IFRS	World Standard-setters Meeting	Agenda reference	Agenda Paper 1
	Staff Paper	Date	20 September 2010

Contact(s)	Rachel Knubley	rknubley@ifrs.org	+44 207 246 6904
	Barbara Davidson	bdavidson@ifrs.org	+44 207 246 6907

Project **Leases**

Introduction

1. As part of their joint project under the Memorandum of Understanding, the IASB and the FASB aim to improve the accounting for leases by issuing a high quality joint standard. The goal of the standard is to:
   (a) eliminate the classification between finance (capital) leases and operating leases, thus improving comparability and providing users with complete information on cash flows that arise from leases; and
   (b) develop a consistent accounting model for lessees and lessors.
2. As a step towards that goal, in August 2010 the boards published the exposure draft *Leases*. The exposure draft can be downloaded from: http://www.ifrs.org/Current+Projects/IASB+Projects/Leases/ed10/Ed.htm. The deadline for comments is 15 December 2010. During the comment period, the boards will perform fieldwork to assess the costs and benefits of applying the new proposals and undertake further outreach to discuss the proposals.
3. The staff would like to use the WSS break-out sessions to discuss and obtain feedback on some of the more contentious issues under the proposals.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Overview of the proposals

4. The boards are proposing a single accounting model, the 'right-of-use' model, for both lessees and lessors.

5. Under the right-of-use model, lessees would recognise a right to use the underlying asset (the 'right-of-use' asset) arising from all leases in the statement of financial position, along with a corresponding liability to make lease payments.

6. Lessors would recognise a right to receive lease payments arising from all leases. The lessors' approach to accounting for the underlying asset would depend on whether they retain exposure to significant risks or benefits associated with the underlying asset. If they do not retain exposure to significant risks or benefits, they would derecognise the portion of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease (the derecognition approach). If they retain exposure, they would keep the underlying asset on their statement of financial position and recognise a lease liability representing their obligation to permit the lessee to use the underlying asset over the lease term (the performance obligation approach).

Issues to discuss

7. The issues we would like to discuss with the WSS are:

   (a) Treatment of complex features:

      (i) options to extend or terminate

      (ii) contingent rentals

      (iii) purchase options

   (b) Lessor accounting model: performance obligation versus derecognition approach

   (c) Scope:

(i) service contracts versus leases

(ii) purchases or sales versus leases.

Treatment of complex features

Options to extend or terminate

8. Many leases include options to extend or terminate. Under the proposals, lessees and lessors would determine the longest possible term that is more likely than not to occur and recognise the related assets and liabilities based on that term. In addition, the lease term should be reassessed at each reporting date if there are changes in facts or circumstances that indicate that there is a material change in the assets or liabilities

9. Some note that determining the present value of lease payments on the basis of the most likely lease term might result in the recognition of an asset or liability that does not meet the definition of an asset or liability. Also this approach does 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.

10. However, the boards think that using the most likely lease term is a practical solution to the problems associated with the accounting for leases with options. If optional periods are not included in the lease term, the related assets and liabilities might be misstated or this may encourage structuring.

Question #1
Do you agree with the boards' proposed approach to recognition and measurement of options in lease contracts? If not, why not? What would you recommend?

Contingent rentals

11. Lease contracts may also include payments that are linked to usage of the underlying asset, an index or a rate, or lessee performance. Under the proposals, lessees would include in their liability to make lease payments amounts payable

under contingent rental arrangements and lessors would include these amounts in their right to receive lease payments if they can be measured reliably. The liability and the asset would be reassessed at each reporting date if there are changes in facts or circumstances that indicate that there is a material change in the liability or asset.

(a) Changes in contingent rentals for lessees: The changes in amounts payable under contingent rental arrangements arising from current or prior periods should be recognised in profit or loss. All other changes would be recognised as an adjustment to the lessee's right-of-use asset.

(b) Changes in contingent rentals for lessors: A change in contingent rentals should be recognised in profit or loss under the derecognition approach. Under the performance obligation approach, the boards propose to adjust the lease liability for any change in the amount of contingent rentals if it relates to unsatisfied obligations and to recognise any change in profit or loss if it relates to satisfied obligations.

12. Some think that the lessee's liability to pay and the lessor's right to receive contingent rentals do not exist until the future event requiring the payment occurs. Accordingly, they suggest that entities should only provide disclosure of contingent rentals.

13. However, in the boards' view, the liability to pay and the right to receive contingent rentals exist at the date of inception of the lease. Such contingent rentals meet the definition of a liability for the lessee and an asset for the lessor. It is only the amount to be paid that is uncertain.

Question #2
Do you agree with the boards' proposed approach to recognition and measurement of contingent rentals? If not, why not? What would you recommend? Do you think that different types of contingent rentals (eg those linked to usage, an index or a rate, or lessee performance) should have a different recognition and measurement requirement (including reassessment)?

Purchase options

14. The exposure draft proposes that purchase options should not be accounted for until they are exercised. The boards think that when a lessee exercises a purchase option, it terminates the lease and purchases the underlying asset. Thus, the exercise price of the option is not a lease payment and should not be included in the measurement of assets and liabilities arising from a lease.

15. Some think that purchase options should be treated consistently with options to extend or terminate because purchase options are the ultimate extension options.

Question #3
Do you agree with the boards' proposed approach to purchase options in lease contracts? If not, why not? What would you recommend?

Lessor accounting model

Performance obligation versus derecognition approach

16. The boards propose that the lessor's accounting for the underlying asset should differ depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term.

17. The derecognition approach views the lessor as having transferred significant economic risks and benefits associated with the underlying asset during or after the expected lease term to the lessee at the date of commencement of the lease. The lessor derecognises the economic benefits associated with the rights it transfers to the lessee when it transfers those rights. Under this approach, the lessor may recognise revenue on commencement of the lease. The remaining economic benefits, ie the lessor's residual interest in the underlying asset, are classified as a residual asset in the lessor's statement of financial position.

18. The performance obligation approach views the underlying asset as the lessor's economic resource. The lessor continues to recognise the underlying asset in the statement of financial position, and recognises a lease liability, representing its

obligation to permit the lessee to use the underlying asset during the lease term. That liability is satisfied over the lease term (on a systematic basis) as the lessor permits the lessee to use the underlying asset. Thus, the lessor would recognise lease income during the lease term.

Question #4
Do you agree with the boards' proposals regarding the different approaches to lessor accounting for the underlying asset? Specifically, do you agree that a lessor should apply (i) the derecognition approach if it does not retain exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the performance obligation approach if it does? Why or why not? If not, what alternative approach would you propose and why?

Scope

Service contracts versus leases

19. To help entities determine whether an arrangement in within the scope of the proposals (ie is a lease contract or a service contract) the exposure draft carries forward the guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease*. In particular, the exposure draft indicates that a contract is or contains a lease if:

    (a) fulfilment of the contract depends upon providing a specified asset; and

    (b) the contract conveys the right to control the use of a specified asset.

20. A contract conveys that right to control the use of an underlying asset if:

    (a) The entity has the ability or right to operate the asset (or direct others to operate the asset) while obtaining more than an insignificant amount of the output or utility of the asset; or

    (b) The entity has the ability or right to control physical access to the asset while obtaining more than an insignificant amount of the output or utility of the asset; or

(c) The entity will obtain all but an insignificant amount of the output or other utility of the asset and the price paid is neither contractually fixed per unit of output nor equal to the market price per unit of output.

Question #5
Do you think the proposed criteria for differentiating service contracts from leases is appropriate? If not, what alternative criteria would you use and why. Do you think that further guidance is needed to help differentiate leases from service contracts?

Purchases or sales versus leases

21. The exposure draft would not apply to transactions in which control and all but a trivial amount of the risks and benefits associated with the underlying asset is transferred at the end of the lease term, because such transactions represent purchases or sales of the underlying asset.

22. Some were concerned that attempting to distinguish between purchases or sales and leases would reintroduce a classification requirement that would increase the complexity of the proposals. However, the boards think that purchases or sales and leases have different economic effects and that the accounting should reflect those economic differences, regardless of the way that the contract describes the transaction.

23. Some note that the proposed lessee accounting is similar (but not identical) to purchase or sale accounting. In addition, the proposed lessor accounting under the derecognition approach (applied if a lessor has not retained exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term) is similar to purchase or sale accounting. Therefore, differentiation between purchases or sales and leases is not necessary.

Question #6
Do you agree with the boards' proposed approach to distinguishing between purchases or sales and leases? If not, why not? What would you recommend?