’ asset). When a lease is determined to be economically similar to purchasing the underlying asset, the lease is classified as a finance lease and is reported on the lessee’s statement of financial position, and the lessor recognises a receivable from the lessee. All other leases are classified as operating leases and are not reported on the lessee’s statement of financial position. Operating leases are accounted for like service contracts, with the lessee reporting a rental expense and the lessor reporting rental income (typically on a straight-line basis) in each period of the lease.

BC332 This Exposure Draft proposes significant changes to how a lessee accounts for operating leases of more than 12 months. For all practical purposes, the accounting for finance leases for both lessees and lessors would remain unchanged.

BC333 A lessee would recognise assets and liabilities for all leases of more than 12 months. The recognition and presentation of lease-related expenses in a lessee’s statement of profit or loss and other comprehensive income, and cash paid for leases in the statement of cash flows, would largely depend on the nature of the underlying asset. The main effects are set out in the following paragraphs.

BC334 For most leases of equipment or vehicles (for example aircraft, ships, mining equipment, cars and trucks), a lessee would:

- (a) recognise a right-of-use asset and a lease liability, initially measured at the present value of lease payments;
- (b) recognise amortisation of the right-of-use asset separately from interest on the lease liability over the lease term; and
- (c) separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).

¹ The Basis for Conclusions on the FASB’s Exposure Draft includes the FASB’s cost benefit analysis.

- BC335 Accordingly, a lessee's statements of financial position, profit or loss and other comprehensive income and cash flows would change for leases of equipment or vehicles classified as operating leases according to IAS 17.
- BC336 For most leases of property (ie land and/or a building), a lessee would:
- (a) recognise a right-of-use asset and a lease liability on a discounted basis, in the same way as it does for equipment and vehicle leases;
 - (b) recognise a lease expense on a straight-line basis over the lease term; and
 - (c) present the cash paid within operating activities.
- BC337 Accordingly, only a lessee's statement of financial position would generally be expected to change for leases of property classified as operating leases according to IAS 17.
- BC338 This Exposure Draft proposes less significant changes to how a lessor accounts for leases. For all practical purposes, there is little change for finance leases and operating leases of property. For lessors that enter into operating leases of equipment or vehicles, however, the changes proposed are significant. In summary, a lessor of most equipment and vehicle leases would:
- (a) recognise a lease receivable and a retained interest in the underlying asset (the residual asset), rather than recognising the underlying asset itself; and
 - (b) recognise interest income on both the lease receivable and the residual asset over the lease term.
- BC339 In addition, if the lessor were a manufacturer or dealer lessor, the lessor might also recognise profit on the lease at the commencement date.

Benefits for users of financial statements

- BC340 The IASB expects the proposals in this Exposure Draft to improve the quality of financial reporting significantly for a number of reasons:
- (a) for many lessees, the assets and liabilities that arise from operating leases are significant. Recognising assets and liabilities for all leases of more than 12 months would provide a more faithful representation of the financial position of a lessee and, together with enhanced disclosures, greater transparency about the lessee's leverage. Providing information about a lessee's undiscounted future lease payments only in the notes to the financial statements (as is required by IAS 17) is:
 - (i) misleading for some users of financial statements (who rely on an entity's statement of financial position to provide information about leverage); and
 - (ii) provides insufficient information for others (who often estimate a lessee's lease liabilities using makeshift techniques that produce estimates that can vary widely and may not be accurate—see paragraph BC352 for further information).

- (b) recognising and presenting lease expenses arising from most equipment leases differently from those arising from most property leases would reflect the differing economics of most equipment leases and property leases.
- (c) accounting for most equipment leases differently from most property leases from a lessor's perspective would reflect that, broadly speaking, a property lessor's business model is different from an equipment lessor's business model.

Costs for preparers

BC341 Lessees with operating leases are expected to incur costs in implementing the proposals, the significance of which will depend on the terms and conditions of leases, the size of the lease portfolio and the systems already in place to manage leasing activities. Those costs would arise from, for example:

- (a) the need to determine a discount rate for each lease of more than 12 months; and
- (b) if a lessee enters into leases with variable lease payments that depend on an index or a rate, the need to remeasure the lease liability on the basis of the index or rate at the end of each reporting period.

Lessees would also incur costs to educate staff and update internal procedures. In providing the disclosures required by IAS 17, lessees are already required to have an inventory of leases and information about the lease term and future lease payments for each lease. Accordingly, costs are not expected to increase in this respect.

BC342 Lessees that have less sophisticated systems in place to manage and track leases are expected to incur more significant costs than lessees that have sophisticated systems.

BC343 Equipment and vehicle lessors that enter into operating leases are also expected to incur costs in enhancing and updating their accounting systems. Although most of those lessors would be expected to have the information required to apply the proposed accounting within their leasing businesses, that information may reside outside the accounting departments and there are likely to be costs associated with obtaining the information for accounting purposes.

Conclusions of the IASB

BC344 On the basis of the information obtained about the effects of the proposals in this Exposure Draft, the IASB is of the view that the benefits that would arise from the proposals substantially exceed the expected costs.

BC345 The following sections discuss in more detail all of the following:

- (a) the expected changes to the quality of financial reporting;
- (b) the expected changes to amounts reported in the financial statements of those applying IFRS; and
- (c) the expected costs of implementation for preparers and users.

The likely effects for lessees

Expected changes to the quality of financial reporting

How the changes would provide more relevant information about, and a more faithful representation of, lease transactions

- BC346 According to the *Conceptual Framework*, if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. Information is relevant if it has predictive or confirmatory value. These characteristics are referred to as the fundamental qualitative characteristics of financial information.
- BC347 Providing information about lease assets and lease liabilities as would be required under the proposals will make financial reporting more relevant than it is today under IAS 17. That is because a lessee would be required to recognise a right-of-use asset and lease liability for all leases over 12 months. Information about lease liabilities has predictive value because it provides information about minimum future cash outflows in relation to leases, which is useful for decision-making.
- BC348 Although the disclosure of future lease payments required by IAS 17 has predictive value, that information alone is not as useful as the information provided under the proposals because it is shown only on an undiscounted basis. This makes it less comparable with information provided about other financial liabilities recognised in an entity's statement of financial position and measured on a discounted basis.
- BC349 The IASB is of the view that a lease gives rise to a liability and an asset for the lessee and that liability and asset should be reported in the financial statements. The IASB does not view the commitments that arise from operating leases to be different from the commitments that arise from finance leases.
- BC350 The IASB thinks that disclosure in the notes to the financial statements is not a substitute for recognising lease assets and lease liabilities, even when those disclosures aim to provide some of the information that would be provided if those assets and liabilities were to be recognised. This is because not recognising the assets and liabilities arising from leases provides a misleading picture in the statement of financial position of a lessee's leverage and the assets that the lessee uses in its operations.

User needs regarding a lessee's lease assets and lease liabilities

- BC351 At present, many users of financial statements make adjustments to a lessee's financial statements to capitalise operating leases on a discounted basis and use those adjusted financial statements for their decision-making. In the user outreach that the IASB has conducted throughout the life of the project (meeting with users including buy- and sell-side equity analysts, credit analysts and representatives of investor groups), almost all users of financial statements said that they adjust lessees' statements of financial position by recognising lease assets and lease liabilities for operating leases.

- BC352 The adjustments made by users of financial statements regarding operating leases are, however, based on estimates and short cuts because the information available about operating leases in the notes to the financial statements under IAS 17 is insufficient to allow them to make reliable adjustments. The adjustments can, therefore, be incomplete and inaccurate. Adjustment techniques are often not updated even though the economic environment surrounding lease transactions changes constantly, and, in more recent years, has changed dramatically. This means that the adjustment techniques employed may have little to do with the lessee's actual lease portfolio. This can result in users of financial statements making different adjustments, even when those users are attempting to measure the same amounts.
- BC353 The IASB is of the view that the proposals for leases would significantly improve the quality of information provided to users of financial statements. This is because the information would provide a measure of all lease liabilities (incorporating fixed lease payments) on a discounted basis, as well as undiscounted cash flow information in the notes, prepared by lessees in a consistent manner. The measurement basis would also be consistent with the measurement of other similar financial liabilities, thereby providing better information about a lessee's leverage in the statement of financial position.

How the changes improve the comparability of financial information

- BC354 One of the biggest criticisms of IAS 17 is the significant difference in accounting between operating leases and finance leases. This means that two very similar transactions from an economic perspective could be reported very differently, which reduces comparability between entities.

Statement of financial position

- BC355 The proposals will significantly improve the comparability of financial information reported in the statement of financial position. Assets and liabilities for all leases of more than 12 months will be recognised, and all lease liabilities will be measured in the same way.
- BC356 Under IAS 17, the majority of leases are classified as operating leases and, thus, do not result in the recognition of assets and liabilities.² Consequently, lessees with very different operating lease portfolios may look very similar both in terms of their reported financial position and performance. For example, if a lessee changes its lease portfolio in such a way that the portfolio consists of 10-year operating leases rather than two-year operating leases, this significant difference in the economic position and commitments of the lessee is not reflected in the reported assets and liabilities of the lessee, nor might it be evident from its profit or loss (it might be reflected only in the disclosures of operating lease commitments). In contrast, when a lessee changes the size of its lease portfolio by, for example, deciding to sell assets that it owns and leasing those assets back under operating leases, this significantly changes the lessee's reported assets and liabilities when economically the change might not be very significant. The entity may continue to use the same asset base and have

² Some surveys suggest that up to 80 per cent of leasing transactions today are operating leases, although the actual figures vary depending on the industry sector, region and entity.

significant financial commitments under those operating leases, and yet its statement of financial position would imply a smaller asset base and very little financial debt.

- BC357 According to the proposed requirements, accounting between leases and purchases will be more comparable because assets and liabilities arising from leases will be recognised. Nonetheless, entities that buy assets would not report the same amounts in the statements of financial position and profit or loss and other comprehensive income as those who lease assets, unless the lease is for all of the economic life of the underlying asset. The IASB concluded that this is appropriate because, even though economically similar, leases and purchases are not the same transactions. A lessee controls the right to use the underlying asset, not the underlying asset itself, and has a liability only for payments specified in the lease contract. However, recognising assets and liabilities arising from purchases as well as leases aids comparability and provides clarity about an entity's financial liabilities.
- BC358 In addition, the proposed requirements would provide better information when a lessee changes its financial flexibility by extending or shortening the length of its leases. According to the proposed requirements, any change in a lessee's lease portfolio (for example, a change from two-year leases to 10-year leases as described in paragraph BC356) would be reflected in a lessee's statement of financial position. Such a change would be reflected in a lessee's statement of financial position under IAS 17 only if the leases were classified as finance leases or the leases changed from being operating leases to finance leases or vice versa.

Optional and variable lease payments

- BC359 The IASB considered whether the information provided about lease assets and lease liabilities in accordance with the proposals would be incomplete because:
- (a) most variable lease payments are excluded from the measurement of lease assets and lease liabilities; and
 - (b) there is a high threshold for recognising lease payments that would be payable in optional renewal periods.
- BC360 The simplified approach proposed regarding the measurement of such amounts means that lease assets and lease liabilities might be viewed as incomplete in some cases. The proposed requirements for variable lease payments and options could be viewed as causing the accounting for some economically similar contracts to be less comparable. For example, assume a lessee enters into a five-year lease with an option to extend for three years. The lessee intends to exercise the option but does not have a significant economic incentive to do so. Under the proposed requirements, the lessee would report different lease assets and lease liabilities arising from this lease than a lessee who enters into a lease for eight years. Those two contracts could be viewed as being economically similar transactions, for which the same assets and liabilities should be reported. There is, however, an important difference between the two contracts with respect to the financial flexibility provided by one contract but not by the other. The IASB concluded that this financial flexibility is best reflected by reporting different assets and liabilities for those two contracts.

BC361 To take another example, two leases of a similar retail outlet may be for the same lease term, with lease payments being fixed for one lease and linked to sales for the other, and the variable lease payments for the second lease are expected to be about the same as the fixed payments for the first lease. According to the proposed requirements, those two leases would be reported differently. Those two contracts could be viewed as economically similar transactions that would be best reported in the same way. However, even though both leases may result in the same cash outflows, the lessees are in different economic positions. For example, if there is an economic downturn resulting in lower than expected sales, the lessee with variable lease payments would make correspondingly smaller lease payments than the lessee with fixed lease payments. The opposite would apply in the case of significant growth. The IASB concluded that this difference in the contractual commitments of a lessee is best reflected by reporting different assets and liabilities for those two contracts.

Statements of profit or loss and other comprehensive income and cash flows

- BC362 The proposals retain a dual approach in relation to the recognition and presentation of lease expenses and cash flows for lessees, which means that there would not be comparability across all leases in the statements of profit or loss and other comprehensive income and cash flows. Some would prefer that comparability and would suggest having a single lessee accounting approach. Indeed, proposing a dual lessee accounting approach increases the complexity of the proposals compared to a single approach. That is because it requires a lessee to classify its leases and, if the lessee has both types of lease, to develop systems to account for leases in two different ways. Both of these steps would not be required under a single approach.
- BC363 However, not all leases have the same economic characteristics. The different recognition and presentation of lease expenses and cash flows reflects the differing economics of different leases and, thus, is expected to provide useful information to users of financial statements. Leases of property are generally priced differently from equipment leases, largely because of the difference in the nature of the underlying asset and the amount of the underlying asset expected to be consumed over the lease term.
- BC364 The proposal to require different recognition and presentation of lease expenses has been supported by feedback the IASB received from some users. A number of retail and restaurant analysts have informed the IASB that, whilst they support the recognition of lease assets and lease liabilities in a lessee's statement of financial position, they would find it most useful to have a single rent expense for property leases, similar to the operating lease expense recognised today for those leases. Those analysts tend not to adjust the reported expenses of lessees, but only adjust the reported assets and liabilities of lessees. A number of analysts that follow lessees that have operating leases of equipment (for example airline analysts), however, request that the accounting for leases of equipment be consistent with the accounting for purchases of equipment. They already adjust a lessee's profit or loss by allocating rent expense (which is typically an operating expense) between operating and financing expenses. Some users of

financial statements allocate the rent expense using a set rate (for example, 33 per cent of rent expense allocated to interest expense and 67 per cent of rent expense allocated to depreciation expense), while other users allocate the expense by estimating the interest expense corresponding to the estimated lease liability, using the lessee's estimated borrowing rate. The proposed requirements should eliminate the need for some of those adjustments.

Other potential effects

BC365 During its deliberations, the IASB also considered the following potential effects of the leases proposals:

- (a) behavioural changes and structuring that may arise;
- (b) increased cost of borrowing for lessees as a result of higher reported leverage; and
- (c) increased regulatory capital requirements for banks and the effect on debt covenants.

Each of these is addressed below.

Behavioural changes and structuring

BC366 The IASB considered whether the proposals might give rise to behavioural changes and provide incentives to structure transactions to achieve desired accounting outcomes. Examples include structuring leases as service contracts, reducing the length of lease terms and making lease payments variable, all in an attempt to recognise smaller lease liabilities.

BC367 The IASB expects some changes to the structure of leases but thinks a major reason for this would be the removal of the incentive in IAS 17 to structure a lease as an operating lease in order to achieve off-balance-sheet accounting.

BC368 According to research on lease accounting, some leases are currently structured to achieve a desired outcome, which is often operating lease accounting for lessees. For example, the SEC report on off-balance-sheet activities issued in 2005 says the following:

“...when the FASB issued a standard in 1976 that required some lease obligations to be recorded on the balance sheet as liabilities, many lessees immediately began to restructure their leases to avoid recognizing liabilities. Their efforts were aided by parties who sought to profit from offering their expertise in structuring leases in ways that provided “preferable” accounting. Such structuring tends to reduce transparency. Indeed, oftentimes that is its point... The fact that lease structuring based on the accounting guidance has become so prevalent will likely mean that there will be strong resistance to significant changes to the leasing guidance, both from preparers who have become accustomed to designing leases that achieve various reporting goals, and from other parties that assist those preparers.”

BC369 The proposals to recognise assets and liabilities for all leases over 12 months would remove the incentive to structure transactions to achieve off-balance-sheet accounting. Nonetheless, differences in the recognition and presentation of expenses for the two types of leases might give rise to some lessees trying to achieve a particular outcome in profit or loss. This incentive for structuring, however, is expected to be small because the differences in

accounting are less fundamental. For example, when a lessee has a lease portfolio that is evenly distributed (ie the same number of leases with similar terms and conditions commence and expire during a period), there would be little, if any, effect on a lessee's profit or loss from applying Type A lease accounting or Type B lease accounting (see Appendix C for further information regarding the effects of the proposals on a portfolio of leases).

- BC370 There may be a desire for some lessees to structure their contracts as services in order to achieve off-balance-sheet accounting. The IASB already expects that there will be fewer leases identified under the proposals than under IAS 17 because of the changes proposed to the guidance on the definition of a lease. In addition, the IASB expects that some contracts may be restructured to be service contracts because the customer genuinely requires a service and not a lease. The IASB does not, however, expect the proposed guidance on the definition of a lease to be easy to structure around if an entity wishes to obtain the right to use an asset. This is because the guidance is based on a principle—the lessee's right to control the use of an asset—and does not include bright lines. Typically, to avoid the proposed lease accounting, an entity would need to introduce changes to a contract that result in real economic differences, and those differences would in turn justify different accounting.
- BC371 The IASB expects that some entities will re-examine their leasing activity as a result of applying the new requirements. This may result in changes to the lengths of leases, changes in payment terms or changes in lease versus buy decisions. This, however, is not always expected to be the result of a desire for structuring but also as a result of the greater transparency of information under the proposals. Although lessees, as parties to leases, might already be expected to have all relevant information about their leases, it is possible that some lessees do not pay as much attention to the efficiency of their leases, especially if lease decisions are decentralised. Because the proposals would require the recognition of lease assets and lease liabilities, entities will, for example, need to determine the discount rates charged in the lease and possibly identify scope for improvements in how they finance and operate their business. These changes would therefore be genuine business decisions, rather than changes motivated solely by accounting outcomes.

Increased cost of borrowing for lessees

- BC372 The IASB considered the effect the proposals might have on the cost of borrowing for lessees because lessees would report higher financial liabilities under the proposals. The IASB's outreach confirmed that many (including all of the credit rating agencies that participated in the outreach) already consider operating leases to be financial liabilities of a lessee, and already estimate the effect of the consequential leverage. Consequently, capitalising leases should not generally have an effect on the cost of borrowing that is equivalent to the effect of the total change in a lessee's reported financial liabilities. Instead, the IASB is of the view that any effect would reflect differences arising from more accurate information about the amount of borrowing relating to leases. It is possible that the cost of borrowing for some lessees may increase. Equally the cost of borrowing may actually decrease, depending on how different the lessee's recognised lease liabilities are from those that had been estimated by users of

financial statements. Such changes (if they occur) would, therefore, result from improved decision-making based on improved transparency about the lessee's leverage.

Effects on covenants and regulatory capital

- BC373 The IASB also considered the effects the proposals might have on debt covenants and regulatory capital requirements. If debt covenants are linked to the amounts recognised in a lessee's IFRS financial statements, some entities may no longer comply with those covenants upon adoption of the proposed requirements and without changes to the terms and conditions of the covenants. In addition, the proposed requirements might increase the amount of risk weighted assets and thus affect the regulatory capital needs of lessees that are financial institutions.
- BC374 The IASB has concluded that the proposed accounting requirements provide a more faithful representation of lease transactions. Accordingly, the IASB would expect amendments to be made to any requirements that depend on the accounting in IAS 17. The IASB is also aware that many debt covenants define their terms and conditions independently of accounting requirements and, thus, a change in accounting requirements would not affect the provisions of those covenants. Although the IASB's role includes considering the effects of its proposals, it does not include addressing territory-specific or entity-specific regulations, nor prudential regulations. However, the IASB will continue working to raise awareness of potential issues so they can be addressed on a timely basis. The IASB has an ongoing dialogue on the project with prudential regulators.

The likely effect of proposed changes on how leasing activities would be reported in the financial statements of lessees applying IFRS

- BC375 The proposals in this Exposure Draft would result in significant changes to how a lessee reports leases that are currently classified as operating leases. For all leases over 12 months, the proposals would require lessees to recognise the assets and liabilities that arise upon entering into a lease. There are also some changes to how lessees would report leases currently classified as finance leases, but those changes are not significant.
- BC376 Because operating leases account for the majority of leasing transactions, the proposed requirements would have an effect on the financial statements of many lessees, especially lessees that have a large volume of, or high value, operating leases. The overall effect would be different for individual entities, depending on factors such as the capital intensity of the business, their lease versus buy policies, the proportion of leases accounted for as operating leases under IAS 17, and the average lease terms. However, most reporting entities applying IFRS would be affected to some extent because leasing is a common transaction in most countries throughout the world.
- BC377 However, some leases classified as operating leases in accordance with IAS 17 would not be affected by the proposed requirements, such as some capacity contracts (for example some power purchase agreements) and other contracts

that involve the use of a portion of an asset for which the lessee does not control the use of that asset. This is because the definition of a lease in this Exposure Draft would capture a somewhat smaller population of contracts than the scope of IAS 17.

- BC378 In addition, lessees who enter into leases for 12 months or less would be able to choose not to apply the proposed requirements and instead simply recognise lease payments in profit or loss on a straight-line basis over the lease term (and not recognise lease assets and lease liabilities for those short-term leases).³

Effects for leases currently classified as operating leases

- BC379 Except as noted in paragraphs BC377–BC378, leases classified as operating leases would be within the scope of the proposals and would be classified as one of two new categories of leases: Type A leases or Type B leases.

Effect on the statement of financial position

- BC380 The biggest effect on the statement of financial position for former operating leases would be the recognition of a right-of-use asset and lease liability. According to the proposals in this Exposure Draft, the newly recognised right-of-use asset would be a non-current non-financial asset, and the lease liability would be part of current and non-current financial liabilities, depending on the timing of lease payments.

- BC381 For leases classified as operating leases, shareholders' equity is usually not affected because the lessee does not recognise a lease asset or lease liability. The effect of the proposals on shareholders' equity would depend on whether the lease is classified as a Type A lease or Type B lease, as follows:

- (a) for a lease classified as a Type A lease, the carrying amount of the right-of-use asset would, under the proposals, typically reduce more quickly than the carrying amount of the lease liability. This in turn would result in a reduction in reported shareholders' equity compared to operating lease accounting in IAS 17. The level of the reduction would depend on the length of the lease, the discount rate and the point in the lease term. The effect on equity is discussed further in Appendix B.
- (b) for a lease classified as a Type B lease, the carrying amount of the lease asset and liability will often be the same or similar throughout the lease term. Consequently, the IASB expects that there would be little effect of Type B lease accounting on reported shareholders' equity compared to operating lease accounting in accordance with IAS 17.

Effect on the statement of profit or loss and other comprehensive income

- BC382 The effect on the statement of profit or loss and other comprehensive income would depend on whether the lease is classified as a Type A lease or a Type B lease, as set out below.

³ Research suggests that such leases currently account for between one and ten per cent of all leases, depending on the region and industry sector, and the type of asset being leased.

Operating leases classified as Type A leases

- BC383 The presentation in the statement of profit or loss and other comprehensive income of the expenses associated with a Type A lease would be different from that for operating leases in IAS 17. The proposals would require a lessee to recognise interest on the lease liability separately from amortisation of the right-of-use asset. A lessee would be expected to present interest expense as a part of finance costs and amortisation expense within a similar line item to that in which it presents lease expenses for operating leases. For a lessee with operating leases classified as Type A leases, the lessee would be expected to report increased profit before interest (for example operating profit/EBIT) according to the proposals. This is because the lessee would report the interest element of lease payments below that profit measure whereas the entire amount of lease payments would be reported within that profit measure when applying operating lease accounting.
- BC384 For an individual Type A lease, the total expense recognised would be different from the expense recognised under IAS 17 in any individual reporting period. According to the proposals in this Exposure Draft, the sum of the interest expense and the amortisation expense during the first half of the lease term would generally be higher than a straight-line operating lease expense recognised in accordance with IAS 17. The opposite is true in the second half of the lease term—ie the sum of the interest expense and the amortisation expense during the second half of the lease term would generally be lower than a straight-line operating lease expense. Over the lease term, the total amount of expense recognised would be the same.
- BC385 Lessees typically hold a portfolio of leases at any one time, and the size of the effect of adopting the proposals on the statement of profit or loss and other comprehensive income would depend on the terms and conditions of the leases held by the lessee and how far those leases are into their respective lease terms.
- BC386 For example, if the lessee's lease portfolio is evenly distributed (ie the same number of leases commence/expire during a period and the lessee enters into new leases under the same terms and conditions as the leases that expire), then the overall effect on profit or loss from adopting the proposed requirements would be neutral. If the composition of the portfolio is not evenly distributed, either because of a change in the number of leases or because new leases have terms and conditions that are different from the leases that expire, then there would be an effect on profit or loss from adopting the proposed requirements. However, those factors would have to be significant to have a noticeable effect on profit or loss. This is illustrated in Appendix C.
- BC387 Finally, because differences between the proposed accounting and tax accounting are often expected to arise for a Type A lease, there is likely to be an effect on the amount of deferred tax recognised.

Operating leases classified as Type B leases

- BC388 For an operating lease accounted for in accordance with IAS 17, a lessee typically recognises lease expense arising from minimum lease payments during the lease term on a straight-line basis. The lessee recognises any other expenses (for

example variable lease payments) as they are incurred. For a lease classified as a Type B lease in accordance with the proposals, a lessee would recognise a lease expense (excluding most optional and variable lease payments) on a straight-line basis. Consequently, the proposals for Type B leases would generally result in little change to the statement of profit or loss and other comprehensive income.

Effect on the statement of cash flows

BC389 Differences in accounting guidance do not cause a difference in the amount of cash transferred between the parties to a lease (to the extent that there are no differences in behaviour created by the proposals). Consequently, there would be no effect on the total amount of cash flows reported, although adoption of the proposed requirements would have an effect on the presentation of cash flows if the lease is a Type A lease (there is no change in presentation for Type B leases).

BC390 For Type A leases, lessees would be required to split cash payments for leases between principal and interest payments. Lessees would present principal repayments as financing activities and interest payments in accordance with IAS 7 *Statement of Cash Flows*. Consequently, a lessee of operating leases that are recognised as Type A leases would be expected to report higher cash inflows from operating activities on adoption of the proposals because some lease cash outflows, ie repayments of the lease principal would be presented in the financing section of the statement of cash flows rather than the operating section. Conversely, those lessees would be expected to report higher cash outflows from financing activities.

Disclosures about leasing activities

BC391 The proposals in this Exposure Draft would result in a lessee providing enhanced disclosures as compared with the disclosures required by IAS 17.

BC392 The additional disclosures proposed include:

- (a) a more detailed maturity analysis of the lease liability that shows the undiscounted cash flows on an annual basis for each of the first five years;
- (b) a narrative description of the terms and conditions of any residual value guarantees and options recognised as part of the right-of-use asset;
- (c) information about any significant assumptions and judgements made in applying the proposals; and
- (d) a reconciliation of opening and closing balances of right-of-use assets (by class of underlying asset) and of lease liabilities.

Effects for leases currently classified as finance leases

BC393 The IASB expects almost all leases classified as finance leases in accordance with IAS 17 to be classified as Type A leases according to this Exposure Draft.

BC394 Although lease assets and lease liabilities are recognised for both finance leases in IAS 17 and Type A leases in accordance with the proposals, there are some

differences in how they would be measured and reported. Such differences would result in the following effects on the financial statements of a lessee.

Effect on the statement of financial position

- BC395 The main difference between the accounting for finance leases in IAS 17 and Type A leases in this Exposure Draft relates to residual value guarantees. In accordance with IAS 17, a lessee in a finance lease recognises the maximum amount of any residual value guarantees provided to the lessor as part of the lease asset and lease liability. In contrast, this Exposure Draft proposes that the lessee would recognise only amounts expected to be payable under residual value guarantees, not necessarily the maximum amount guaranteed. Consequently, a lessee that provides a residual value guarantee to a lessor would recognise a smaller amount of lease assets and lease liabilities when applying the proposals in this Exposure Draft if the guarantee is expected to result in cash outflows for the lessee that are lower than the maximum amount.

Effect on the statement of profit or loss and other comprehensive income

- BC396 A lessee recognises interest expense on the lease liability and depreciation/amortisation of the lease asset for both finance leases in IAS 17 and Type A leases in accordance with the proposals. Because the IASB does not expect any significant differences in the amounts recognised in the statement of financial position, there would be no significant difference in the interest and depreciation/amortisation expenses in the statement of profit or loss and other comprehensive income.

Statement of cash flows

- BC397 Cash payments for both finance leases in IAS 17 and Type A leases in accordance with the proposals are split between repayment of principal and payment of interest. Principal payments are presented as financing activities and interest payments are presented in accordance with IAS 7. Consequently, the IASB does not expect any effect on the statement of cash flows.

Disclosures about leasing activities

- BC398 There are some disclosures provided by lessees of finance leases in accordance with IAS 17 that would not be provided for Type A leases under the requirements in this Exposure Draft. They include a description of purchase options that exist in leases and a maturity analysis of the present values of minimum lease payments.
- BC399 This Exposure Draft also proposes that a lessee provide some disclosures for Type A leases that are currently not provided by lessees of finance leases in accordance with IAS 17. Those disclosures are listed in paragraph BC392.

Effects on key financial ratios

- BC400 For leases currently classified as finance leases, there would be no significant change to the key financial ratios derived from a lessee's financial statements unless the lessee provides significant residual value guarantees that are not expected to result in cash outflows (see paragraph BC395 above).

- BC401 However, for leases currently classified as operating leases, there could be significant changes in some financial ratios if those ratios are based on figures reported in the financial statements.⁴ The potential changes include the following:
- (a) For all leases, recognising a liability that was previously unrecognised will lead to higher reported debt, thus increasing reported leverage (gearing).
 - (b) For all leases, recognising an asset that was previously unrecognised will lead to a higher reported asset base, which will affect ratios such as asset turnover.
 - (c) For Type A leases, recognising amortisation and interest instead of operating lease expense will lead to higher reported operating results (because interest is typically excluded from operating expenses). Similarly, profit measures that exclude interest and amortisation but include operating lease expense, such as EBIT and EBITDA, would be higher for Type A leases than under IAS 17.
- BC402 The effect of the proposals on some of the most frequently used ratios when analysing a lessee's financial statements is illustrated in Appendix A.

The likely effect on compliance costs for lessees

- BC403 The IASB expects lessees with leases classified as operating leases in IAS 17 to incur costs when first implementing the proposals in this Exposure Draft. The significance of the costs will depend on the extent to which a lessee uses leases to obtain access to assets, the terms and conditions of those leases and the systems already used to manage leases. Case studies A–C in Appendix D provide further information about the potential costs associated with implementing the proposals. The IASB expects costs to be only marginally higher on an ongoing basis compared to those incurred in applying IAS 17 once a lessee has updated its systems to provide the information required by the proposals (refer to the table of information required by the proposals below).
- BC404 The IASB does not expect costs to be higher for lessees with leases classified as finance leases in IAS 17, either when first implementing the proposals or on an ongoing basis. This is because the accounting for those leases would not change significantly as described in paragraphs BC393–BC399.
- BC405 In addition, the IASB expects lessees to apply a similar materiality threshold to leases as it does to items of property, plant and equipment. This would result in a lessee not applying the proposals to leases considered to be immaterial on a basis similar to that applied to items of property, plant and equipment, whereby an entity does not capitalise the costs of purchasing items of property, plant and equipment when that cost is less than a particular amount.
- BC406 The following table provides a summary of information that a lessee would require to apply the proposals, indicating the information that the lessee would already require to apply IAS 17.

⁴ The effects on ratios will be smaller to the extent that adjustments are already made to the amounts reported by lessees.

BASIS FOR CONCLUSIONS ON LEASES

Information	Required to apply the proposals	Required to apply IAS 17
Inventory of leases (separate from non-lease components of contracts)	Yes Non-lease (service) components of contracts are required to be separated only if the lessee has observable stand-alone prices.	Yes There are some contracts considered to contain leases under IAS 17 that would not contain leases under the proposals. Non-lease (service) components of contracts containing operating leases may not be separated by some lessees when preparing the note disclosures required by IAS 17.
Terms and conditions of each lease	Yes	Yes
Classification of leases: economic life of the underlying asset and/or fair value of the underlying asset for each lease	Yes	Yes IAS 17 requires a lessee to separate the land and building elements of some property leases when classifying leases. This is not required under the proposals.
Lease term and lease payments for each lease	Yes The proposals regarding the lease term and lease payments are similar to the requirements in IAS 17.	Yes
Initial direct costs	Yes Not required for leases commencing before the effective date.	Yes—required for finance leases. No—not required for operating leases.
Discount rate for each lease	Yes Required for all leases over 12 months. On transition, a lessee can determine the discount rate for a portfolio of leases with similar characteristics.	Yes—required for finance leases. No—not required for operating leases.
Index or rate at the end of each reporting period when variable lease payments depend on that index or rate	Yes	No—not required for accounting purposes but likely to be required to determine or monitor lease payments being made.

BC407 There are some specific areas that the IASB has identified as likely to result in compliance costs for lessees. These are:

- (a) the identification of leases;
- (b) the separation of lease and non-lease components;
- (c) the reassessment of the lease liability; and
- (d) systems changes.

Identifying a lease

- BC408 The IASB expects some lessees to incur costs in assessing whether contracts contain a lease. Any costs, however, are expected to relate mainly to developing a process to assess whether a contract contains a lease and, accordingly, would be expected to be incurred only when first implementing the proposals. Consequently, the IASB expects costs to be higher on implementing the proposals with ongoing costs for this aspect of the proposals being no higher than they are today in complying with IAS 17.

Separating lease and non-lease components

- BC409 The IASB expects some lessees to incur costs to separate lease components within multiple-element contracts when first implementing the proposals. Lessees applying IAS 17 are required to separate lease components and non-lease components of a contract. However, the accuracy of the separation and allocation of payments to components would become more important under the proposals given the proposed differences in accounting for services and leases. The IASB expects that, for many contracts, practice will evolve whereby lessors would provide the information required by lessees. Consequently, the IASB expects any costs to be higher on first implementing the proposals with ongoing costs for this aspect being little higher than they are today in complying with IAS 17.

Reassessing the lease liability

- BC410 The IASB expects some lessees to incur costs to reassess options and to remeasure the lease liability on an ongoing basis. Such costs would mainly arise from leases that include variable lease payments that depend on an index or a rate. However, for many leases there would be no need for remeasurements during the lease term (for example leases without options and without variable lease payments that depend on an index or a rate). In addition, even when a lease contains options, reassessment is unlikely to be onerous because the threshold for recognition is high. Accordingly, changes to the assessment of options are expected only in a small number of cases.

Systems changes

- BC411 Many lessees already have systems in place to manage and track leases, which should help to mitigate the costs of implementing the proposals in this Exposure Draft. This is because the information required to provide the note disclosures required by IAS 17 is similar to that required to apply the proposals, except that a lessee must also determine the discount rate for each lease under the proposals. Accordingly, the systems in place are likely to already provide most of the information required to apply the proposals.
- BC412 Other lessees do not have sophisticated systems in place to manage and track leases. For those lessees, the costs of implementing the proposals are likely to be higher. Those lessees may have to implement or upgrade IT systems. Software vendors offer lease management systems, some of which are being adapted to take account of the lessee accounting proposals.

The likely effects on costs of analysis for users

- BC413 The IASB expects the cost of analysis for users of a lessee's financial statements to remain the same. Some users of financial statements may rely solely on the improved information provided in the financial statements. However, other users would be expected to continue to make adjustments to suit their needs, but those adjustments would be made on the basis of better quality information available in a lessee's financial statements.

The likely effects for lessors

- BC414 This Exposure Draft proposes that a lessor would account for Type A leases by:
- (a) recognising a lease receivable and a residual asset (and derecognising the underlying asset); and
 - (b) recognising interest income on both the lease receivable and the residual asset over the lease term.

In addition, if the lessor were a manufacturer or dealer lessor, the lessor might also recognise profit on the lease at the commencement date.

- BC415 A lessor would account for Type B leases similarly as for leases classified as operating leases in IAS 17 by:
- (a) continuing to recognise the underlying asset; and
 - (b) recognising rental income over the lease term, typically on a straight-line basis.

- BC416 The IASB expects that most equipment and vehicle leases would be classified as Type A leases and most property leases would be classified as Type B leases.

Expected changes to the quality of financial reporting

- BC417 The largest lessors of equipment and vehicles are financial institutions, subsidiaries of manufacturers that operate similarly to financial institutions or independent asset financing entities. Accordingly, those lessors typically view and operate their leasing activities as the provision of finance to customers—ie a lease is a way of providing secured funding to a customer and, for some lessors, is also an alternative means of providing goods to customers. The pricing of equipment and vehicle leases is often driven by assumptions about asset values at the beginning and the end of the lease term and the cost of financing. Accordingly and subject to market constraints, a lessor often prices those leases to provide a particular return on its investment in the equipment or vehicle—ie the lessor calculates lease payments so as to recover the expected decline in the service potential or value of the equipment or vehicle over the lease term and to provide a return on the lessor's total investment in that asset (the lease embeds an implicit interest rate).
- BC418 In contrast, many lessors of property view their leasing activities as an important component of their broader investment strategy to invest in particular types of assets. Leases provide a means of allowing a customer to have access to, or use of, the lessor's property in return for a fee, with the expectation of the return of the property in a similar condition to that which was leased

after a specified period of time. Subject to market constraints, their pricing is driven by desired yields based on the fair value of the property.

- BC419 The application of the lease classification requirements in IAS 17 results in most property lessors applying one accounting model, ie operating lease accounting. However, IAS 17 requires many lessors of equipment and vehicles to apply two different accounting models to their leases (ie both finance and operating lease accounting), even though those lessors may view their entire leasing business as the provision of secured funding to customers. Because the accounting for operating and finance leases is very different, this results in a lack of comparability within a lessor's financial statements.
- BC420 The proposed lease classification in this Exposure Draft is expected to be more closely aligned with a lessor's business model and, therefore, to better reflect the way a lessor manages its business. This should make the financial information prepared by equipment and vehicle lessors more comparable. It should also result in financial statements that more faithfully represent the leasing activities of a lessor.

User needs

- BC421 The underlying asset in most property leases meets the definition of investment property in IAS 40 *Investment Property*. Lessors of investment property applying IFRS must either measure their investment property at fair value or, if measured at cost, disclose the fair value of the investment property. Some users of financial statements have confirmed that the fair value of an entire investment property gives them more useful information than other measurements. Rental income and changes in fair value are inextricably linked as integral components of the performance of the lessor and having both pieces of information (ie rental income and fair value changes) results in a lessor reporting performance in a meaningful way. Consequently, the IASB concluded that there was no need to change the existing lessor accounting requirements for leases of property.
- BC422 The main concern from users of financial statements about lessor accounting in IAS 17 is the lack of transparency of residual values of equipment and vehicles that are subject to operating leases. The IASB has been informed by some analysing the financial statements of equipment lessors that they would find it beneficial to distinguish credit risk (embedded in the lease receivable) from asset risk (embedded in the residual asset).
- BC423 Users of financial statements are interested in understanding the assumptions lessors make about the residual values in leases of equipment and vehicles, particularly when those residual values are significant (which they can be in leases currently classified as operating leases). The proposals would help provide that information for all leases classified as Type A leases by requiring disclosure of the carrying amounts of the residual asset and a reconciliation of changes during the period, as well as disclosures about the lessor's risk management strategy regarding residual assets (including the amounts of any residual value guarantees).
- BC424 In addition, providing information about Type A lease receivables, and a detailed maturity analysis of lease payments for both Type A leases and Type B leases,

would help users of financial statements better assess future cash flows. Although a maturity analysis is also required by IAS 17, the information required is less detailed than proposed in this Exposure Draft.

The likely effect of proposed changes on how leasing activities would be reported in the financial statements of lessors applying IFRS

BC425 IAS 17 requires lessors to classify their leases as either operating or finance leases. For leases classified as operating leases, a lessor continues to recognise the underlying asset that is subject to a lease and recognises lease income over the lease term, typically on a straight-line basis. For finance leases, a lessor derecognises the underlying asset, and recognises a net investment in a lease comprised of a lease receivable and a residual asset, both measured on a current value basis, as well as any related gain or loss. Over the lease term, a lessor in a finance lease recognises interest income on its net investment in a lease.

Operating leases classified as Type A leases

BC426 The most significant change in lessor accounting would arise for leases classified as operating leases under IAS 17 but that, under the proposals, would be classified as Type A leases. The IASB expects this would mainly occur for existing operating leases of equipment and vehicles. For those leases, lessors would no longer retain the underlying asset on the statement of financial position. Instead, at the commencement date a lessor would recognise a lease receivable measured on a current value basis (ie at the present value of lease payments), and a residual asset measured on a cost basis.

BC427 In terms of the statement of financial position, the lease receivable and residual asset recognised for a Type A lease at the commencement date could be higher than the amortised cost carrying amount of the underlying asset for operating leases in IAS 17. This is more likely to be the case for manufacturer or dealer lessors for which the cost of the underlying asset might be lower than its fair value at the commencement date. A manufacturer or dealer lessor is also more likely to recognise profit at the time of entering into a Type A lease as well as interest income over the lease term, whereas they do not recognise profit at the time of entering into operating leases in IAS 17 and recognise rental income over the lease term. A lessor (for example, a financial institution) that purchases an underlying asset at, or close to, the commencement date is expected to have little change in the value of assets reported before and after entering in a Type A lease, and is unlikely to recognise any profit on entering into the lease. Instead, it would only recognise interest income over the lease term.

BC428 The pattern of income recognition would also be different. Instead of recognising lease income on a typically straight-line basis as is the case for an operating lease in IAS 17, a lessor would recognise interest income on both the lease receivable and the residual asset. For a Type A lease with even lease payments, interest income recognised in the early years of the lease term would be higher than the interest income recognised in the later years. If a lessor, however, has a reasonably balanced portfolio of leases without significant

changes from year to year, there would be no significant difference in the income pattern at a portfolio level (see portfolio discussion regarding lessees in Appendix C).

Finance leases classified as Type A leases

BC429 The IASB expects leases classified as finance leases in accordance with IAS 17 to be Type A leases in accordance with proposals. The main differences between the accounting proposed for Type A leases and finance lease accounting in IAS 17 is as follows:

- (a) a lessor would not recognise any profit associated with the residual asset arising from a Type A lease at the commencement date, whereas it would when applying finance lease accounting in IAS 17. Because the residual asset is typically not material for existing finance leases (unless its value is guaranteed), this change would not be expected to result in a significant change in practice for leases classified as finance leases in accordance with IAS 17.
- (b) a lessor would exclude residual value guarantees from the measurement of a Type A lease receivable, whereas the maximum amount of any residual value guarantee provided to a lessor is considered to be part of the lease payments and included within the lease receivable for finance leases in IAS 17. Nonetheless, according to the proposals, a lessor would include as part of the Type A lease receivable any lease payments structured as residual value guarantees for which the lessee has taken on all exposure to residual asset risk.
- (c) a lessor accounts for the lease receivable and residual asset separately, although it would present those two amounts together, as lease assets, in its statement of financial position. According to IAS 17, those two amounts are embedded within the net investment in a lease and are not disclosed separately.

Operating leases classified as Type B leases

BC430 There would be very little change to the accounting for existing operating leases classified as Type B leases in accordance with the proposals. The main change relating to those leases would be the additional disclosures proposed, which include more detailed disclosures of future lease payments (showing undiscounted payments for each of the first five years after the reporting date) and narrative descriptions of the terms and conditions of the lease.

The likely effect on compliance costs for lessors

BC431 The IASB expects that the implementation of the lessor accounting proposals in this Exposure Draft would not result in higher costs for many lessors than would be incurred in complying with IAS 17. This applies in particular to property lessors, for which there is very little change proposed to the way they account for leases, other than providing some additional disclosures about future lease payments. This is also the case for lessors of finance leases in IAS 17.

BC432 Lessors of equipment and vehicles, which apply operating lease accounting in IAS 17 and are expected to apply Type A lease accounting in this Exposure Draft,

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would incur costs because the accounting applied to those leases would change significantly. Case study D in Appendix D provides further information about the potential costs associated with implementing the proposals.

BC433 The following table provides a summary of information that a lessor would require to apply the proposals for Type A leases. The table sets out the information that a lessor would already require to apply IAS 17 and the information already required to price leases, assuming the lessor prices its leases as financing transactions (by estimating the fair value and residual value of the asset being leased at the commencement date, and incorporating an implicit interest rate).

Information	Required to apply the Type A lease accounting proposals	Required to apply IAS 17	Required to price leases if priced as financing transactions
Inventory of leases (separate from non-lease components of contracts)	Yes Non-lease (service) components of contracts are required to be separated in accordance with the revenue recognition proposals.	Yes	Yes
Terms and conditions of each lease	Yes	Yes	Yes
Classification of leases: economic life of the underlying asset and/or fair value of the underlying asset for each lease	Yes Fair value of the underlying asset may also be required periodically if the lease receivable or residual asset are potentially impaired.	Yes	Yes
Estimated residual value of the underlying asset at the commencement date (and periodically if the asset is potentially impaired)	Yes	Yes-required for finance leases. No-not required for operating leases.	Yes
Lease term and lease payments for each lease	Yes The proposals regarding the lease term and lease payments are similar to the requirements in IAS 17.	Yes	Yes

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Information	Required to apply the Type A lease accounting proposals	Required to apply IAS 17	Required to price leases if priced as financing transactions
Initial direct costs	Yes Not required for leases commencing before the effective date.	Yes-required for finance leases. No-not required for operating leases.	Yes
Discount rate for each lease	Yes Required for all leases over 12 months.	Yes-required for finance leases. No-not required for operating leases.	Yes
Index or rate at the end of each reporting period when variable lease payments depend on that index or rate	Yes This feature is not expected to exist in many Type A leases.	No-not required for operating leases.	Yes
Risk management strategy regarding residual asset risk, including residual value guarantees and other means of reducing this risk	Yes	No	Yes

Costs of implementation

BC434 The IASB expects that most lessors of existing operating leases that will be classified as Type A leases under the proposed requirements (ie most equipment and vehicle lessors) would be likely to have the information required to apply the proposed requirements. This is because the changes proposed to the accounting are expected to be consistent with the way in which most equipment and vehicle lessors price their leases as set out in the table above. Nonetheless, even when that information is already available within a lessor's business, that information may reside within different systems (for example those used to price and manage the leases), rather than within the accounting systems. There are likely to be costs associated with obtaining that information for accounting purposes. In addition, those lessors are also likely to need to enhance or replace their accounting systems in order to apply Type A lease accounting under the proposals. The costs associated with changes to accounting systems would depend on the terms and conditions of the leases held by the lessor and the sophistication of the systems already in place to manage and account for leases. For example, if a lessor already has a system in place to account for finance leases in IAS 17, that system may only need to be enhanced rather than replaced to apply Type A lease accounting.

BC435 The IASB is also aware that there are some lessors who may be required to apply Type A lease accounting who do not already have information about interest rates and residual values for each individual lease. Those lessors might include services within contracts that contain leases, with those contracts being priced as a package. Such lessors are likely to incur more significant costs than other lessors in applying the proposals. They would be required to separate lease components from non-lease components of a contract and account for them separately, estimate the fair value and residual value of assets subject to a Type A lease at transition and calculate the interest rate charged in the lease. Those lessors are likely to need to invest in systems to collect data and account for leases in accordance with the proposals.

Costs of ongoing application

BC436 The IASB expects the ongoing costs of applying the lessor accounting proposals to be only marginally higher than those incurred to comply with IAS 17 once a lessor has set up the systems required to apply Type A lease accounting.

BC437 Although lessors are required to make reassessments during the lease term, particularly in relation to the lease term, the IASB expects that reassessments will be relatively infrequent because such reassessments relate to optional periods and the threshold for recognition of payments in optional periods is high. In addition, although the proposals would require regular remeasurement of lease receivables with respect to payments linked to an index or a rate, the IASB does not think these features are common in Type A leases. Accordingly, those proposals should not create ongoing costs for lessors that are higher than complying with IAS 17.

BC438 There may be indirect costs of the proposals for some lessors. This is because some customers (ie lessees) would be likely to require more information about leases to account for them according to the proposals. This might include information about the pricing assumptions, the rate charged in the lease and the prices of lease components and non-lease components when contracts contain multiple elements. At the same time, the proposals might provide those lessors with an opportunity to earn additional revenue by providing additional services to lessees (for example, accounting or lease management services).

The likely effects on the costs of analysis for users

BC439 The IASB expects the cost of analysis for users of a lessor's financial statements to remain the same. Users may change how they perform their analyses of an equipment or a vehicle lessor's activities on the basis of the new information available under the proposals. The proposals should provide much better information about those leasing activities, and in particular about a lessor's exposure to credit risk and asset risk.

Appendix A

Effect of the proposals on key financial ratios of a lessee with operating leases (IASB-only)

These ratios are based on the information that would be reported in accordance with IAS 17 and with this Exposure Draft and do not take into account any subsequent adjustments to reported amounts that would be made by users. Those adjustments may mean that the changes arising from these proposals are less pronounced. The table compares the accounting for leases classified as operating leases according to IAS 17 with the accounting for Type A and Type B leases according to the proposals.

Name of ratio	What it measures	How it is calculated	Applicable to which class of leases	Expected effect using reported information	Explanation
Gearing	long-term solvency	liabilities/equity	All	increase	increase because reported debt increases (and equity would decrease for Type A leases)
Current ratio	liquidity	current assets/current liabilities	All	decrease	decrease because current lease liabilities would increase while current assets would not
Asset turnover	profitability	sales/total assets	All	decrease	decrease because lease assets will be reported
Interest cover	long-term solvency	profit before interest and tax/interest expense	Type A (no change for Type B)	depends	depends on whether the ratio of lease amortisation/lease interest expense is higher or lower than the existing ratio (short-term leases have higher ratios than long-term leases), and on the proportion of total interest that relates to lease interest (higher proportion will have a larger effect)
EBIT	profitability	profit before interest and tax	Type A (no change for Type B)	increase	increase because the amortisation added is lower than the operating lease expense eliminated
EBITDA	profitability	profit before interest, tax, depreciation and amortisation	Type A (no change for Type B)	increase	increase because there will be no operating lease expense included

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Name of ratio	What it measures	How it is calculated	Applicable to which class of leases	Expected effect using reported information	Explanation
EBITDAR	profitability	profit before interest, tax, depreciation, amortisation and operating lease expense	All	no change	no change because all lease-related expenses are excluded
Operating profit	profitability	n/a	Type A (no change for Type B)	increase	increase because the amortisation added is lower than the operating lease expense eliminated, ie interest would be reported below the operating profit line
Net income	profitability	n/a	Type A (no change for Type B)	depends	depends on the characteristics of the lease portfolio and the tax rate
EPS	shareholder	net income/number of shares in issue	Type A (no change for Type B)	depends	depends on the effect on net income, which depends on characteristics of the lease portfolio and the tax rate
ROCE	profitability	EBIT/total assets less current liabilities	All	depends	the ROCE ratio may need to be adjusted because lease assets reported are not comparable with purchased assets for leases shorter than the economic life of the underlying asset—ie for those leases, the lease asset reported will be smaller than the asset reported if the underlying asset were purchased. For Type B leases, the entire lease expense will also be included in EBIT (ie part of the lease payments is not reported as interest) whilst the lease liability is a financial liability

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Name of ratio	What it measures	How it is calculated	Applicable to which class of leases	Expected effect using reported information	Explanation
ROE	profitability	net income/equity	Type A (no change for Type B)	depends	depends on the effect on net income, which depends on the lease portfolio—if there is no effect on net income, then the ratio will be higher because reported equity will decrease
Operating cash flow	profitability	n/a	Type A (no change for Type B)	increase	increase because at least part of the lease payments (those payments relating to the principal) will be moved to the financing section
Net cash flow	profitability	n/a	All	no change	no change because the proposals do not affect cash

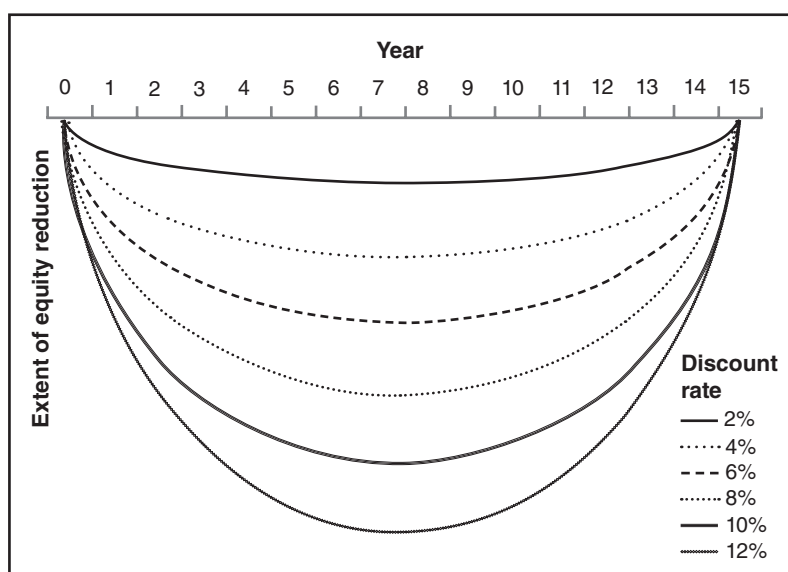
Appendix B

Effect on a lessee's reported equity of accounting for operating leases as Type A leases (IASB-only)

BC440 The amount of a lessee's right-of-use assets for Type A leases would typically be lower than the amount of the lease liability throughout the lease term, except at lease commencement and at the end of the lease term. Because a lessee does not generally recognise assets or liabilities for operating leases, applying Type A lease accounting would result in a reduction in reported equity when compared to operating lease accounting. (This analysis of equity effects assumes all other factors that might affect equity are constant, for example, a lessee's dividend policy would remain the same, the lessee does not have any new capital, etc.)

BC441 The effect on equity is shown in the following chart, using a 15-year lease to illustrate:

Figure 1 Equity reduction (as a percentage of the lease liability) compared to operating lease accounting (15-year lease with a range of discount rates)

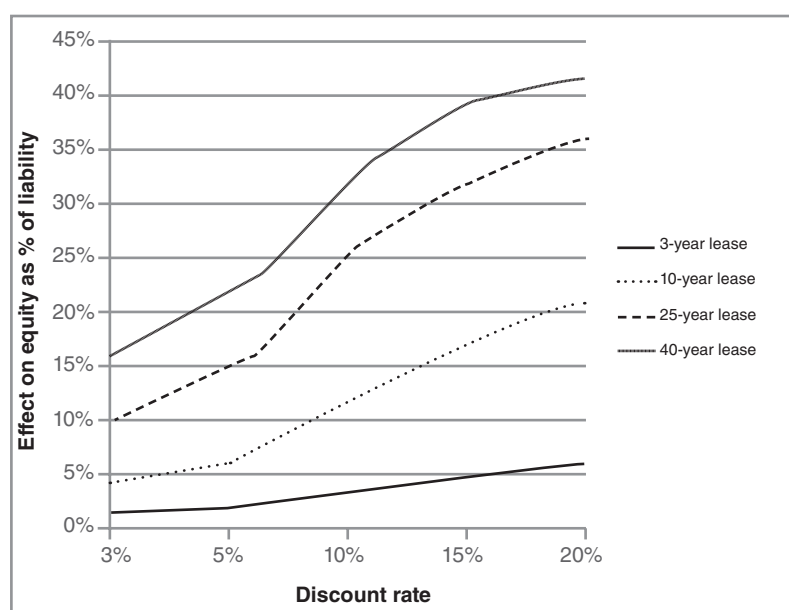


BC442 The chart shows the following:

- (a) The size of the reduction in reported equity (when compared with operating lease accounting) increases during the lease term until about the mid-point of the lease (this is the same point at which the total lease expense for Type A leases is equal to the straight-line lease expense for operating leases).
- (b) The higher the discount rate, the higher the reduction in reported equity.

BC443 At a portfolio level, because equity would be lower (when comparing Type A lease accounting with operating lease accounting) throughout the lease term of each individual lease, equity would also be lower for every portfolio of Type A leases. This is shown in the following chart, which compares various evenly-distributed portfolios of Type A leases (an evenly-distributed portfolio being a portfolio with the same number of leases terminating and commencing in any one period, with the same terms and conditions):

Figure 2 Equity reduction as a percentage of the lease liability (before tax effects)



BC444 The chart shows that the effect on equity (ie the amount by which lease liabilities would be higher than lease assets) as a proportion of the lease liability increases as the lease term lengthens and the discount rate increases.

BC445 The diagram in Figure 2 ignores the effect of tax. Because lease assets and lease liabilities would be different throughout the lease term, this might give rise to a deferred tax asset, which would reduce the effect on equity.

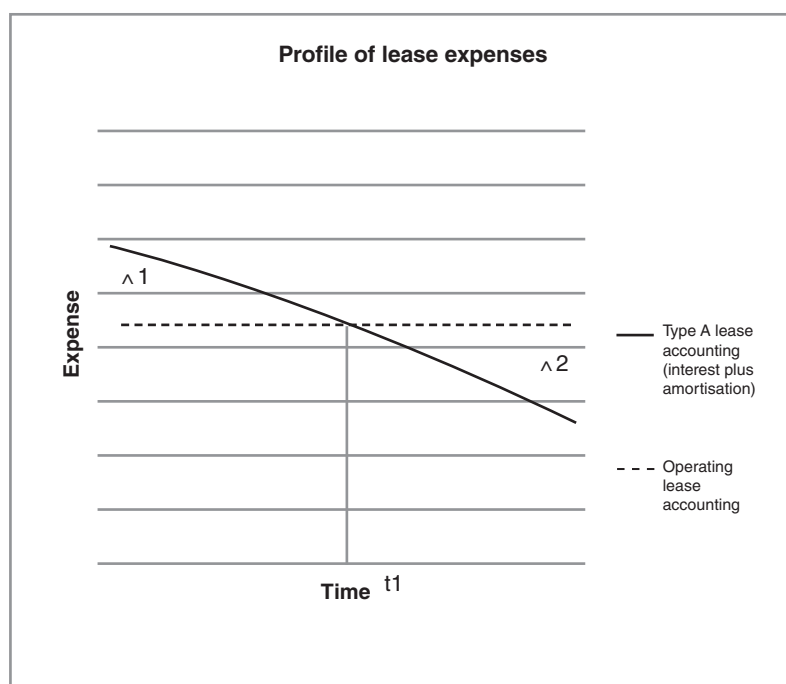
BC446 The analysis above considers the effect on equity relative to the lease liability. The actual effect on a lessee's reported equity of applying Type A lease accounting to leases classified as operating leases would depend on the lessee's leverage (gearing), and on the ratio of the lease liability to equity. This in turn depends on the proportion of assets the lessee owns, the proportion of assets leased and how the lessee finances its operations.

Appendix C

Effect on a lessee's profit or loss of accounting for operating leases as Type A leases (IASB-only)

Effect on profit or loss—individual lease

BC447 For an individual lease, the lease expense recognised when applying operating lease accounting is typically the same in each period throughout the lease term, ie a lessee recognises operating lease expenses typically on a straight-line basis (excluding variable lease payments). In contrast, the pattern of expense recognition for Type A leases would depend on the length of the lease term, the timing of lease payments and the rate charged in the lease. Type A lease accounting and operating lease accounting patterns are shown in the following chart for an individual lease (assuming lease payments are even throughout the lease term):



BC448 The chart shows the following:

- (a) The sum of the interest and amortisation expenses on a Type A lease is higher than a straight-line operating lease expense at the beginning of the lease term and lower at the end of the lease term.
- (b) The point at which interest plus amortisation is equal to the straight-line operating lease expense (t_1 in the chart above) occurs somewhere after the mid-point of the lease. This is also the point at which the difference between the carrying amounts of the right-of-use asset and the lease

liability is greatest and, thus, the point at which there is the greatest effect on a lessee's equity compared to IAS 17.

- (c) The difference between the sum of interest and amortisation expenses for Type A leases and the straight-line operating lease expense at the beginning of the lease term ($\Delta 1$) is lower than the difference at the end of lease term ($\Delta 2$).

BC449 In our analysis, the conclusions noted above were consistent for a range of lease terms from three to 40 years and using a range of discount rates from 2 to 20 per cent. However, the relative difference between the two expenses ($\Delta 1$ and $\Delta 2$ in the chart), as well as the point at which they become equal (t_1 in the chart), depends upon the length of the lease term and the rate charged in the lease.

Effect on profit before interest

BC450 The expense pattern for Type A leases would be expected to be the same as the expense pattern for operating leases with respect to the effect on a lessee's profit before interest (for example operating profit)—ie for both Type A leases and operating leases, a lessee would recognise lease expenses within operating profit typically on a straight-line basis. A lessee's operating profit would, however, increase when applying Type A lease accounting. This is because, for Type A leases, a lessee would report lease payments as two expenses—a lessee would be expected to report amortisation of the right-of-use asset within operating expenses and interest on the lease liability within finance costs (below the operating profit line). In contrast, for operating leases, a lessee would be expected to report lease payments within operating expenses in their entirety.

Portfolio effect

BC451 Because lessees usually have many leases at any time, the following section considers the change in the expense pattern for a portfolio of Type A leases that are classified as operating leases in accordance with IAS 17.

BC452 If a lessee's lease portfolio is evenly distributed (ie the same number of leases begin and end in any one period, and new leases have the same terms and conditions as the leases they replace), then there would be no difference between the sum of amortisation and interest expenses for Type A leases compared to a straight-line expense for operating leases. For example, if a lessee had a portfolio of three-year Type A leases, one third of that portfolio would have an expense 5 per cent higher than a straight-line operating lease expense, one third would be 5 per cent lower and one third would be the same. Consequently, the overall effect on lease expenses is neutral, assuming that all of those contracts have equal lease payments.

BC453 However, such an evenly distributed portfolio rarely exists in practice. Consequently, the following paragraphs consider the following scenarios:

- (a) new leases that have different terms and conditions to leases that they replace;
- (b) the size of the lease portfolio changes; and
- (c) the discount rate changes.

- BC454 For simplicity and to illustrate the effect, in each of the examples below, the starting point is an evenly-spread lease portfolio whereby only one factor varies and all others remain the same.
- BC455 In summary, the findings in paragraphs BC456–BC465 illustrate that when a lessee has a portfolio of Type A leases that is constantly evolving, with leases expiring and new leases being added, there may be relatively little overall effect on the lessee's profit or loss from applying the proposed requirements.

Change in lease term

- BC456 For example, consider a lessee that has an equally distributed portfolio of 10-year Type A leases, at a rate of 6 per cent. Consequently, the total lease expense (ie the sum of amortisation and interest) for those leases is equal to a straight-line operating lease expense. At the beginning of Year 1, the lessee renews 10 per cent of the lease portfolio under the same conditions, except that the new leases are for only five years (the leases continue to be Type A leases). This means that leases that account for 10 per cent of the portfolio would have a Year 1 expense that is higher than a straight-line operating lease expense (the difference is calculated to be 10 per cent). If those leases had been renewed for a 10-year term, the Year 1 expense for those leases would have been 18 per cent higher than a straight-line operating lease expense. Consequently, the total expense for that part of the lease portfolio is now 8 per cent (18 per cent less 10 per cent) lower than if the lessee had entered into 10-year leases. The effect on the overall lease portfolio would be an expense that is 0.8 per cent lower than a straight-line operating lease expense (because new leases account for one tenth of the portfolio (ie 8 per cent \times 10 per cent of the portfolio = 0.8 per cent)). Consequently, the lessee's total expense in Year 1 would be 0.8 per cent lower than a straight-line operating lease expense.
- BC457 The effect increases if the new policy of replacing expired leases with shorter-term leases continues into Year 2, making the overall expense 1.7 per cent lower than a straight-line operating lease expense in Year 2.
- BC458 If the lessee continues to apply its new policy and ultimately changes its entire portfolio of 10-year Type A leases to five-year Type A leases, the maximum difference between the total lease expense under the proposals for Type A leases and a straight-line operating lease expense would be 5.3 per cent, in Year 5. That difference would reduce over time to zero in the year that the lessee again has an evenly-spread portfolio of five-year leases.
- BC459 The opposite conclusion would apply when a lessee replaces shorter-term leases with longer-term leases, in which case the total expense recognised would be higher than a straight-line operating lease expense. If the example above is reversed (ie if the lessee replaces five-year Type A leases with 10-year Type A leases), in year 1 the total expense would be 1.6 per cent higher (8 per cent difference \times 0.2, with 0.2 representing the proportion of the portfolio that consists of new leases because, in an evenly-spread portfolio of five-year leases, one-fifth of those leases would be renewed in each year).

Change in the size of the lease portfolio

- BC460 Suppose that, as in the previous example, a lessee has an evenly-spread portfolio of 10-year Type A leases, at a rate of 6 per cent. The lessee increases its lease portfolio by 10 per cent in Year 1. This means that the lessee would have 10 per cent more leases that have a total lease expense that is 18 per cent higher than a straight-line operating lease expense in Year 1. The overall effect, therefore, would be that the total Type A lease expense is 1.8 per cent higher than the straight-line operating lease expense ($18 \text{ per cent} \times 0.1$) in Year 1.
- BC461 The effect increases if the new policy of increasing the portfolio by 10 per cent continues into Year 2, making the total Type A lease expense 3.2 per cent higher than a straight-line operating lease expense in Year 2.
- BC462 The opposite conclusion applies when a lessee reduces the size of its Type A lease portfolio. Using the example above, if none of the leases that expired in Year 1 were replaced (ie if the Type A lease portfolio were reduced by 10 per cent), the total lease expense in Year 1 would be 1.8 per cent lower than a straight-line operating lease expense.

Change in discount rate

- BC463 Using the same example, assume that the lessee has the same portfolio of 10-year Type A leases, but that the rate charged for the new leases decreases from 6 per cent to 4 per cent. This would result in 10 per cent of leases having a total lease expense that is 14 per cent higher than a straight-line operating lease expense, instead of 18 per cent higher if they had been renewed using a rate of 6 per cent. Consequently, the lessee's total lease expense in Year 1 would be 0.4 per cent lower than a straight-line operating lease expense in the first year of change (the difference of $4 \text{ per cent} \times 0.1$).
- BC464 The effect increases if the lower rate continues into Year 2, resulting in a total Type A lease expense 0.7 per cent lower than a straight-line operating lease expense.
- BC465 The opposite conclusion applies when the rate increases. In the scenario above, if the rate were increased from 4 per cent to 6 per cent, the total Type A lease expense would be 0.4 per cent higher than a straight-line operating lease expense.

Appendix D

Case studies (IASB-only)

BC466 The following case studies illustrate the information that an entity would be required to have, and the drivers of the costs that an entity might incur, when applying the proposals in this Exposure Draft.

Case study A
<p><i>Lessee A is an entity that operates in a number of countries.</i></p> <p><i>It has approximately 20,000 leases of vehicles (ie cars and trucks) throughout the group, with non-cancellable lease terms of between three and five years. Many of these contracts include purchase or extension options priced at market rates. Lessee A has systems in place to manage its vehicle leases, for example to monitor when and whether to return a vehicle or extend a lease, or when lease payments should be stopped on return of a vehicle.</i></p> <p><i>Lessee A also has a relatively small number of property leases (approximately 60) used for corporate purposes, with non-cancellable lease terms of between five and 12 years. Many of these leases include variable lease payments that depend on an index or a rate. Lessee A does not have sophisticated systems to manage its property leases—the management of those leases are decentralised within subsidiaries, each of which has only a few property leases.</i></p> <p><i>Lessee A classifies all of its leases as operating leases in accordance with IAS 17. 1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessee A first applies [draft] IFRS X; the effective date is 1 January 20X2.</i></p> <p>Implementing the proposals</p> <p>At or before transition</p> <p><u>Steps to be taken at transition</u></p> <p>Lessee A prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. Lessee A classifies all of its leases of vehicles as Type A leases, and all of its leases of property as Type B leases.</p> <p>Lessee A obtains the following information at 1 January 20X1:</p> <ul style="list-style-type: none"> (a) For property leases, the remaining lease term and remaining lease payments, including variable lease payments determined using the index or rate as at 1 January 20X1. (b) For vehicle leases, the remaining lease term, remaining lease payments and original lease term. <p>Lessee A also determines a discount rate for each portfolio of leases with similar characteristics.</p>

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Case study A
<p><u>Costs on transition</u></p> <p>Lessee A incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:</p> <ul style="list-style-type: none"> (a) Lessee A already prepares disclosures about operating leases required by IAS 17 (ie the disclosure of future minimum lease payments under non-cancellable operating leases). Lessee A, therefore, already has an inventory of all of its leases, including information about the remaining lease term and the remaining lease payments. (b) Lessee A has systems in place to manage its vehicle leases. (c) Classifying the vehicle and property leases is straightforward given Lessee A's lease portfolio. A three-year lease of any car or truck is more than an insignificant part of the economic life of that car or truck. Even a 12-year lease of property is expected to meet the criteria to be classified as a Type B lease in most instances. <p>Lessee A incurs costs in determining the appropriate discount rate to apply to each portfolio of leases, in training its employees and updating its group accounting policies.</p> <p>Lessee A also incurs costs in setting up systems to account for its leases according to the proposals. Lessee A requires systems that can apply the requirements for Type A leases (its vehicle leases) and for Type B leases (its property leases). Lessee A is able to modify its existing systems for vehicle leases to produce the information required to account for those leases in accordance with the proposals. Lessee A incurs costs in setting up a system to account for its property leases using spreadsheets—the spreadsheets developed are distributed to subsidiaries that hold property leases.</p> <p>Ongoing</p> <p><u>Steps to be taken and costs on an ongoing basis</u></p> <p>Lessee A remeasures the lease liability arising from property leases that include variable lease payments that depend on an index or a rate during the terms of those leases. There is a cost associated with implementing that remeasurement on an ongoing basis.</p> <p>Lessee A is not expected to change the measurement of lease assets and lease liabilities to reflect changes in the lease term. This is because it is unlikely that Lessee A would conclude that it has a significant economic incentive to exercise the options within its vehicle lease contracts, or that there would be a change to that conclusion during the lease term, when those options are priced at market rates at the commencement date and lease terms are for less than five years.</p> <p>Lessee A also incurs some costs in providing enhanced disclosures in its financial statements about leases (for example a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of right-of-use assets and lease liabilities).</p>

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Case study A

Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessee A inputs any new leases into that system.

Case study B

Lessee B is a retailer that operates in a number of countries. Apart from 10 stores that it owns in key locations, Lessee B leases all of the retail outlets from which it operates.

It has approximately 6,000 leases of retail outlets throughout the group, with non-cancellable lease terms of between three and 15 years, with most being for less than 10 years. Many of these contracts include (a) extension options priced at market rates, (b) variable lease payments that either depend on an index or a rate, or are linked to sales, and (c) maintenance services. Lessee B also renegotiates and modifies the terms and conditions of many property leases before the end of the non-cancellable period. Lessee B has sophisticated systems in place to manage its property leases, for example to determine (a) when and whether to extend or renegotiate a lease and (b) the amounts payable when those amounts are variable.

Lessee B classifies all of its property leases as operating leases in accordance with IAS 17. Lessee B does not have other leases that are material to the group.

1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessee B first applies [draft] IFRS X; the effective date is 1 January 20X2.

Implementing the proposals

At or before transition

Steps to be taken at transition

Lessee B prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. Lessee B classifies all of its leases of property as Type B leases.

Lessee B obtains the following information for its property leases at 1 January 20X1:

- (a) the remaining lease term;
- (b) the remaining lease payments, including variable lease payments determined using the index or rate as at 1 January 20X1. Lessee B does not need to estimate amounts expected to be payable when those amounts are linked to sales; and
- (c) the observable stand-alone prices for any maintenance services included in its lease contracts—those stand-alone prices are generally available in the contracts.

Lessee B also determines a discount rate for each portfolio of leases with similar characteristics.

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Case study B
<p><u>Costs on transition</u></p> <p>Lessee B incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:</p> <ul style="list-style-type: none"> (a) Lessee B already prepares disclosures about operating leases required by IAS 17 (ie the disclosure of future minimum lease payments under non-cancellable operating leases). Lessee B, therefore, already has an inventory of all of its leases, including information about the remaining lease term and the remaining lease payments. (b) Lessee B already has sophisticated systems in place to manage its property leases. (c) Classifying the property leases is straightforward given Lessee B's lease portfolio. Even a 15-year lease of property would be expected to meet the criteria to be classified as a Type B lease in many instances, and relatively few of Lessee B's portfolio of leases are for longer than 10 years. In addition, if Lessee B concluded that its property leases were operating leases under IAS 17, those leases would be expected to meet the criteria to be classified as Type B leases under the proposals. <p>Lessee B incurs costs in determining the appropriate discount rate to apply to each portfolio of leases, training its employees and updating its group accounting policies.</p> <p>Lessee B also incurs costs in setting up systems to account for its property leases according to the proposals. Lessee B is able to extend its existing property lease management systems to produce the information required to account for its leases in accordance with the proposals.</p> <p>Ongoing</p> <p><u>Steps to be taken and costs on an ongoing basis</u></p> <p>Lessee B remeasures the lease liability arising from leases that include variable lease payments that depend on an index or a rate during the terms of those leases based on the relevant spot amount at future reporting dates. There is a cost associated with implementing that remeasurement on an ongoing basis. Because variable lease payments linked to sales are not included in the measurement of the right-of-use asset and lease liability, there are no additional costs associated with accounting for those variable lease payments—those payments are recognised as an expense as incurred, consistently with IAS 17.</p>

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Case study B

Lessee B is not expected to change the measurement of lease assets and lease liabilities to reflect changes in the lease term. This is because changes to the lease term should be relatively rare because a significant economic incentive is a high threshold for including optional periods in the lease term and the options are priced at market rates at the commencement date. Lessee B accounts for other modifications to contracts as new leases.

Lessee B also incurs some costs in providing enhanced disclosures in its financial statements about leases (for example qualitative and quantitative information about the options and variable lease payments in its leases as well as information about contract renegotiations; a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of right-of-use assets and lease liabilities).

Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessee B inputs any new leases (and modified contracts accounted for as new leases) into that system.

Case study C

Lessee C is an entity that uses large and smaller items of equipment in its operations. In general, it has a policy of using equipment that is less than 12 years old, ie if purchased, Lessee C will sell equipment that is 12 years old to a third party. In order to manage its exposure to residual asset risk and to provide financial flexibility, Lessee C has a policy of purchasing 60 per cent of the equipment used in its operations and leasing the remaining 40 per cent.

Lessee C has approximately 800 leases of equipment throughout the group, with non-cancellable lease terms of between six and eight years. For some of these contracts, Lessee C provides a residual value guarantee to the lessor.

Lessee C has a relatively small number of property leases (approximately 30) used for corporate purposes, with non-cancellable lease terms of between five and 10 years. Lessee C also has three property leases with non-cancellable lease terms of 30 years.

In addition, Lessee C has approximately 40 capacity contracts that are considered to be leases in accordance with IFRIC 4.

Lessee C classifies its leases as follows in accordance with IAS 17:

- (a) 70 per cent (approximately 560) of its equipment leases are operating leases; the remaining 30 per cent (approximately 240) are finance leases.
- (b) three of its property leases are finance leases; the remainder are operating leases.
- (c) All of the capacity contracts are operating leases.

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Case study C
<p><i>Lessee C has a sophisticated system in place to account for its finance leases but does not have such a system in place for its operating leases.</i></p> <p><i>1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessee C first applies [draft] IFRS X; the effective date is 1 January 20X2.</i></p> <p>Implementing the proposals</p> <p>At or before transition</p> <p><u>Steps to be taken at transition</u></p> <p>Lessee C prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. In doing so, Lessee C analyses its capacity contracts and determines that they do not contain leases.</p> <p>Lessee C classifies all of its equipment leases as Type A leases and any operating leases of property as Type B leases. Lessee C is not required to reclassify leases previously classified as finance leases—they are treated as Type A leases for presentation and disclosure purposes.</p> <p>Lessee C obtains the following information at 1 January 20X1:</p> <ul style="list-style-type: none"> (a) For equipment leases previously classified as operating leases, the remaining lease term, remaining lease payments and original lease term. (b) For property leases previously classified as operating leases, the remaining lease term and remaining lease payments. <p>Lessee C determines a discount rate for each portfolio of those leases with similar characteristics.</p> <p>Lessee C is not required to obtain new information for leases previously classified as finance leases—it continues to account for those leases consistently with how they were accounted for in accordance with IAS 17.</p> <p><u>Costs on transition</u></p> <p>Lessee C incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:</p> <ul style="list-style-type: none"> (a) Lessee C already prepares disclosures about operating leases required by IAS 17 (ie the disclosure of future minimum lease payments under non-cancellable operating leases). Lessee C, therefore, already has an inventory of all of its leases, including information about the remaining lease term and the remaining lease payments. (b) Lessee C does not incur any costs relating to accounting for leases previously classified as finance leases because of the transition relief for such leases.

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Case study C	
(c)	Lessee C has a system in place to account for its finance leases. This system is able to be used to account for Lessee C's equipment leases, with some modifications, because the accounting for Type A leases is largely consistent with existing finance lease accounting.
(d)	Lessee C also has relatively few property leases that are classified as Type B leases. Although Lessee C is required to set up a system to account for those leases as Type B leases, Lessee C is able to do so using spreadsheets already available within the group.
(e)	Classifying the equipment and property leases is straight-forward given Lessee C's lease portfolio. A lease of any item of equipment (including longer-lived equipment) that is between six and eight years is more than an insignificant part of the economic life of that equipment. If Lessee C concluded that a property lease was an operating lease under IAS 17, that lease would be expected to meet the criteria to be classified as a Type B lease under the proposals.
	Lessee C incurs costs in determining the appropriate discount rate to apply to each portfolio of operating leases, training its employees and updating its group accounting policies. Lessee C also incurs costs in assessing that the capacity contracts do not contain a lease.
	Ongoing
	<u>Steps to be taken and costs on an ongoing basis</u>
	Lessee C remeasures the lease liability arising from equipment leases that have residual value guarantees during the terms of those leases. There is a cost associated with implementing that remeasurement on an ongoing basis.
	Lessee C also incurs costs in providing enhanced disclosures in its financial statements about leases (for example a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of right-of-use assets and lease liabilities for both Type A leases and Type B leases). However, Lessee C excludes its capacity contracts from its lease disclosures.
	Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessee C inputs any new leases into that system.

Case study D

Lessor D is an entity that leases vehicles to numerous third parties. Lessor D has approximately 300,000 vehicle leases throughout the group, with non-cancellable lease terms of between two and eight years, depending on the nature of the vehicle. Some of these contracts include:

- (a) purchase or extension options priced at market rates;
- (b) restrictions on mileage. The lessee is required to pay additional amounts at the end of the lease if it exceeds specified mileage limits; or
- (c) maintenance services.

Lessor D prices its leases by estimating the residual value of the vehicle at the end of the lease term (assuming the mileage limits are not exceeded) and determining a required return on its investment in the vehicle (taking into account, among other factors, the credit rating of the lessee), subject to market constraints.

Lessor D classifies approximately 55 per cent of its leases as operating leases and the remaining 45 per cent as finance leases in accordance with IAS 17. In applying IFRS, Lessor D already separates the maintenance services from the lease components of a contract.

Lessor D has sophisticated systems in place to manage its vehicle leasing operations. That system has all of the following information—an inventory of all leases and, for each lease, the rate implicit in the lease, the fair value and estimated residual value of the vehicle at the commencement date, the non-cancellable period, information about options, payments separated into lease and service components, and initial direct costs.

1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessor D first applies [draft] IFRS X; the effective date is 1 January 20X2.

Implementing the proposals**At or before transition**Steps to be taken at transition

Lessor D prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. Lessor D classifies all of its vehicle leases as Type A leases.

Lessor D chooses to apply the proposals retrospectively because it has already determined, for each lease, the rate implicit in the lease and estimated the residual value of the vehicle at the commencement date. The rate implicit in the lease does not include estimated variable payments that a lessee might make for exceeding mileage limits.

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Case study D
<p><u>Costs on transition</u></p> <p>Lessor D incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:</p> <ul style="list-style-type: none"> (a) Lessor D has sophisticated systems in place to manage its vehicle leasing operations, which have all of the information that is required to apply the proposals. (b) Classifying the vehicle leases is straight-forward given Lessor D's lease portfolio. Even a two-year lease of any vehicle is more than an insignificant part of the economic life of that vehicle. <p>Lessor D incurs costs in adapting its accounting systems to apply the accounting proposed for Type A leases. Although the accounting proposed for Type A leases is similar to finance lease accounting in many respects, there are important differences that need to be built into the accounting systems (for example accounting for the residual asset separately from the lease receivable (including accounting for impairment of those separate assets), not recognising any unearned profit on the residual asset until the end of the lease term, calculating the rate implicit in the lease). As noted above, all of the information required to apply the proposals retrospectively is already available within Lessor D. However, that information resides within systems used to price and manage the leases, instead of within the accounting systems.</p> <p>Ongoing</p> <p><u>Steps to be taken and costs on an ongoing basis</u></p> <p>Lessor D is not expected to change the measurement of lease assets and lease liabilities to reflect changes in the lease term. This is because it is unlikely that Lessor D would conclude that the lessee has a significant economic incentive to exercise the options within its leases, or that there would be a change to that conclusion during the lease term, when those options are priced at market rates at the commencement date.</p> <p>Lessor D incurs costs in providing enhanced disclosures in its financial statements about leases (for example a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of lease receivables and residual assets; information about how Lessor D manages its exposure to residual asset risk).</p> <p>Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessor D inputs any new leases into that system.</p>

Appendix E

Summary of changes from the 2010 Exposure Draft

The following table summarises the changes to the boards' August 2010 proposals in response to feedback received:

Topic	Description of changes to the proposals
The lessee and lessor accounting models	<p>Changed the proposals on the classification of leases as follows:</p> <p>The 2010 Exposure Draft proposed that, when determining how to account for leases, a lessor would assess whether significant risks and benefits associated with the underlying asset are transferred to the lessee.</p> <p>This Exposure Draft proposes that a lessee and lessor would classify leases on the basis of whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. That principle would be applied by presuming that:</p> <ul style="list-style-type: none"> (a) a lease of property is a Type B lease unless specified criteria are met; and (b) a lease of an asset that is not property is a Type A lease unless specified criteria are met.
	<p>Changed the lessee accounting model as follows:</p> <p>The accounting for Type A leases is consistent with the lessee accounting approach proposed in the 2010 Exposure Draft.</p> <p>The accounting for Type B leases differs from the lessee accounting approach proposed in the 2010 Exposure Draft as follows:</p> <ul style="list-style-type: none"> (a) a lessee would amortise the right-of-use asset so that the remaining cost of the lease is allocated over the lease term on a straight-line basis; (b) the lessee would present amortisation of the right-of-use asset and the unwinding of the discount on the lease liability together as a single lease cost; and (c) the lessee would classify cash flows arising from Type B leases within operating activities.

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Topic	Description of changes to the proposals
	<p>Changed the lessor accounting model as follows:</p> <p>The 2010 Exposure Draft proposed that a lessor would apply either the derecognition approach or the performance obligation approach, depending on whether significant risks and benefits associated with the underlying asset are transferred to the lessee.</p> <p>This Exposure Draft proposes that a lessor would apply:</p> <p>(a) an approach similar to the derecognition approach in the 2010 Exposure Draft to Type A leases. The accounting for Type A leases differs from the derecognition approach as follows:</p> <p>(i) the lessor would recognise the unwinding of the discount on the residual asset as interest income over the lease term; and</p> <p>(ii) the lessor would present the carrying amount of the lease receivable and the residual asset together as lease assets, with the lease receivable and the residual asset presented or disclosed separately.</p> <p>(b) an approach similar to operating lease accounting in IAS 17 to Type B leases, recognising lease income over the lease term on either a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset.</p> <p>This Exposure Draft does not retain the performance obligation approach proposed in the 2010 Exposure Draft.</p>
Other topics	
Definition of a lease	<p>Retained the definition of a <i>lease</i> but:</p> <p>(a) clarified that the underlying asset can be a physically distinct portion of a larger asset, and cannot be a capacity portion of a larger asset that is not physically distinct.</p> <p>(b) changed the guidance on the right to control the use of an asset to be more consistent with the concept of control applied in other requirements and projects (ie the revenue recognition proposals and consolidation requirements).</p>
Accounting for changes to a lease	Clarified that contract modifications resulting in substantive changes to a lease would result in the modified contract being treated as a new contract.

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Topic	Description of changes to the proposals
Cancellable leases	<p>Clarified that a lease creates <i>enforceable</i> rights and obligations.</p> <p>Added requirements on cancellable leases, specifying that a lease is cancellable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party, with no more than an insignificant penalty.</p>
Separating lease and non-lease components	<p>Modified the proposals to require both a lessee and a lessor to identify and account for each lease component separately from non-lease components of a contract, subject to some specified requirements for lessees.</p>
Measurement of lease assets and lease liabilities	<p><u>Variable lease payments</u></p> <p>Changed the proposals to include in the measurement of lease assets and lease liabilities only variable lease payments that either depend on an index or a rate or are in-substance fixed payments, rather than requiring the inclusion of an estimate of all variable lease payments. Variable lease payments that depend on an index or a rate would be measured using the index or rate at the commencement date and would be reassessed as at the end of each reporting period.</p>
	<p><u>Options to extend or terminate a lease or to purchase the underlying asset</u></p> <p>Changed the proposals to include in the measurement of lease assets and lease liabilities lease payments to be made in optional periods, or the exercise price of a purchase option, only when a lessee has a significant economic incentive to exercise an option, rather than including lease payments on the basis of an estimate of the lease term as the longest possible term that is more likely than not to occur.</p>
	<p><u>Reassess the discount rate</u></p> <p>Changed the proposals to require an entity to reassess the discount rate when there is a change in either of the following, unless the change was reflected in determining the discount rate at the commencement date:</p> <p>(a) relevant factors, other than market-based factors, that result in a lessee having, or no longer having, a significant economic incentive either to exercise an option to extend the lease or purchase the underlying asset, or not to exercise an option to terminate the lease.</p> <p>(b) reference interest rates, if variable lease payments are determined using those reference rates.</p>

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Topic	Description of changes to the proposals
	<p data-bbox="560 443 900 472"><u>Lessor—residual value guarantees</u></p> <p data-bbox="560 488 1262 607">Changed the scope of application of the requirements on residual value guarantees for lessors so that they apply to all residual value guarantees rather than only residual value guarantees provided by a lessee.</p> <p data-bbox="560 629 1278 815">Modified the proposals on the accounting for residual value guarantees to be consistent with the changes to the lessor accounting model to require a lessor to consider guarantees relating to Type A leases when determining whether the residual asset is impaired, but not include the expected amounts to be received under residual value guarantees in the measurement of the lease receivable.</p> <p data-bbox="560 837 1254 891">Added requirements on lease payments structured as residual value guarantees.</p>
Costs relating to the construction or design of an underlying asset	Added application guidance on costs incurred by a lessee relating to the construction or design of an underlying asset.
Disclosure	Modified to reflect changes to the lessee and lessor accounting models.
Sale and leaseback transactions	<p data-bbox="560 1173 1270 1234">Retained the proposal to account for a sale and leaseback transaction as a sale and leaseback when the transferred asset has been sold.</p> <p data-bbox="560 1240 1270 1391">However, revised the proposals to require an entity to assess whether the transferred asset has been sold using the control principle in the 2011 Exposure Draft <i>Revenue Recognition</i> rather than on the basis of a list of conditions that would apply only when assessing sale and leaseback transactions.</p>
Short-term leases	Revised the proposals to permit both a lessee and a lessor to apply an approach similar to operating lease accounting in IAS 17 as an accounting policy election.

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Topic	Description of changes to the proposals
Transition	<p>Revised the transition proposals to permit an entity to apply the proposed requirements using a full retrospective approach or, alternatively, using a modified retrospective approach reflecting changes to the lessee and lessor accounting models.</p> <p>According to the modified retrospective approach:</p> <ul style="list-style-type: none"> (a) for leases classified as finance leases in accordance with IAS 17, an entity would carry forward amounts previously recognised for lease assets and lease liabilities, subject to some reclassifications. (b) for leases classified as operating leases in accordance with IAS 17, an entity would apply a retrospective approach but would use information available at the date of transition when measuring lease assets and lease liabilities. (c) the Exposure Draft includes some specified reliefs for transitioning to the proposed requirements on a retrospective basis. <p>Added transition requirements relating to sale and leaseback transactions and amounts previously recognised in respect of business combinations.</p>
Business combinations	<p>Added requirements relating to the measurement of lease assets and lease liabilities acquired in a business combination.</p>
FASB – Related-party leases	<p>The FASB decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties on the basis of legally enforceable terms and conditions of the lease, acknowledging that some related-party transactions are not documented and/or the terms and conditions are not at arm's length. In addition, a lessee and a lessor would be required to apply the disclosure requirements for related-party transactions in Topic 850. Under existing US GAAP, entities are required to account for leases with related parties on the basis of their economic substance, which may be different from the legally enforceable terms and conditions of the arrangement.</p>

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Topic	Description of changes to the proposals
FASB – Application by nonpublic entities	<p data-bbox="561 443 1214 501">Added FASB-only specific requirements for nonpublic entities as follows:</p> <p data-bbox="561 521 703 551"><u>Discount Rate</u></p> <p data-bbox="561 566 1287 658">Added a specified relief for nonpublic entity lessees permitting the use of a risk-free discount rate, determined using a period comparable to that of the lease term, as an accounting policy election for all leases.</p> <p data-bbox="561 678 743 707"><u>Lessee Disclosures</u></p> <p data-bbox="561 723 1246 808">Added an exemption for nonpublic entity lessees from the requirement to provide a reconciliation of the opening and closing balances of the lease liability.</p>

Alternative views

Alternative view of Prabhakar Kalavacherla and Wei-Guo Zhang

- AV1 Messrs Kalavacherla and Zhang support a right-of-use model, according to which a lessee would account for a lease as the acquisition of a right to use an underlying asset and the lessor would account for a lease as the transfer of that right-of-use in exchange for a commitment from the lessee to make lease payments. They also support an exception to that model for short-term leases.
- AV2 However, Messrs Kalavacherla and Zhang voted against publication of this Exposure Draft for the following reasons:
- (a) First, Messrs Kalavacherla and Zhang disagree with the dual accounting model proposed for both lessees and lessors (as described in paragraphs AV3–AV7), which in their view undermines the principles underlying the proposed right-of-use model, is operationally complex and creates structuring opportunities.
 - (b) Second, Mr Kalavacherla disagrees with the proposals regarding variable lease payments and payments to be made in optional periods (as described in paragraphs AV8–AV9). Mr Kalavacherla believes that those proposals result in a failure to apply the definitions of assets and liabilities in the *Conceptual Framework* and create inconsistencies within the Exposure Draft.
 - (c) Finally, Mr Kalavacherla disagrees with the proposal to require a lessee to separate lease components and non-lease components (as described in paragraph AV10).

Dual accounting model

- AV3 Messrs Kalavacherla and Zhang disagree with the dual accounting model proposed for lessees because they believe it contradicts an important objective of the project, which is to create a single lease accounting model. For Type B leases, the amortisation of the right-of-use asset in each period is, in effect, a balancing figure to achieve a straight-line expense in profit or loss, and combines a financing cost and amortisation of the right-of-use asset. Accordingly, a lessee would not measure right-of-use assets arising from Type B leases consistent with other non-financial assets measured on a cost basis. Messrs Kalavacherla and Zhang believe that, having recognised the right-of-use asset separately from the lease liability at the commencement date, a lessee should subsequently measure the right-of-use asset independently of the lease liability. They would propose that a lessee should account for all leases, except short-term leases, according to the proposals in this Exposure Draft for Type A leases. This would also remove the complexity and structuring opportunities described in paragraphs AV5–AV6 for lessees.
- AV4 Messrs Kalavacherla and Zhang believe that to apply the right-of-use model consistently, a lessor should recognise a receivable for all leases for which a lessee recognises a lease liability, unless the lessor measures the underlying asset at fair value. Accordingly, they disagree with the lessor accounting proposals for

Type B leases when the underlying asset is not investment property measured at fair value. They believe that regardless of the type of lease and the business model of the lessor, the right to receive lease payments is a financial asset and accordingly should be reflected as such in the lessor's financial statements. This is because the nature of the risks associated with a financial asset are different from those of the underlying asset, and information about those different risks is critically important to users of a lessor's financial statements, including banks providing financing to lessors and investors in securitised vehicles that hold lease receivables. When the underlying asset is measured at fair value, the value of the lease receivable is embedded in the measurement of the underlying asset. Hence, Messrs Kalavacherla and Zhang do not view the lessor accounting proposals for leases of investment property measured at fair value as being inconsistent with the lease accounting proposals.

- AV5 Messrs Kalavacherla and Zhang also have operational concerns about the application of the proposed dual accounting model and, in particular, the classification of leases. They question how an entity would assess what 'insignificant', 'substantially all' and 'major part' mean without additional guidance. They also believe that it is arbitrary and unnecessarily complex to have different 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.
- AV6 In addition, they believe that in a property lease incorporating land and a building, the land and the building should be evaluated separately when classifying the lease. Evaluating the land and the building separately would better reflect the consumption principle developed by the boards and the underlying economics of such transactions. For example, to correctly apply the consumption principle, Messrs Kalavacherla and Zhang believe that a lease of freehold land should always be classified as a Type B lease because the economic benefits embedded in that land would not be expected to be consumed by a lessee. However, under the proposals, when a lease incorporates both freehold land and a building, the entire lease could be classified as a Type A lease, even though the lessee does not consume the economic benefits embedded in the land. If land and buildings were evaluated separately, Messrs Kalavacherla and Zhang would then propose that the consumption principle be applied in the same way to all leases without the need for different classification criteria for different leases, which in their view would reduce the complexity of the proposals.
- AV7 Finally, Messrs Kalavacherla and Zhang believe that the dual accounting model provides structuring opportunities and could lead to accounting that does not faithfully reflect the economics of a lease. For example, a lessee could enter into a lease that has a relatively short non-cancellable period but has a long optional extension period. Because payments to be made in optional periods would affect lease classification only if a lessee has a significant economic incentive to exercise an option, and a significant economic incentive is a high threshold, the lease is likely to be classified as a Type B lease. However, if the lessee subsequently exercises the extension option, the lease will continue to be

classified as a Type B lease because the proposals prevent the reassessment of lease classification. This would be the case even though the lease might have been classified as a Type A lease if the lessee was required to reassess lease classification at the time of exercising the option. Messrs Kalavacherla and Zhang believe that lease classification should be reassessed when the lease term changes to ensure comparability with the classification of new leases and to avoid creating structuring opportunities.

Accounting for variable lease payments and options

AV8 Mr Kalavacherla believes that lease payments should not be treated differently solely because the amounts to be paid are uncertain or variable. Consequently, he disagrees with the proposal to exclude variable lease payments based on use or performance from the measurement of a lessee's lease liability and right-of-use asset, and a lessor's lease receivable. In his view, all variable lease payments give rise to an obligation for the lessee that meets the definition of a liability and are part of the cost of the right-of-use asset. Similarly, all variable lease payments give rise to a right for the lessor that meets the definition of an asset. Mr Kalavacherla believes that the proposals are inconsistent because an entity is required to estimate amounts expected to be payable under a residual value guarantee, which is a form of variable lease payment, but is not required to do so for other variable lease payments. Mr Kalavacherla would, therefore, propose to include in the measurement of the lessee's lease liability the amount of variable lease payments expected to be payable. He would also propose that a lessor include variable lease payments in the measurement of its lease receivable using criteria similar to those developed in the Revenue Recognition project. To reduce the costs of applying this approach, Mr Kalavacherla would propose that an entity not be required to reassess the amounts recognised unless a specified threshold is met.

AV9 Similarly, Mr Kalavacherla is of the view that lease payments to be made in optional periods give rise to a right (for the lessor) and an obligation (for the lessee) that meet the definition of an asset and a liability respectively in the *Conceptual Framework*. Consequently, he disagrees with the proposal to include lease payments to be made in optional periods when measuring lease assets and lease liabilities only if a lessee has a significant economic incentive to exercise the option. He believes that the 'significant economic incentive' threshold sets too high a hurdle for recognition and, thus, will result in accounting that does not reflect the economics of leases that include optional periods. Mr Kalavacherla would, therefore, propose to include lease payments expected to be made in optional periods in the measurement of the lessee's lease liability and the lessor's lease receivable. Mr Kalavacherla would propose that an entity not be required to reassess the amounts recognised unless a specified threshold is met to alleviate cost concerns.

Separating lease components and non-lease components

AV10 Mr Kalavacherla disagrees with the proposal to require a lessee to separate a contract and to account for the lease component separately from any non-lease components. He believes that, if a contract contains a lease, a lessee should include all payments to be made under the contract within the measurement of

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lease assets and liabilities. In many lease contracts, the lessee does not have the option to lease the asset alone. Default on the contract occurs for failing to make the entire payments due under the contract, not for failing to make only lease payments. Mr Kalavacherla believes that the right-of-use asset comprises the right to use the underlying asset for a period of time and any services that are provided by the lessor within the same contract if those services are not legally separable. For example, in a contract for the lease of a building and maintenance of that building for the term of the contract, Mr Kalavacherla believes that the lessee has a right to use a maintained building—it does not have a right to use a building and a separate contract for the maintenance of that building. In Mr Kalavacherla's view, the proposal to separate lease components and non-lease components of a contract understates the assets and liabilities of the lessee and results in unwarranted complexity within the proposals. The proposal would also require a user of financial statements to look to various places for information about an entity's cash flow commitments.

The following alternative views expressed by members of the FASB are not part of the IASB's Exposure Draft, but have been included for information.

Alternative view of Thomas J. Linsmeier

- AV11 Mr Linsmeier disagrees with issuance of this Exposure Draft because he believes it will result in financial reporting by the lessee that is so complex that it will hinder users' abilities to assess the amount, timing, and uncertainty of the cash flows arising from the lease contract. Under the proposed requirements, complexity is created for lessees in all of the following:
- (a) The statement of financial position, by not recognising and measuring in the right-of-use asset or the lease liability certain renewal options and variable payments required under the contract as well as not recognising and measuring rights and obligations of the lessee under lease contracts that either are short term or contain payments that are classified as nonlease payments. As a result, users are provided with an incomplete representation of contract assets and liabilities and are forced to seek additional information to adjust statement of financial position numbers to understand and faithfully represent the present value of cash flows committed to be paid under lease contracts.
 - (b) The statement of comprehensive income, by requiring or permitting presentation of expenses associated with different lease contracts in the following line items: amortisation expense and interest expense for Type A leases, lease expense for Type B leases, and in unspecified line items for short-term leases, variable payments, and payments for nonlease components. Thus, under the proposed requirements, to determine the aggregate income statement effects of lease contracts, users would need to understand that for each type of lease contract expense information may be provided in multiple and differing income statement line items.
 - (c) The statement of cash flows, by requiring presentation of cash flows from lease contracts in multiple different line items in the financing and operating sections of the statement. Under the proposed requirements, repayments of principal on Type A leases would be required to be presented in the financing section. In addition, payments relating to the unwinding of the discount on Type A leases, payments on Type B leases, and payments relating to variable payments, short-term leases, and nonlease components for all leases would be required to be presented in the operating section. Thus, again, under the proposed requirements, to determine the aggregate cash flow effects of lease contracts, users would need to understand that cash flow information may be provided in up to six different line items in two different sections of the statement of cash flows.
 - (d) The footnotes, due to the boards' failure to require a comprehensive disclosure in one location that provides financial statement users with the information necessary to comprehend all the rights and obligations and related income and cash flow effects inherent in lease contracts,

especially if that information is not presented separately as financial statement line items. That information is necessary to obtain complete information about the economic effects of leasing activities and to facilitate the understanding of the differences arising from permitting or requiring the use of three lease models in the proposed requirements (Type A, Type B, and short-term).

- AV12 Mr Linsmeier believes that because the proposed requirements would result in this complexity, they do not represent an improvement to existing requirements for lessees. Current guidance requires that sufficient information be provided in the footnotes to the financial statements for users to estimate the present value of cash flows committed to under operating lease contracts (the most prevalent type of lease contract under current requirements), making it easier to find the information to make any adjustments to reported numbers necessary to reflect the economics of those lease contracts.
- AV13 Mr Linsmeier does not believe the proposed requirements represent an improvement because they complicate users' abilities to make any adjustments to reported numbers by forcing them (a) to understand which rights and obligations *are and are not* recognised and measured in lease assets and lease liabilities and (b) to seek and aggregate income and cash flow information from multiple line items across a wide range of different lease contracts. The adjustment process is complicated further by the failure of the proposed guidance to require presentation or disclosure of all the components that comprise the total expense incurred each period under the lease contract. Research during the standard-setting process on this project has indicated that users do not have a monolithic view about the economics of lease contracts with some users viewing leases primarily as resulting in rental expense while other users viewing leases as financing vehicles and, finally, other users viewing leases as derivatives. That observation suggests that many users will continue to seek information to adjust reported numbers to reflect their varying views of the economics of lease contracts. The proposed requirements do not facilitate making such adjustments and, therefore, Mr Linsmeier believes they represent a step backward from the current requirements.
- AV14 Mr Linsmeier also believes that the complexity in the proposed requirements is due to the following three fundamental decisions that are implicit in the proposed requirements:
- (a) Individual rights and obligations under the lease contract are treated under the proposed requirements as separate units of account for recognition, measurement, and/or presentation purposes rather than consistently having the lease contract itself treated as the single unit of account. That decision permits inconsistent and incomplete recognition of all present rights and obligations under the lease contract in the right-of-use asset and the lease liability in the statement of financial position. In addition, it permits or requires the various changes in rights and obligations under a single lease contract to be presented in multiple different line items in the statements of income and cash flows. If the unit of account is the lease contract, the lease liability (asset) would recognise and measure all present obligations (rights) under the

contract. Those include not just present obligations to make future fixed payments, but also present obligations to make variable payments for use of the asset during the contract term and present obligations to make payments during the contract term for the so-called ‘non-lease’ components included in the contract. In contrast, at contract inception there is no present obligation to exercise extension or termination options. However, those options create a present right (asset) for the holder of the option, and, therefore, if the lease asset is made equal to the lease liability at initial recognition then the option rights under the contract either must be included or excluded from both the right-of-use asset and the lease liability, creating an inherent conceptual inconsistency by either excluding the option from measurement of the lease asset or including it in the measurement of the lease liability.⁵ Finally, if the unit of account is the lease contract, it permits presentation of the collective income and cash flow outcomes from leasing activity in one line item (or perhaps two line items) in the statements of income and cash flows, reducing complexity and potentially facilitating the decision usefulness of the reported information.

- (b) Lessor accounting under the proposed requirements is determined by applying the lessee model symmetrically to lessors without considering differences in the substance of rights and/or obligations under the lease contract associated with the residual asset for lessees as compared to lessors. Each lease contract includes an obligation at the end of the lease term for the lessee to return the underlying asset to the lessor and the symmetric right of the lessor to get the underlying asset back from the lessee. The proposed requirements for the lessee view the obligation to return the underlying asset to the lessor at the end of the lease term as nonsubstantive, merely requiring the lessee to return an asset that it never had the right to under the lease contract. The transfer to the lessor, therefore, does not involve transfer of economic resources controlled by the lessee and does not increase the value of the lessee’s lease liability. In contrast, the underlying asset being returned to the lessor does have economic value to the lessor because it involves the return of the underlying asset that the lessor owns and the lessor can either subsequently re-lease or otherwise use for future economic return. The right to the return of the underlying asset to the lessor, therefore, is substantive having direct bearing on whether the lease transaction is economically beneficial to the lessor. Reobtaining a residual asset that is worth either less or more than anticipated at lease inception can make the lessor’s return on the lease contract either negative or more positive, respectively. Thus, the economic benefits to the lessee and lessor associated with rights and obligations under a lease contract are not symmetric because the lessor’s economic return is affected by its continuing involvement with the full underlying asset (including the residual asset), while the lessee’s benefits under the lease are limited

⁵ Mr Linsmeier discusses his recommendation for dealing with this inconsistency later in this alternative view.

only to benefits it receives from using a portion of the lessor's underlying asset over the lease term. Mr Linsmeier believes that difference should cause differences in the accounting required for lessees and lessors, as is discussed below.

- (c) The proposed requirements for right-of-use assets recognised by the lessee are defined without resolving what the right-of-use asset is—the underlying tangible asset, an intangible asset, a unique asset subject to lease, or a service provided over the lease period. Yet the subsequent accounting by the lessee for Type A leases generally is prescribed to be consistent with the accounting for tangible/intangible assets and the subsequent accounting by the lessee for Type B leases generally is prescribed to be consistent with the accounting for services. The proposed requirements describe the right-of-use asset held by the lessee under the lease contract as the future economic benefits associated with the lessee's contractual right to use the underlying asset of the lessor over the lease term. The proposed guidance also would require that the lessee's right-of-use asset be presented along with similar owned assets in the property, plant, and equipment section of the statement of financial position. While the boards recognise that there are differences between owned assets and right-of-use assets, they fail in the proposed requirements to specify what a right-of-use asset is. That decision is important because it could provide the basis for defining the subsequent accounting for the right-of-use asset. If the boards were to decide that the right-of-use asset either represents the underlying physical asset or an intangible asset, then there may be conceptual justification for subsequent accounting that requires amortisation of the right-of-use asset over the remaining contractual term in a pattern consistent with the pattern used for tangible assets or intangible assets. In contrast, if the boards were to decide that the right-of-use asset is a service provided by the lessor to the lessee, then it could be argued that the subsequent accounting for the right-of-use asset should be the recognition of a single lease expense in the statement of income. However, a decision to view the asset as a service also might suggest that the right-of-use asset and the lease liability should be presented net on the statement of financial position.

AV15 Mr Linsmeier believes that the right-of-use asset neither represents the underlying physical asset owned by the lessor nor an intangible asset or service because intangibles and services do not involve control over the use of a physical asset. Thus, he believes that the right-of-use asset is unique and represents the benefits accrued by the lessee from access granted by the lessor to use and temporarily control the underlying asset over the lease term as well as from any other rights conveyed by the lessor under the contract (including nonlease components) and, therefore, that subsequent accounting for the lease asset should not be defined by reference to other literature.

AV16 Mr Linsmeier's preferred approach to accounting for lease contracts by both lessees and lessors addresses each of those issues. First, he believes the lease contract should be the unit of account for both lessees and lessors. Second, he believes the accounting for lessees and lessors should be asymmetric, reflecting

the differences in the substance of the rights and/or obligations in the lease contact associated with the residual asset for lessors as compared to lessees. Finally, he does not take a position about the subsequent accounting for lessees based on references to other literature. Rather, he suggests that to maximise the decision usefulness of the information for users and to minimise reporting complexity, the boards should prescribe a single (but asymmetric) lease model for both lessees and lessors and provide additional disclosures in one location that permit users to make the adjustments necessary to fit their decision models.

- AV17 Mr Linsmeier's preferred approach to lease accounting first would require that lease contracts that transfer substantially all of the benefits of the underlying asset from the lessor to the lessee be accounted for as constructive sales by the lessor and constructive purchases by the lessee of the underlying asset. He would require that the accounting for those contracts be consistent with point-in-time sales accounting by the lessor and purchase/acquisition accounting by the lessee. He would base the constructive sale and purchase decision on the principle in IAS 17, scope those contracts out of the leasing requirements, and scope them into the guidance on revenue recognition for lessors and property, plant, and equipment for lessees.
- AV18 Based on that scoping decision and the views expressed above, Mr Linsmeier believes the proposed leasing requirements for lessors should represent an application of the new revenue recognition requirements for contracts with customers with the unit of account being the lease contract and the underlying asset owned by the lessor being the focus of the analysis because under the lease contract the lessor retains substantive rights to the residual asset. Under the revenue recognition model, an entity would first decide whether there are one or more performance obligations under the contract. In that regard, the primary issue for lease contracts is whether performance obligations under the contract relating to any nonlease components are distinct from performance obligations relating to the lease of the underlying asset. If so, the nonlease components would be accounted for separately from the lease components in the contract.⁶
- AV19 Regardless of that decision, Mr Linsmeier believes that application of the new revenue recognition requirements to lease contracts would result in recognition of revenue over time for both types of performance obligations: lease and nonlease. Revenue would be recognised over time for leases with lease components only or with nondistinct lease and nonlease components for one or more of the following reasons:
- (a) The lease does not transfer substantially all of the underlying asset to the lessee, and the revenue recognition model would require that substantially all of the underlying asset be transferred to the customer to recognise revenue at a point in time rather than over time.

⁶ The only exception is that if the separate performance obligations relating to both the lease and nonlease components are recognised in revenue over time using the same input or output method, then the two sets of performance obligations can be combined for revenue recognition purposes.

- (b) The lease contract requires the lessee to return the underlying residual asset with an uncertain value to the lessor at the end of the lease term. The revenue recognition model would require revenue to be constrained from being recognised until the uncertainty in value of the residual asset is resolved, causing revenue not to be recognised at the inception of the lease but, instead, as the uncertainty is resolved over time.
- (c) If nondistinct, nonlease components exist in a contract and the performance obligations relating to those nonlease components are satisfied over time, the revenue recognition model would require all revenue in the contract to be recognised over time.

AV20 Under his preferred lessor model, Mr Linsmeier would measure the contract assets and contract liabilities consistent with the measurements for lessees, as discussed below. In addition, he would require presentation of accounts receivables, net contract assets, and net contract liabilities consistent with the new revenue recognition requirements for contracts with customers.

AV21 In terms of his preferred lessee model, Mr Linsmeier believes that the unit of account should be the lease contract and, therefore, that all present rights and obligations under the contract should be recognised and measured, including rights and obligations associated with fixed and variable payments that are required from use of the underlying asset during the lease term and rights and obligations associated with payments for nonlease components promised to be delivered under the contract. To simplify the reporting, Mr Linsmeier would not include the rights relating to extension or termination options in the measurement of the rights and obligations under the lease contract until they are exercised, but he would require information on those options in the comprehensive disclosures relating to the lease contract. In addition, the obligation of the lessee to return the leased asset to the lessor at the end of the lease term would not affect the measurement of the rights or obligations of the lessee because the resource being transferred under the contract belongs to the lessor and not to the lessee. Finally, Mr Linsmeier believes that recognised rights should be presented separately from the recognised obligations at contract inception as separate lease assets and lease liabilities. He supports that presentation because at contract inception the lessee obtains control of the underlying asset and has the unconditional right to its use during the lease term. The receipt of that right also creates a present obligation to make payments for the use of the underlying asset during the lease term as well as a present obligation for paying for bundled services committed to be provided by the lessor under the contract.

AV22 In terms of the subsequent income statement accounting for lessees, Mr Linsmeier believes that conceptual arguments can be made supporting either the method used for Type A leases or the method used for Type B leases, as defined in the proposed requirements. The subsequent income statement accounting for Type A lease treatments can be supported by viewing the accounting as being consistent with current requirements on recognising and subsequently measuring liabilities used to finance the purchase of tangible or intangible assets and is driven from a perspective that those rights and obligations should be accounted for separately throughout the financial

statements. The subsequent income statement accounting for Type B lease treatments can be supported conceptually by viewing the contract as a whole that provides the lessee with equal access to the leased asset over the lease term with subsequent accounting reflecting equal payments for equal access over time. The latter approach may be most consistent with viewing the unit of account as the lease contract while still requiring the gross up of the lease asset and lease liability in the statement of financial position for the reasons discussed above.

- AV23 Mr Linsmeier believes that to reduce complexity in reporting, the boards should select one of the two subsequent income statement accounting approaches described in the preceding paragraph and apply it to all leases. He also believes that the boards should augment that approach by providing additional disclosures in one location that provide users with the information needed to make any adjustments they find necessary to fit their decision models. The outcome of that approach would reduce the number of line items reported for each lease in the income statement and in the statement of cash flows, would facilitate users' abilities to understand what is and what is not reported in the financial statements, and would allow users to make adjustments to reported numbers. Finally, to the extent that the boards do not agree with aspects of this alternative view in redeliberations, Mr Linsmeier believes it is paramount to facilitate users' decisions that the boards require that comprehensive information is provided in a single lease disclosure footnote to facilitate adjustments to reported numbers for all rights and obligations in the lease contract that are not recognised in lease assets and lease liabilities.

Alternative view of R. Harold Schroeder

- AV24 Mr Schroeder disagrees with the issuance of this Exposure Draft because he believes its requirements fail to adequately meet its primary objectives to improve financial reporting and to faithfully represent related rights and obligations. He also does not believe the proposed disclosures provide users with certain decision-useful information.
- AV25 Mr Schroeder agrees with the majority view that leases represent rights and obligations that meet the definitions of assets and liabilities in Concepts Statement 6. However, because the liability for all recognised leases is based on a present value of cash flows, he sees no conceptual basis for not separately recognising related financing costs (that is, periodic reversal of the present value discount) for certain types of leases (that is, Type B leases) while recognising it for other types (that is, Type A leases).
- AV26 Mr Schroeder's view is consistent with paragraph 93 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which states that 'an interest method...is generally considered more relevant than other methods' when applied to liabilities that exhibit one or more of several characteristics. One of those characteristics is that 'measurement at initial recognition was based on present value.' Clearly, all leases recognised as a liability under this Exposure Draft meet this characteristic (and likely others) identified in Concepts Statement 7.

- AV27 In a separate but related issue, 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.
- AV30 A related concern results from permitting an accounting policy election to not apply the proposed requirements to short-term leases. In low-rate environments, financing costs could be immaterial and ignored. However, that may not be true when interest rates rise or the volume of leasing is substantive. Therefore, Mr Schroeder believes that election could lead to an incomplete representation of some entities' rights and obligations, thereby reducing comparability.
- AV31 Mr Schroeder agrees with the majority view that the existing requirements on leases are complex, in part, because of the bright-line distinction between capital leases and operating leases. However, the proposed requirements maintain a two-model approach for both lessees and lessors, albeit by substituting a more opaque consumption-based classification approach for the current bright-line test.
- AV32 The boards heard clear feedback from stakeholders that a single method of accounting for leases would significantly reduce complexity, in part, by eliminating the need for a classification system. Mr Schroeder believes that this Exposure Draft's introduction of a new classification system is not an improvement and, in fact, could add greater complexity for users, preparers and auditors. Furthermore, he questions whether necessary classification assumptions will be operable and auditable.
- AV33 The basis for a two-model approach is that the majority agrees that the economics of all leases are not the same. While there is merit to that view, Mr Schroeder does not believe that consumption of an asset should affect accounting for financing costs of a related liability. He believes that any

economic difference between types of leases is better reflected by lessees in the amount of recognised financing costs, which can vary on the basis of a number of key factors including volume and variety of leasing activities, contract duration, credit quality of the lessee, and the level of interest rates at lease inception.

- AV34 Mr Schroeder believes that the proposed disclosures do not meet the objective of providing decision-useful information about the timing and amount of lease cash flows or expenses by lease type. In his view, elevating the importance of disclosures is essential because there is a greater likelihood that more entities will have both Type A and Type B leases compared to current practice in which most are accounted for as operating leases.
- AV35 While entities will be required to disclose right-of-use assets by type, there is no similar requirement for expense recognition. And, unlike the IASB's Exposure Draft, the FASB's Exposure Draft does not require a roll forward of the right-of-use asset, which could facilitate an assessment of the related expenses. Mr Schroeder believes that not providing such a roll forward, and including a clear segregation of lease expense by type, is inconsistent with the majority view that Type A and Type B leases are economically distinct.
- AV36 Mr Schroeder also believes that disclosing as a single amount the sum of undiscounted cash flows (used in the liability measurement) beyond five years for longer term leases will limit usefulness. The value of cash flow disclosures is further limited by not requiring disclosure of the actual discount rate (or range or weighted-average discount rates) used to determine lease assets and liabilities.
- AV37 Mr Schroeder believes that to faithfully represent the underlying economics of leasing, as well as to reduce the substantial complexity introduced by this Exposure Draft, the boards should require lessees to apply the Type A approach for all leases. Should the boards not agree in redeliberations to apply this single-model approach, Mr Schroeder believes enhanced disclosures will be needed to provide users with decision-useful information not available in this Exposure Draft. While acknowledging this will add even further compliance costs, he believes a single comprehensive lease disclosure footnote will be necessary to facilitate adjustments to reported numbers for all rights and obligations in the lease contract that are not recognised in lease assets and lease liabilities. The single footnote also should provide a clear tabular segregation of expenses and cash flows for Type A and Type B leases that reconciles to the amounts recognised in the financial statements. Mr Schroeder believes that the added compliance costs incurred by entities to provide those additional disclosures would, from a user perspective, be adequately offset by providing more decision-useful information related to the amount, timing and uncertainty of lease-related cash flows.
- AV38 While Mr Schroeder has primarily addressed his concerns from the lessee perspective, he believes the same concerns apply to the proposed requirements for lessors. He also believes that, from a user perspective, the existing lessor accounting requirements work well in practice. Taken as a whole, Mr Schroeder does not believe there is sufficient improvement to justify incurring costs to

implement the proposed requirements as they relate to lessors. Therefore, he supports retaining current lessor accounting requirements.

Alternative view of Marc A. Siegel

- AV39 Mr Siegel disagrees with the issuance of the requirements in this Exposure Draft because he believes that the benefits of the new information will not justify the costs. He believes that the measurement of the lessee's liability required by the proposed requirements will provide insufficient decision-useful information for investors, such that significant adjustments will continue to be made by financial statement users. Specifically, Mr Siegel disagrees with the proposed requirements on renewal options and variable lease payments. Mr Siegel also believes that the presentation and disclosures required by the proposed requirements exacerbate the difficulty users will have in analysing the lessee's financial position and performance. As such, Mr Siegel asserts that the proposed requirements fail to meet the objective of reporting useful information to users of financial statements about the amount, timing and uncertainty of cash flows arising from a lease that is set forth in this Exposure Draft.
- AV40 Mr Siegel agrees that leases create rights and obligations that meet the definitions of assets and liabilities that are set forth in Concepts Statement 6. However, he disagrees that the measurement of the obligation of the lessee should exclude amounts to be paid that are uncertain or variable. Paragraph QC7 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information*, states that 'financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both.' Paragraph QC8 elaborates, stating that 'financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes.' Mr Siegel believes that the exclusion of all but some renewal options and variable payments will result in significantly increased efforts by users to make predictions using solely the measurements recorded in the financial statements. As such, he believes that the benefits of the measurements will not justify the costs to prepare and audit those measurements.
- AV41 Furthermore, with respect to variable lease payments, Mr Siegel finds it inconsistent that the requirements in this Exposure Draft would create a higher threshold for the measurement of those *contractual* liabilities than the measurement of *noncontractual* liabilities required by Subtopic 450-20, *Contingencies—Loss Contingencies*. Specifically, for *noncontractual* contingencies, paragraph 450-20-25-2 in part requires a liability be recognised when it is probable that a liability has been incurred. Conversely, the proposed requirements would prohibit the recognition of *contractual* variable lease payments that do not depend on an index or a rate when there is no uncertainty that a liability has been incurred. For example, he believes that the proposed requirements would result in no recognition of a liability for a lease of retail space if the lease payments were solely calculated as a percentage of sales. As such, Mr Siegel believes the measurement will not meet the qualities of predictive value set forth in paragraphs QC7 and QC8 of Concepts Statement 8.

Mr Siegel asserts that the measurement of the lessee liability should include these uncertain amounts for the information to be decision useful.

- AV42 Regarding lease payments to be made in optional periods, Mr Siegel believes that excluding the measurement of the expected cash flows for those periods would impair the decision usefulness of the lease liability. He understands the operational challenges of measuring the renewal options as a separate component of the lease contract; therefore, he believes renewal options should be considered in the lease term, which was defined in the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)*, as the longest possible term that is more likely than not to occur. He understands that the majority view is that the measurement of the renewal options should only take place when the lessee has a 'significant economic incentive' to exercise the option, but believes the resulting measurement will not meet the qualities of predictive value set forth in paragraphs QC7 and QC8. Mr Siegel asserts that the measurement of the lessee liability should include those uncertain amounts for the information to be decision useful.
- AV43 With respect to presentation, Mr Siegel believes the proposed requirements could impede the ability of users to understand the economics of a reporting entity's lease transactions. Mr Siegel is concerned that expenses associated with variable lease payments may be presented by a lessee within a line item other than lease expenses on the statement of comprehensive income. Because the presentation for those expenses was not prescribed in the proposed requirements, he believes that investors may have to make additional adjustments to understand the period costs associated with lease transactions. Furthermore, Mr Siegel is concerned that the cash flow presentation of lessees' lease payments will be too complex for users to understand. Repayments of the principal portion of the lease liability arising from Type A leases will be presented within financing activities. Interest from the unwinding of the discount on the lease liability arising from Type A leases will be presented within operating activities in accordance with paragraph 230-10-45-17. Variable lease payments and short-term lease payments not included in the lease liability will be presented within operating activities and payments arising from Type B leases will be presented within operating activities. Mr Siegel believes that complexity will make it difficult for investors to aggregate cash outflows associated with lease transactions.
- AV44 Mr Siegel believes that some of the complexities with the presentation requirements could have been mitigated by disclosures that the boards considered. Specifically, the boards considered a disclosure that would have aggregated a reporting entity's lease activities into a single table that would have included the following lease expense items, followed by cash payments:
- (a) Amortisation expense for Type A leases
 - (b) Interest expense for Type A leases
 - (c) Expenses relating to variable lease payments not included in the liability to make lease payments
 - (d) Expenses for those leases in which the short-term practical expedient is applied

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- (e) Lease expense for Type B leases
- (f) Principal and interest paid for Type A leases
- (g) Cash paid on the fixed portion of the leases for Type B leases.

AV45 Mr Siegel disagrees with the boards' decision to exclude that disclosure. While recognising that a prescribed tabular disclosure potentially adds costs and complexity for preparers, Mr Siegel believes that the table would mitigate the presentation issues discussed above and be responsive to the varied feedback from investors about the underlying economics of lease transactions. Mr Siegel believes that because the views from investors ranged from those who noted that all leases should be reflected in the performance statement as financings to those who noted that all leases should be reflected as access to the underlying, the above-mentioned table would provide all investors with the information to adjust the statement of comprehensive income for their own purposes. Mr Siegel also believes that the table would have provided a much easier means for investors to derive the aggregate cash outflows for lessees. He agrees that the proposed requirements do require the components of cash paid to be disclosed; however, he notes that the users would have to look to the rollforward of the lease liability, which will include cash paid relating to amounts included in the liability, and then will have to search for separate disclosures of amounts expensed for variable lease payments not included in the lease liability.

AV46 In conclusion, Mr Siegel agrees with the objective of this Exposure Draft but feels that the benefits do not justify the cost. He is concerned that users who noted that all leases should be reflected as financings in the statement of comprehensive income and those who noted that all leases should be reflected as access to the underlying will be compelled to make considerable, albeit very different adjustments to unwind the accounting in the proposed requirements to accommodate their analyses. He asserts that to meet the objective of the proposed requirements and the qualitative characteristics of decision-useful information outlined in the conceptual framework, variable lease payments and renewal options should be included in the measurement of the lessee's lease liability. Mr Siegel believes that some of the above-mentioned presentation and disclosure concerns would be mitigated if the measurement includes these components of the lease obligation for lessees.

AV47 Mr Siegel understands that the alternative view he suggests would, while significantly increasing the benefits, also increase the costs and complexities to prepare the financial statements. Should his alternative view not be supported, Mr Siegel believes that a more cost-beneficial approach would be to make only targeted improvements to current US GAAP by (a) replacing the current bright-line classification criteria with one similar to IAS 17, and (b) improving disclosures for lease transactions with specific, quantitative information about renewal options, variable lease arrangements and cash payments for operating leases to facilitate users' ability to assess the nature, timing and amount of future cash flows. More specifically, Mr Siegel believes that there should be a requirement such that reporting entities do not aggregate lessee and lessor transactions. Additionally, he would include requirements for lessees to disclose the actual lease terms for the most significant leases and a weighted-average lease term for the total liability included in the statement of financial position.

For renewal options on those most significant leases, Mr Siegel would require a disclosure of the reporting entity's assessment of the likelihood of exercise into one of several categories such as 'remote', 'reasonably possible', or 'more likely than not' and the impact on the maturity analysis of future committed cash flows currently required by US GAAP for those with renewal options more likely than not to be exercised. Furthermore, Mr Siegel would require explicit separate disclosures of any lease payments in excess of contractual payments and their nature, such as variable payments, payments on residual value guarantees, or penalty payments if material so that investors can understand cash flows made that might not be recurring. Mr Siegel believes these targeted recognition, measurement and disclosure changes would be more cost-beneficial than the proposed requirements and would still achieve the stated objective.

Table of concordance

This table shows how the contents of the FASB's revised Exposure Draft correspond with the IASB's revised Exposure Draft.

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62—63	IASB-only
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Example 12	842-10-55-62—842-10-55-63
Example 13	842-10-55-64—842-10-55-65
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