

Project

**Leases**

Topic

**Redeliberations plan**

## Purpose of this paper

1. The purpose of this paper is to provide an overview of the staff proposals for redeliberations on the leases exposure draft (ED).
2. As such, this paper provides an overview of:
  - (a) the five main issues identified in feedback received on the ED and the staff proposals for redeliberations on these issues; and
  - (b) details of additional topics for redeliberations.

## Main issues identified in the ED

3. Throughout field-testing, outreach activities and comment letters received on the ED, five main issues have been consistently identified. These issues formed the basis of the agenda for the roundtables that were held in December 2010 and January 2011 and for the joint working group meeting that was held in January 2011.
4. These main issues are:
  - (a) Definition of a lease.
  - (b) Lessor accounting model.
  - (c) Lease term.

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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 FASB or the IASB.

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- (d) Variable lease payments.
- (e) Profit and loss recognition pattern.

**Definition of a lease**

*Background to the issue*

5. The majority of interested parties believe that the boards need to perform additional work to develop the definition of a lease in the ED. The staff think that this work would involve:
  - (a) Clearly stating what a lease is and the rationale for determining whether all leases:
    - (i) are a form of financing.
    - (ii) are different from executory contracts.
    - (iii) should be uniquely accounted for.
  - (b) Clarifying what is the asset acquired by a lessee and whether it is a 'right-of-use' asset, an underlying physical asset or a component/portion of an underlying physical asset.
  - (c) Assessing whether the current principles in US GAAP and IFRSs are appropriate for defining a lease and, if so, how they should be amended to address current application issues identified in practice.
  - (d) Discussing how lease elements should be separated from any service elements included in a contract.
  - (e) Identifying whether additional guidance is needed relating to contracts that may be considered in-substance purchases and in-substance sales.

*Proposed redeliberations plan*

6. The staff believe that the definition of a lease is a very pervasive issue that has implications on a number of the other main issues identified below.

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7. Consequently, the staff think that the boards should begin their redeliberations by addressing this issue in relation to both lessees and lessors. The staff have prepared an agenda paper to start these discussions in a January 2011 education session.
8. The staff have also engaged with outside parties, including the large accountancy firms, the joint working group and EFRAG, to obtain further input on their views of how a lease should be defined.
9. The staff believe that additional field-testing and outreach may be required if the boards recommend changes to the proposed definition of a lease.

***Lessor accounting model***

*Background to the issue*

10. Many interested parties observed that the lessor accounting proposals in the ED are less developed than those for lessee accounting. They believe that the boards need to perform significant additional work as part of their due process before finalising any amendments to lessor accounting. The staff think that this work would involve consideration of whether the:
  - (a) current lessor accounting model in US GAAP and IFRS is 'broken'.
  - (b) lessor accounting proposals in the ED are an improvement to current financial reporting.
  - (c) boards can redeliberate some, or all of the proposals on lessee accounting separately from the proposals on lessor accounting.
  - (d) redeliberations on lessor accounting should be dependent upon conclusions reached by the boards in their projects on Revenue recognition, and the FASB deliberations on investment property.

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*Proposed redeliberation plan*

11. The staff believe that, in addition to beginning redeliberations on the definition of a lease, the boards should consider their redeliberation strategy for lessor accounting.
12. The staff think that the boards should determine both the extent and timing of their proposed redeliberations on lessor accounting as a priority to enable the staff to effectively plan the process for redeliberations on lessee accounting and coordinate with the Revenue recognition project team. The staff have prepared an agenda paper for discussion in a January 2011 education session to begin these redeliberations.
13. The staff believe that additional field-testing and outreach may be required as the boards redeliberate the lessor accounting proposals.

***Lease term***

14. Interested parties are concerned with the complexity and practicality of applying the proposals in the ED, together with concerns on how the proposals align with the current IFRSs and US GAAP definitions of assets and liabilities. The staff recommend that the boards should assess in their redeliberations whether to proceed with an approach that is consistent with:
  - (a) current guidance in IFRS and US GAAP (based upon applying a ‘reasonably assured’ or ‘reasonably certain’ threshold); or
  - (b) increasing the threshold for taking into account options to renew from ‘longest possible lease term that is more likely than not to occur’ to ‘virtually certain’ or including only contractual minimum lease terms; or
  - (c) the Alternative View to reflect options to cancel and extend leases in the measurement of lease assets and liabilities only when the lease contract includes incentives for the lessee or lessor to exercise the options.

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*Proposed redeliberations plan*

15. The staff believe that the boards should reconsider the proposals for lease term, specifically given the level of complexity and cost of implementation that has been identified by preparers.
16. The staff think that the boards should redeliberate this issue, with a focus on the three potential approaches described above. The staff think that these redeliberations should be held in the context of both lessees and lessors and should include considering whether reassessment of the lease term should be required. The staff believe that the boards could continue with these redeliberations in parallel with their redeliberations on the lessor accounting model and the definition of a lease.

***Variable lease payments***

17. Similarly to the proposals for lease term, interested parties believe that the boards should simplify the requirements relating to variable lease payments. The staff believe that the options that the boards should consider for simplification should focus on the implications of:
  - (a) changing the threshold for including variable lease payments from an ‘expected outcome’ approach to either a ‘reasonably assured/certain’, ‘virtually certain’ or ‘best estimate basis’; or
  - (b) the Alternative View to include only variable lease payments based upon indices or rates and exclude variable lease payments that vary with usage or performance. This would include assessing how consistent this is with current US GAAP practice; or
  - (c) accounting only for those variable lease payments which are outside of an entity’s control and therefore unavoidable; or
  - (d) disclosures relating to variable lease payments and how these should complement the recognition requirements.

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*Proposed redeliberations plan*

18. The staff believe that the boards should reconsider the proposals for variable lease payments after redeliberating the lease term, taking into account the specific complexity identified by preparers of estimating these payments in periods beyond the contractual minimum lease term.
19. The staff think that the boards should redeliberate this issue considering recognition and disclosure together, in the context of both lessees and lessors. The staff believe that the boards could continue with these redeliberations in parallel with their redeliberations on the lessor accounting model and the definition of a lease.

***Profit and loss recognition pattern***

20. Interested parties have mixed views on the pattern of profit or loss recognition with:
  - (a) some, specifically accounting firms and national standard-setter respondents supporting the proposals in the ED; and
  - (b) others, specifically the leasing industry, some users and preparers supporting applying annuity-based or a mortgage-based amortisation of the right-of-use asset to create a straight-line profit or loss pattern, similar to current operating lease accounting.

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21. The staff believe that the boards should discuss the conceptual basis of the proposals in the ED, including how these arguments align with redeliberations on the definition of a lease and whether leases are considered a form of financing.
22. The staff think that the boards should then consider the technical arguments provided for a straight-line approach for both lessees and lessors and carefully evaluate these arguments, together with the feedback received from users, as part of their redeliberations.

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23. The staff also suggest that the board consider the effect that the ED proposals have on the profit or loss of entities on transition.

**Other issues to be considered in redeliberations ED**

24. The staff have identified a number of other issues that the boards may, or may not, need to consider as part of their redeliberations. These other issues include, but are not limited to the following:

<u>Area</u>	<u>Issue</u>
Scope	Definition of a lease
	Separating lease elements from service elements
	Scope exclusions
	Grandfathering provisions in current US GAAP
Lessee right-of-use model	Recognition of a right-of-use asset and a liability to make lease payments
	Short-term leases
	Subsequent measurement of the right-of-use asset and liability to make lease payments
Lessor accounting	Redeliberations strategy
Measurement	Discount rates
	Initial direct costs
	Foreign exchange
	Impairment
	Revaluation
Inception vs. commencement	When to recognise
	Accounting between inception and commencement
	Build-to-suit leases
Lease term	Option recognition
	Option measurement
	Option reassessment
	Option types (eg cancellable leases, implicit options)
	Purchase options
Variable lease payments	Recognition
	Measurement
	Reassessment
	Residual guarantees and penalties

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Other leasing arrangements	Subleases
	Sale and leasebacks
Presentation	Mandatory vs. judgements
	Statement specific presentation
Disclosure	Preparer burden vs. user requests
	Quantitative vs. qualitative
Consequential amendments	Investment property
	Business combinations
Transition and effective date	Profit and loss 'front loading' effect
	Fully retrospective application
	Situations requiring additional guidance
	First-time adoption (IASB)
	Effective date and early adoption
Other	Cost benefit considerations and other sweep issues
	Private sector considerations
	Lease modifications/extinguishments
	Lease incentives
	Leasehold improvements and lease restoration obligations

25. The staff are assessing which of these matters will require reconsideration and which matters they will recommend to the Board be confirmed without any additional consideration.