Project **Leases**

Topic **Scope - Non-core and short-term leases**

Purpose of the paper

1. This paper addresses whether the new leases standard should provide scope exclusions for non-core asset leases or short-term leases.
2. The paper is structured as follows:
   (a) Background information from the Leases discussion paper (DP).
   (b) A discussion of whether short-term leases should be excluded from the scope of the leases standard.
   (c) A discussion of whether leases of non-core assets should be excluded from the scope of the leases standard.
3. In this paper, the staff recommend the following:
   (a) Exclude short-term leases from the scope of the leases standard for lessees, and account for them on an accrual basis. Define short-term leases as those with an expected lease term of one reporting period or less.
   (b) Do not exclude short-term leases from the scope of the leases standard for lessors. Some staff disagree with this recommendation.
   (c) Do not exclude leases of non-core assets from the scope of the leases standard for lessees and lessors.

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Background

4. The DP discussed possible scope exclusions for:

   (a) leases of assets that are not essential to the operations of an entity (non-core assets); and

   (b) short-term leases (for example, lease contracts of less than one year).

5. The boards did not reach preliminary views on either of these issues. However, the DP asked for respondents' views.

Short-term leases

Comment letter feedback received

6. Respondents were split in their views over whether short-term leases should be excluded from the scope of the leases standard. The majority of users and preparers supported the exclusion, while the majority of accounting firms, professional organisations and standard-setters were against the exclusion.

7. In their responses, respondents did not specifically refer to the lessor's or lessee's perspective, but given that the DP dealt mainly with lessee accounting, it is likely that they considered the question more in the context of lessees than of lessors.

8. The respondents' main arguments for excluding short-term leases are presented below:

   (a) The complexity and costs of capitalising these leases outweigh the benefits.

   (b) The short-term nature of leases makes them more akin to executory contracts.

   (c) Both parties will avoid structuring leases as short-term if they are expected to be used for a longer term (by rolling over short-term leases from one period to the next), because there are risks involved for both lessors (eg the lessee could leave, and finding a new one may be

difficult) and for lessees (eg the lessor can decide not to extend the lease that the lessee was relying on).

9. The respondents' main arguments against excluding short-term leases are:
   (a) There is no conceptual reason for exclusion.
   (b) It could lead to entities structuring lease contracts as short-term to avoid recognition of any lease assets and lease liabilities.
   (c) Even short-term leases could be material (either individually or in aggregate).
   (d) It would add complexity to the standard.
   (e) It would decrease transparency.

10. Many respondents who did not support the exclusion of short-term leases thought that application of the materiality principle should be sufficient. For example a respondent said:

> …trying to draw a distinction between core and non-core assets or short-term and long-term will be very difficult and will only perpetuate the development of a rules-based approach; to address the cost-benefit concerns, the Boards should state specifically in the final Standard that the requirements of the Standard need not be applied to immaterial leases and that materiality should be evaluated individually and in the aggregate. (CL #120)

Staff analysis

11. The staff note that the materiality threshold would apply, just as with any other standard, and entities will not be required to recognise immaterial lease assets and liabilities, regardless of their term. It is common practice that, in applying the materiality provision, entities set a minimum threshold for recognising assets. For example, this is applied today to finance leases and purchased property, plant and equipment. Similar thresholds can be used for recognising lease contracts.

12. The question is whether there should be exceptions to applying the leases guidance over and above the materiality principle.

13. The staff do not think that short-term leases are similar to executory contracts. Every lease gives rise to the same type of assets and liabilities. Consequently,

excluding short-term leases is not justified on a conceptual basis, but only to help reduce the complexity of financial reporting, which is one of the boards' objectives.

14. This exclusion would result in short-term leases that are material either individually or in aggregate not being recognised. Some see this as a justification for not providing any scope exclusions other than the usual materiality provision.

15. The staff agree with respondents who suggested that the cost of accounting for short-term leases is likely to outweigh the benefits. We think so because the full financial performance effect of a short-term lease will show in a set of financial statements with comparative information. The same financial performance effect would show if the lease were accounted for in line with the new leases standard (even though the labelling of items would be different, ie amortisation and interest instead of rent). Providing information on lease assets and liabilities for short-term leases on the balance sheet date will provide limited additional benefit to users while incurring significant cost for preparers.

16. IFRSs already contain a precedent for not capitalising an asset if the asset will be consumed within one reporting period. For example, IAS 16, *Property Plant and Equipment* defines *Property, Plant and Equipment* (in paragraph 6 of the standard) as:

> '….tangible items that: …… are expected to be used during more than one period.'

What is one reporting period?

17. One reporting period usually means one year. However, some entities also publish interim reports. An interim period is defined in IFRSs as: 'A financial reporting period shorter than a full financial year' (IAS 34 *Interim Financial Reporting*, paragraph 4). Consequently, one reporting period is less than one year for entities that publish interim reports.

18. If exclusion of leases with a term of one reporting period or less were to be applied, entities that publish interim reports would have to account for short-term

leases, if material, with an expected lease term of less than one year, but longer than their reporting period, in line with the proposed new leases guidance.

19. Alternatively, the boards could provide a scope exception for leases with an expected lease term of one year or less, without reference to reporting period. This would, however, mean that entities could issue several (interim) financial reports that do not show potentially material assets and liabilities arising from lease contracts that have a term of greater than one reporting period. Also, in this scenario, the full effect of unrecognised leases would not be shown in a single set of comparative statements, unlike in the case of an exception for leases of one reporting period or less only. This would provide misleading information to users.

Which lease term would be looked at?

20. When assessing the lease term for eligibility for scope exclusion, one can either look at the minimum contractual lease term or the expected lease term.

21. Using the minimum contractual lease term would be inconsistent with the approach to options in lease contracts, and could also create structuring opportunities (eg entities might revise the contracts to include options to extend instead of setting a longer minimum lease term).

22. The expected lease term could be defined in the same way as in accounting for options (ie the longest possible lease term that is more likely than not to occur). This would provide consistency and reduce complexity.

23. Alternatively, the expected lease term for the purpose of scope exclusions could include assessment of implicit renewal options, which are not assessed in options accounting. This approach would ensure that assets and liabilities are recognised for all leases that are likely to have a term longer than one reporting period, regardless of whether that option was included in the contract. It would, however, increase complexity and would be difficult to justify given that it is inconsistent with the approach to options.

24. Finally, one could further simplify this assessment by making only simple lease contracts eligible for scope exclusions. Simple lease contracts are those that do

not include options or residual value guarantees. However, in short-term leases, lessees are usually asked to sign standard contracts, which may or may not include renewal options. This approach would require lessees who sign contracts that include renewal options to capitalise a lease asset and liability regardless of whether that option is likely to be exercised or not.

25. All of these approaches were considered in detail when the boards were making a decision on options accounting. The staff see no reason for the boards, for the purpose of short-term lease assessment, to select an approach different to the one chosen as most appropriate for options accounting.

Lessor's perspective

26. As the lessor's main business is normally leasing, providing any scope exclusions could result in misleading information about the lessor's performance. Lessors often have both short-term and longer-term leases, which would be accounted for differently, so users might have to make adjustments before assessing the lessor's overall financial performance. Users would not have access to the same level of information that is available in-house to lessors, so adjustments might misrepresent the lessor's financial performance.

27. Being in the business of leasing, lessors are likely to have the information needed to apply the proposed approach to lease accounting readily available.

28. This implies that, for lessors, the benefit of accounting for all lease contracts consistently (in line with the leases standard) may exceed the cost of preparing this information.

29. There are lessors who only engage in short-term leases and for whom the application of the proposed new leases guidance may not provide enough benefits to justify the cost of compliance. This is because the full financial performance effect of their lease contracts will be shown at any single set of financial statements, when looked at together with comparative information.

30. However, providing exceptions for those lessors would add complexity to the standard. It would also hinder comparability between lessors who only engage in short-term leases and other lessors.

31. Two often-cited examples of short-term leases are leases of cars, and the hotel business.

32. In car leases, it is likely that lease assets and liabilities will be material, and as such lessors will have to recognise them if there is no exception. This might seem like a big burden because lessors might have thousands of these small leases at any point in time. Some staff think that the lessors already make a number of assessments needed for lease accounting in order to manage their operations (eg assessing how many customers are likely to extend their contracts) and could extend the use of these methods for lease accounting.

33. In the case of hotels, the position is more complex because a rental of a hotel room includes significant service elements. It may be the case that the lease component of the rental is immaterial. However, even if this is not the case, the hotel company will presumably already have systems in place to track room occupancy and have information about how long customers are expected to stay.

Recommendation

Lessees

34. Providing an exemption for short-term leases could result in material assets and liabilities remaining unrecognised. However, if the exemption is for leases with an expected lease term of one reporting period or less, the full effect of the lease contract would appear in a single set of financial statements; (ie the effect of the lease contract would be reported in the current period and comparatives). Consequently, such an exemption is unlikely to impair the quality of financial reporting, even though accounting for these leases would be different from accounting for other lease contracts. This is evidenced by the user support for exclusion of short-term leases (from the lessee’s perspective).

35. Consequently, the staff think that short-term leases should be excluded from the proposed new guidance for lessees. Instead, they should be accounted for on an accrual basis.

36. The staff think that short-term leases should be defined as a lease with an expected term of one reporting period or less. Expected term would be assessed in the same way as defined in options accounting (ie the longest possible lease term that is more likely than not to occur). The assessment would be done at lease inception.

Lessors

37. Staff have split views on short-term lease exception for lessors.

38. Some staff think that, because leasing is normally the lessor's main business, the benefits to users of accounting for short-term leases in line with the new leases guidance will exceed the costs. This particularly applies to lessors who engage in both short-term and long-term leases, and who would have to account for their contracts differently, depending on which side of the line it falls under. Those staff think that any exceptions for short-term leases for lessors will hinder comparability and reduce the quality of financial information. They recommend that the short-term leases for lessors should be within the scope of the standard.

39. Some staff think that the same arguments apply for lessors as for lessees, ie that the cost of recognising lease assets and liabilities for short-term leases will exceed the benefits. They therefore recommend that short-term leases should be outside the scope for lessors as well.

40. The materiality principle would apply to all leases not specifically excluded from the scope.

Question 1
The staff recommend that leases with an expected lease term of one reporting period or less should not be within the scope of the proposed new leases guidance for lessees. Expected lease term will be assessed as defined in options accounting. Do the boards agree?

Question 2
Do the boards think there should be scope exclusions in the proposed new leases guidance for short-term leases for lessors?

Leases of non-core assets

Comment letter feedback received

41. Most respondents did not support excluding leases of non-core assets from the scope of the leases standard. None of the accounting firms, and very few professional organisations, supported such an exclusion.

42. The respondents used arguments similar to those for short-term leases, which are not repeated here.

43. In addition, those respondents who supported excluding leases of non-core assets argued that users' information needs for leases of non-core assets are different from those related to leases of core assets. and should therefore be excluded.

44. The respondents' additional arguments against excluding leases of non-core assets from the scope are:

    (a) There is no conceptual reason for exclusion.

    (b) Non-core will be very difficult to define.

    (c) Reporting entities may interpret the term non-core differently.

Staff analysis and recommendation

45. The staff agree that users may treat leases of non-core assets differently. However, users will still be interested in the impact of these leases on an entity's performance (if material). For example, a lease of a head office building could be considered a lease of a non-core asset. However, such a lease could be material, and may be of interest to users. Accounting for them differently could be confusing, especially as there is no precedent in accounting for not recognising other non-core assets and liabilities. For example, purchased assets are still recognised if material even if they are used for non-core activities.

46. Instead of different accounting, separate presentation might be useful. This applies not only to the leases, but also to the entire non-core activities of an entity; however, this is not the subject of this paper or of this project.

47. Consequently, the staff do not think that there is any justification for different accounting for leases of core and non-core assets.

48. The staff therefore recommend that leases of non-core assets should be within the scope of the proposed new leases guidance.

Question 3
The staff recommend that leases of non-core assets should be within the scope of the proposed new leases guidance. Do the boards agree?