Project	**Leases**
Topic	**Scope – Exclusion of short-term leases**

Purpose

1. At the December 2009 joint meeting, the boards discussed whether to provide a scope exclusion for short-term leases. However, the boards did not reach preliminary views and instructed the staff to provide additional analysis on this issue, including:

   (a) How any scope exclusion would interact with normal materiality thresholds

   (b) What period should be used for determining eligibility for exclusion

   (c) How the lease term would be determined

   (d) Whether the exclusion should be extended to lessors.

2. This paper provides that additional analysis.

3. The paper is structured as follows:

   (a) Background information

   (b) Staff analysis on possible approaches to scope exclusion for short-term leases

   (c) Questions for the boards

   (d) Appendix - Feedback from respondents to the Leases Discussion Paper.

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Background

4. The Leases discussion paper (DP) discussed a possible scope exclusion for short-term leases (for example, lease contracts of less than one year). The DP asked for respondents' views without including the boards' preliminary views. An analysis of the respondents' views is included in the appendix to this paper.

Staff analysis on possible approaches to a scope exclusion for short-term leases

Scope exclusion for lessees

5. A materiality threshold is applied to all accounting requirements. Thus, reporting entities will not be required to recognise immaterial lease assets and liabilities, regardless of the lease term, the amount and/or the nature.

6. It is common practice that, in applying the materiality principle, reporting entities set a minimum threshold for recognising assets (for example, leases classified as finance/capital leases at present and purchased property, plant and equipment). Similar thresholds can be used for recognising assets and liabilities arising in lease contracts.

7. The question is whether there should be an additional exclusion to applying the proposed new requirements beyond the materiality principle.

8. The staff note that if the boards decide to provide a scope exclusion for short-term leases, it would result in short-term leases that are material either individually or in aggregate not being recognised (for example, shipping companies that have thousands of containers under lease that are individually immaterial and/or short-term in nature, but material in aggregate). Therefore, whether immaterial short-term leases would qualify for an exclusion would be pointless. As stated earlier, the new leases requirements would not have to be applied to immaterial leases regardless of the lease term.

9. Every lease contract gives rise to assets and liabilities. In an ideal situation those assets and liabilities arising in every lease (including short-term leases) should be recognised. Therefore, there is no conceptual reason for excluding short-term leases from the proposed new leases requirements.

10. However, some staff question whether the cost of accounting for short-term leases outweighs the benefits. They think that providing a scope exclusion for short-term leases may reduce the complexity and costs of financial reporting. This view was supported by many of the preparer respondents to the leases discussion paper. They argued that the costs associated with tracking and recording a large number of short-term leases would significantly outweigh the benefits to users. Those respondents who supported a scope exclusion for short-term leases noted that the concerns about not recognising material short-term leases could be dealt with by disclosures. For example, reporting entities could disclose a description of the nature of lease asset, the value of future lease payments and the length of the lease.

11. Other staff are uncomfortable with providing an exclusion. They think that the materiality concept will allow reporting entities to make an appropriate decision on the accounting for assets and liabilities arising in lease contracts. They also think that providing an exclusion for short-term leases would add complexity to the proposed new leases requirements by introducing a "bright line" rule that simply relies on a period of time to determine recognition of lease assets and liabilities. Those staff note that the new requirements should specifically state that the accounting requirements need not be applied to immaterial leases and that materiality (as usual) should be evaluated both individually and in aggregate.

12. The staff note that another possible approach to reducing the complexity and cost of accounting for short-term leases is to provide simplified accounting for such leases. For example, right-of-use assets and obligations to pay rentals for short-term leases could be recognised on the balance sheet at the present value of the remaining lease payments at the end of the reporting period. Rentals accrued during the reporting period would be expensed and at the end of the lease term, the recognised assets and liabilities would be derecognised.

Question 1
Do the boards think that there should be scope exclusion in the proposed new leases requirements for short-term leases of lessees? If the boards' answer is **no**, ie there is **no** scope exclusion for short-term leases for lessees, do the boards think that there should be some form of simplified accounting for such leases? If you support simplified accounting for short-term leases, would you support an approach similar to that described in paragraph 12? If not, what approach do you prefer, and why?

*What period for exclusion (if there **is** scope exclusion for short-term leases)?*

13. If the boards decide to provide a scope exclusion for short-term leases, the boards would need to define short-term. Defining short-term would be arbitrary.

14. Short-term could be limited to a reporting period. Reporting period is applied differently depending on entities (for example, for publicly listed entities, this could be one quarter but for others, this could be a year) or jurisdictions.

15. Alternatively, the boards could provide a scope exclusion for leases with any other periods (for example, from 1 day to 999 days) without reference to reporting period. For example, the boards could decide that a short-term lease is where the period of the lease is less than 12 months. 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.

16. Many respondents to the DP defined short-term leases as leases of less than one year. The staff think that those respondents considered less than one year as short- term because it is consistent with the view that most financial reports are done annually.

17. As mentioned earlier, defining short-term is arbitrary, and thus every entity could have a different view. On balance, the staff recommend that short-term leases are those leases that are less than 12 months.

Question 2
The staff recommend that the time period eligible for scope exclusion for short-term leases should be lease terms that are less than 12 months. Do the boards agree? If not, what period do you prefer, and why?

How to determine the lease term

18. For simple lease contracts, determining eligibility for a scope exclusion will be straight-forward. That is, the entity will consider the contractually stated term. However, for more complex leases (those leases that include options to extend or terminate the lease), the lessee will have to determine whether a particular lease is eligible for a scope exclusion.

19. The boards could base eligibility for the scope exclusion on the minimum contractual lease term. However, this approach will create structuring opportunities to minimise the recognised assets and liabilities by ignoring the existence of options (eg reporting entities might revise the contracts to include options to extend instead of setting a longer minimum contractual lease term).

20. Therefore, the staff considered three other possible approaches to determine the lease term that should be considered for the short-term lease scope exclusion:

    (a) maximum possible lease term

    (b) expected lease term – explicit only

    (c) expected lease term – include both explicit and implicit options.

21. To illustrate each of those approaches the staff will use the following example:

Example 1
A machine is leased for a period of 9 months (the primary period). The lease contract includes an option for the lessee to lease the machine for an additional 6 months (the secondary period).

22. Under the maximum possible lease term, approach (a), the lessee would conclude that the lease term for scope exclusion in example 1 is 15 months (9 months of the minimum contractual lease term and 6 months of the optional period). This approach could be viewed as the most conservative approach which would reduce

structuring opportunities. However, it may not reflect the 'true' economics of lease contracts if the lessee determines that the option is not likely to be exercised.

23. The second approach (approach (b)), expected lease term considering the explicit options only, is consistent with the boards' tentative decisions on the accounting for options (ie the longest possible lease term that is more likely than not to occur). This would provide consistency and reduce complexity because the lessee/lessor would assess the lease term for short-term leases in the same way as for any other leases with options. In example 1, the lessee/lessor would have either a 9-month lease term or a 15-month lease term depending on whether it is more likely than not that the renewal option will be exercised.

24. Alternatively, the expected lease term for scope exclusion could include assessment of both the explicit and implicit renewal options (approach (c)).

25. It is often the case that at the end of a lease, a lessee and lessor negotiate a new contract that permits the lessee to continue using the leased item. Some think that this ability to renegotiate the lease constitutes an implicit option that should be considered when determining the lease term. A lessee that is likely to renegotiate a lease at the end of the lease term is in an economic position similar to a lessee that has a contractual option to renew the lease at market rentals. If only contractual options are considered, the lessee with an implicit option would not recognise a lease term that is longer than the contractually stated term. However, the lessee that has a contractual option could include the optional period in the recognised lease term.

26. Others note that the contractual position of a lessee with an option to extend is different from that of a lessee without such an option. Consequently, they do not agree that a lessee with an option to renew at market rentals is in the same economic position as a lessee that has no such option. An entity that needs to use an asset after the contractual term will be more likely to ask for renewal options as the lessor could withdraw the asset or demand a much higher rental.

27. Based on the boards' tentative decisions, implicit options are not currently considered in lease term options accounting. This approach would include possible optional periods, regardless of whether that option was explicitly

included in the contract. The staff think that it would increase complexity and it is inconsistent with the current approach to the options accounting, ie the lessee that has a contractual option could include the optional period in the recognised lease term.

Staff recommendation

28. Approach (b) would be consistent with how the boards' tentative decisions on leases with options, and therefore the staff recommend that the lease term is based on the expected lease term including only explicit options.

Question 3
The staff recommend that the expected lease term to consider for a scope exclusion for short-term leases should be assessed in the same way as in the accounting for leases with options (ie determining the longest possible lease term that is more likely than not to occur considering only explicit options). Do the boards agree? If not, what approach do you prefer, and why?

Scope exclusion for lessors

29. Lessors are different from lessees. For most lessees, leases represent one possible way of acquiring assets. For most lessors, leases represent their main business activity. Consequently, some staff think that providing a scope exclusion for short-term leases could result in misleading information about the lessor's performance.

30. Lessors often have both short-term and longer-term leases, which would be accounted for differently. Also, some lessors only engage in short-term leases. Therefore, if a scope exclusion for short-term leases is allowed for those lessors, users could lose significant information about the lessor's overall financial performance. This could impair comparability between lessors' financial statements.

31. Unlike lessees, lessors are much more likely to have the information needed to apply the proposed new requirements to short-term leases. They will have systems in place to track their assets and will have developed expectations about

expected renewals etc. based on past experience. Consequently, for lessors, the benefit of accounting for all lease contracts consistently may exceed the costs of compliance.

32. However, other staff think that the same arguments apply for lessors as for lessees. The costs 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.

Question 4
Do the boards think that there should be scope exclusions in the proposed new leases requirements for short-term leases of lessors? If so, should the exemption be consistent with lessees or should it be modified to reflect the lessor's business?

Appendix - Feedback from respondents to the Leases Discussion Paper

A1. Respondents were split in their views on whether short-term leases should be excluded from the scope of the new leases requirements. The majority of users and preparers supported the exclusion while the majority of accounting firms, professional organisations and standard-setters were against the exclusion.

A2. In their responses, respondents did not specifically refer to the lessor's or lessee's perspective. However, given that the DP dealt mainly with lessee accounting, it is likely that they considered the question in the context of lessees more than of lessors.

A3. The respondents argued for excluding short-term leases:

(a) The complexity and costs of capitalising the short-term 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 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 lessees (eg the lessor can decide not to extend the lease that the lessee has relied on).

A4. Some respondents who recommended excluding short-term leases from the scope of the new leases requirements defined short-term as: (a) terms of one year to five years (b) a certain amount of acquisition cost and/or (c) a certain percentage of the asset's economic life. The majority of those respondents suggested excluding leases with a term of less than one year. Some of them also said that a disclosure requirement (eg the type of leased item and term) of excluded lease contracts would provide useful information.

A5. The respondents' main arguments against excluding short-term leases are:

(a) There is no conceptual reason for exclusion.

(b) It could lead to structuring leases as short-term to avoid recognition of any lease assets and liabilities.

(c) Even short-term leases could be material (either individually or in aggregate).

(d) It would add complexity to the new requirement.

(e) It would decrease transparency.

A6. 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)