Project **Leases**

Topic **Transition**

Objective

1. The purpose of this paper is to determine transitional provisions for the proposed new accounting model for lessees. In March 2009, a Discussion Paper on Leases was published without any preliminary views on this issue.
2. At this meeting, the staff recommends recognising and measuring all existing lease contracts on the date of transition as follows:
   (a) The obligation to pay rentals shall be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate
   (b) The right-of-use asset shall be measured on the same basis as the liability, subject to any adjustments required to reflect impairment.
3. The paper contains:
   (a) Background information;
   (b) Staff analysis on possible approaches; and
   (c) Staff recommendation.

Background

4. Under the approach to lessee accounting proposed in the leases discussion paper, lessees will recognise:
   (a) an asset representing its right to use the leased item for the lease term (the right-of-use asset); and
   (b) a liability for its obligation to pay rentals (the obligation to pay rentals).

5. The obligation to pay rentals will be measured initially at the present value of the lease payments, discounted using the lessee's incremental borrowing rate. Subsequent measurement will be on an amortised cost basis.
6. The lessee will initially measure its right-of-use asset at cost. Consistent with the initial measurement, subsequent measurement will be on an amortised cost basis.
7. Instead of adopting a components approach where lessees identify and measure separately options to extend or terminate a lease, the boards decided to adopt a single asset and liability approach. Under the proposed approach, the lease contract is viewed as giving rise to a single liability that may include rentals payable in optional periods.
8. Uncertainty about the lease term will be addressed through recognition and the lessee will recognise an obligation to pay rentals for a specified lease term. The lessee will determine the most likely lease term, reassess the lease term at each reporting date and recognise a change in the obligation to pay rentals as an adjustment to the right-of-use asset.
9. The lessee's obligation to pay rentals will include amounts payable under contingent rental arrangements. The obligation to pay rentals should be remeasured at each reporting date to reflect changes in estimated contingent rental payments. The IASB tentatively decided that changes in the obligation to pay rentals arising from changes in amounts payable under contingent rental arrangements should be recognised as an adjustment to the carrying amount of the right-of-use asset. The FASB decided that changes in the obligation to pay rentals should be recognised in profit or loss.

Staff Analysis

10. The staff initially analysed two ways of addressing how the new lease standard should be applied:
    (a) Option A: retrospective application
    (b) Option B: prospective application to new lease contracts entered into after the effective date.

Option A: retrospective application

11. Retrospective application would result in the most useful information for users. An entity would be required to present its financial statements as if the proposed new leasing standard had always been in place. Thus, the information presented for all periods would be fully comparable.
12. However, retrospective application might prove to be extremely difficult, if not impossible, to apply. If a reporting entity has many leases currently classified as operating leases, retrospective application would require that entity to go back and apply the right-of-use model in the new lease standard to all those leases. This might include a 10-year or longer lease.
13. Applying the right of use approach retrospectively to the obligation to pay rentals may be relatively straight forward if the boards adopt the IASB's approach of revising the incremental borrowing rate at each reporting date. This is because the liability would be measured based upon expected future rentals discounted at the lessee's current incremental borrowing rate. However, applying a retrospective approach will be more difficult if the FASB's proposed approach of not revising the lessee's incremental borrowing rate after initial recognition is adopted. This is because the lessee would be required to estimate its incremental borrowing rate at the start of the lease.
14. Because of the proposed accounting for options and contingent rentals, recognising and measuring the right-of-use asset retrospectively may be complex and costly for preparers to apply. This is because under the proposed accounting, each time there is an adjustment to the expected lease term (or amounts payable under contingent rental arrangements for the IASB) the carrying amount of the right-of-use asset is adjusted. Therefore, the staff thinks that requiring retrospective application may not be feasible for all lease transactions and could increase the data collection burden on preparers.
15. The boards could consider retrospective application with an impracticability exception. If it is impracticable to determine the carrying amounts of the assets and liabilities in some existing lease contracts, a reporting entity could recognise and measure the assets and liabilities arising in those contracts on some other basis (for example at fair value on the date of transition or at the present value of lease payments on the date of transition).

16. However, this exception would reduce comparability for users. In addition, when the IASB discussed transition in consolidation project, it concluded that IFRSs should not include such clauses. The IASB also concluded that it should consider what impracticability means in particular situations and include its thinking in the requirements of IFRSs.

Option B: prospective application to new lease contracts entered into after the effective date

17. Option B would require a reporting entity to apply the new standard, as from the effective date of the new standard. Only assets and liabilities arising under lease arrangements entered into after the effective date would be recognised in that entity's statement of financial position.
18. For short-term leases (for example, leases of less than one year), a prospective transition would not result in significant information loss for users. However, for long term leases (eg a 99-year real estate lease), prospective treatment could be problematic. Assets and liabilities arising in leases that an entity previously classified as operating leases would continue to be unrecognised in the statement of financial position. This omission of material assets and liabilities could undermine the understandability, relevance, reliability and comparability of an entity's financial statements, especially if such transactions are large and will have effects for many years. The staff notes that requiring additional disclosures may mitigate the problem and provide information about what might be "missing" from the financial statements.
19. The boards could consider permitting preparers to apply the new standard on a date earlier than the effective date if the lessee has sufficient information. This will provide more information about existing lease contracts of a reporting entity. However, different entities will choose different dates, thereby reducing comparability for users. In addition, the boards could consider applying a new leases standard to lease contracts entered into after the publication date of an exposure draft. This is similar to the transition provided for in IFRS 2.
20. Because of the problems associated with both Option A and Option B, the staff has considered two other possible approaches:
    (a) Option C: measure all leases at fair value on the transition date

(b) Option D: measure all leases at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date.

Option C: Measure all leases at fair value on the transition date

21. On the date of transition, Option C requires the lessee to recognise and measure a right-of-use asset and an obligation to pay rentals in respect of all outstanding leases at fair value.
22. Measuring lease contracts at fair value has the following advantages:
    (a) This approach may be less onerous for preparers than retrospective application (Option A).
    (b) Fair value reflects current market conditions. Thus, supporters of this approach think that it provides users of financial statements with more relevant information than other measures.
    (c) Requiring the use of fair value produces information for users that is more comparable because it ignores entity-specific factors.
23. However, requiring measurement at fair value has a number of disadvantages:
    (a) Measuring the asset at fair value is inconsistent with the measurement of other non-financial assets. Consequently, requiring measurement at fair value may decrease comparability for users.
    (b) It is inconsistent with the proposed amortised cost-based approach to subsequent measurement of both the right-of-use asset and the obligation to pay rentals. The boards have tentatively decided to subsequently measure the right-of-use asset and the obligation to pay rentals at cost.
    (c) Requiring fair value measurement is more difficult and costly for preparers to apply than a cost-based approach.
    (d) Determining fair value of the right-of-use asset after the inception of the lease may be difficult and costly for preparers.

Option D: Measure all leases at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date

24. On the date of transition, Option D requires the lessee to recognise and measure an obligation to pay rentals in respect of all outstanding leases at the present value of

the lease payments, discounted using the lessee's incremental borrowing rate. In addition, a right-of-use asset will be recognised and measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate.

25. This approach has the following advantages:
    (a) This approach is consistent with the boards' preliminary views on subsequent measurement. The boards have tentatively decided to subsequently measure the right-of-use asset and the obligation to pay rentals at cost. Consequently, requiring measurement at cost will increase comparability for users.
    (b) This approach is easier and less costly for preparers to apply than requiring fair value measurement.
    (c) The present value of the lease payments discounted using the lessee's incremental borrowing rate will be a reasonable approximation to the fair value of the obligation to pay rentals at the transition date. Consequently, requiring lessees to measure the obligation to pay rentals on this basis will provide users of financial statements with similar information to measuring the liability at fair value at the transition date.

26. However, the staff notes that although the right-of-use asset and the obligation to pay rentals are clearly linked at the inception of the lease, this is not necessarily the case after inception. The right-of-use asset and the obligation to pay rentals do not remain equal over the lease term. For example, the right-of-use asset could be impaired but the lessee would still be required to make the same rental payments. Conversely, increases in the value of the right-of-use asset do not necessarily result in a change to the rental payments. As such, Option D may result in an overstatement or understatement of the right-of-use asset.

27. As the boards decided to adopt an amortised cost-based approach to initial and subsequent measurement of the right-of-use asset, the cost approach will not in general reflect increases in the value of the right-of-use asset. Thus, the staff does not think that the carrying amount of the right of use asset recognised on transition should be adjusted to reflect possible understatements.

28. However, the carrying amount of the right-of-use asset will not be faithfully represented if it is overstated. Thus, the staff recommends that Option D should require that the right-of-use asset be reviewed for impairment on the transition date.

The boards will discuss how to determine impairment of a right-of-use asset at a later date.

Staff Recommendation

29. The staff recommends Option D. That is, on the date of transition the lessee will be required to:

    (a) Recognise an obligation to pay rentals in respect of all outstanding leases at the transition date. That obligation will be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date.

    (b) Recognise a right-of-use asset measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date with an impairment review of the right-of-use asset.

30. The staff recommends this approach for the following reasons:

    (a) It is consistent with the proposed approach of initial and subsequent measurement of the asset and liability arising in lease contracts.

    (b) Unlike retrospective application (Option A), this approach is less costly and burdensome for preparers to apply.

    (c) Unlike prospective application (Option B), it ensures all lease contracts are recognised.

    (d) It is easier and less costly for preparers to apply than requiring fair value measurement (Option C).

Question 1
Do the boards agree with the staff recommendation on transitional provisions (paragraph 29)? If not, why not?

Question 2
What amendments or alternative (if any) do you suggest, and why?