Staff Paper

Project **Leases**

Topic **Inception versus commencement**

Paper overview

1. This paper considers concerns raised regarding the date of inception versus the date of commencement from both the lessee's and lessor's perspective.

2. The staff recommend that the final leases standard:

   (a) require a lessee and lessor to recognise and initially measure lease assets and liabilities (and derecognise any corresponding assets and liabilities, eg derecognise a portion of the underlying asset if using the lessor derecognition approach) at the date of commencement of the lease.

   (b) require a lessee to use its incremental borrowing rate calculated at the date of inception when using that rate to measure the liability to make lease payments.

   (c) state that costs incurred by the lessee before the date of commencement relating to the construction of the underlying asset are outside the scope of the leases standard (such contracts are usually build-to-suit leases—arrangements for the right to use an asset that is constructed to meet the needs of the lessee). The lessee would apply other applicable standards when accounting for such construction costs.

   (d) include application guidance on how to account for lease payments made by the lessee before the date of commencement as set out in paragraphs 42-44 of this paper.

(e) include application guidance on how to account for incentives provided by the lessor to the lessee as set out in paragraphs 48 and 49of this paper.

(f) not include requirements that apply only to build-to-suit lease contracts.

3. The appendix to this paper includes preliminary draft wording showing changes to relevant paragraphs of the *Leases* exposure draft (ED) to reflect the staff recommendations.

Background and introduction

The proposals in the ED

4. The ED proposes that:

   (a) at the date of inception of the lease, a lessee

      (i) measures the liability to make lease payments at the present value of the lease payments, discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee.

      (ii) measures the right-of-use asset at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee.

   (b) at the date of commencement of the lease, a lessee recognises a right-of-use asset and a liability to make lease payments.

5. The ED proposes the same dates for recognition and initial measurement of a lessor's assets and liabilities arising from a lease contract.

6. The ED defines:

   (a) the date of inception as the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement.

   (b) the date of commencement as the date on which the lessor makes the underlying asset available for use by the lessee.

Comments from respondents and others on the proposals

7. Although respondents agreed that for most lease contracts, the time between the dates of inception and the commencement of the lease is usually short, some noted that there are contracts for which that is not true. They raised questions about the date of inception versus the date of commencement as follows:

   (a) Whether the date of commencement, rather than the date of inception, is the appropriate date on which to measure lease assets and liabilities?

   (b) How to account for build-to-suit leases?

   (c) How to account for lease payments made by the lessee before the date of commencement?

   (d) How to account for initial direct costs incurred between the date of inception and the date of commencement?

   (e) How to account for incentives provided by the lessor to the lessee?

The date of recognition and initial measurement

The date of recognition

8. The recognition point (ie the date of commencement) proposed in the ED is consistent with the right-of-use model proposed for lease contracts. According to the right-of-use model, a lessee recognises an asset representing its right to use an underlying asset throughout the lease term and a liability representing its obligation to make lease payments throughout the lease term. To be consistent with that model, a lessee should recognise its right to use the asset, and its obligation to make lease payments, from the time at which it obtains that right-of-use and is obliged to make lease payments. That date is the date of commencement—the date on which the lessor makes the underlying asset available for use by the lessee.

9. Before that date, the lessor has not yet performed under the contract. Although the lessee may have an obligation to stand ready to make lease payments if the lessor performs under the contract, the lessee is unlikely to have an obligation to

make lease payments, or a right to use the asset, before the asset is made available for the lessee's use. Similarly from the lessor's perspective, although the lessor may have an obligation to stand ready to deliver the right to use the underlying asset from the date of inception, the lessor is unlikely to have a right to receive lease payments before the asset is made available for the lessee's use.

10. Nonetheless when applying IFRSs, to be consistent with the accounting for other contracts, if a lease contract meets the definition of an onerous contract (as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) before the date of commencement, a lessee would not apply the requirements of the leases standard but account for such an onerous contract in accordance with IAS 37 until the date of commencement.

11. The recognition point for lease contracts is consistent with the convention followed in other non-financial instrument accounting standards in which rights and obligations are not recognised while contracts remain executory. The recognition point for lease contracts is also consistent with that proposed for revenue contracts in the exposure draft *Revenue from Contracts with Customers*. Both models do not propose recognition before the lessor or seller has performed under the contract.

12. Respondents to the ED generally agreed that the date of commencement is the appropriate date for the lessee and lessor to initially recognise lease assets and liabilities.

The date of initial measurement

13. A number of respondents raised questions about how to apply the initial measurement proposals at the date of inception when the lessee and lessor would not recognise lease assets and liabilities until the date of commencement. They questioned:

    (a) whether, and how, to account for changes to the terms of the contract between the date of inception and the date of commencement?

    (b) whether, and how, to account for the time value of money, changes in indices and changes to the fair value of the underlying asset between the date of inception and the date of commencement? Should a lessee and lessor recognise gains or losses from remeasuring the lease asset and liability on initial recognition?

14. One respondent noted:

> We question the benefits and merits of performing the initial measurement as at lease inception versus lease commencement. An inception measurement date is not consistent, for example, with the measurement date for other transactions involving tangible and intangible assets (i.e. the acquisition date) nor with the measurement date used for purposes of business combination accounting (also the acquisition date). The inception date guidance was developed for purposes of lease classification, which the Boards intended to eliminate pursuant to their objectives in developing this standard. If the Boards retain the inception date measurement requirements, further clarification of how those requirements are to be applied is needed as follows:
> - A significant change may occur between the date of inception and the date of commencement of a lease, for example when construction of the underlying leased asset is involved. Thus guidance should be provided as to whether a remeasurement should be performed and, if so, how the change should be recognised.
> - The Boards should clarify the requirements so that the accounting works mechanically upon lease commencement with the discount rate estimated at lease inception (i.e. estimated payments must be discounted only to commencement and not to inception in order for the accounting to work mechanically). [CL367]

Staff analysis

15. We think that the boards' intention in the ED was to ensure that initial measurement of a lessee's right-of-use asset and liability to make lease payments, and the lessor's right to receive lease payments, reflects the nature of the transaction and the specific terms of the lease. That would often mean looking to the terms agreed in the contract at the date of inception. We do not think, however, that the boards intended that a lessee and lessor would recognise a gain or loss on initial recognition of the lessee's and lessor's asset and liability at the date of commencement, ie the intention was to measure the lessee's liability and the lessor's receivable by discounting the lease payments to the date of commencement, rather than to the date of inception (if those dates are different).

16. We recommend that, at the date of commencement:

    (a) a lessee recognises *and* initially measures the right-of-use asset and the liability to make lease payments.

(b) a lessor recognises *and* initially measures a right to receive lease payments and, depending on the approach, either recognises and measures a lease liability or derecognises a portion of the underlying asset.

17. We think that the approach recommended in paragraph 16 is the best way to clarify the boards' intentions and, at the same time, deal with the concerns raised for the following reasons:

(a) Recognising and measuring lease assets and liabilities at the same date clarifies how the lessee's liability and the lessor's asset should be measured, and that gains or losses should not arise on initial recognition of the lessee's right-of-use asset and its liability to make lease payments.

(b) The approach removes the need to include any guidance on how to account for changes to the terms of lease contracts, or in assumptions used in measuring the asset and liability, between the date of inception and the date of commencement. Any changes to the lease contract that occur after the date of inception are taken into account when initially measuring the asset and liability at the date of commencement.

(c) The approach clarifies that the lessee and lessor would capitalise initial direct costs incurred before the date of commencement as part of the right-of-use asset (lessee) or right to receive lease payments (lessor), assuming the boards reconfirm the proposal in the ED to capitalise, rather than expense, those costs. If costs incurred meet the definition of initial direct costs, we think they should be treated as such, regardless of whether those costs were incurred before or after the date of inception. Some respondents noted that the proposals regarding initial measurement at the date of inception in the ED implied that a lessee and lessor would not be permitted to capitalise initial direct costs incurred after the date of inception.

(d) The approach is more consistent with the measurement date for other transactions, such as business combinations and the acquisition of tangible assets.

(e) We understand that the approach recommended in paragraph 16 is how IAS 17 *Leases* and Topic 840 *Leases* are applied in practice today regarding the recognition and measurement of assets and liabilities arising from finance leases. IAS 17 and Topic 840 both require the lessee and lessor to recognise finance lease assets and liabilities at the date of commencement, and measure those assets and liabilities at the date of inception. Practice has interpreted that to mean that measurement occurs at the date of commencement, using (where appropriate) the lessee's incremental borrowing rate, which is calculated and 'locked in' at the date of inception.

The ROU model versus the existing lease model

18. Paragraphs BC16 and BC17 of IAS 17 state the following on the date of inception for initial measurement:

> '..The Standard now specifies that recognition takes place at commencement, based on values measured at inception. However, if the lease is adjusted for changes in the lessor's costs between the inception of the lease and the commencement of the lease term, the effect of any such changes is deemed to have taken place at inception…In agreeing on this treatment, the Board noted that measurement at commencement would have been more satisfactory in principle. However, this cannot be done properly within the framework of IAS 17 because the Standard generally requires a finance lease receivable or payable to be recognised at an amount based on the fair value of the asset, which is inappropriate at any date after inception.

19. The right-of-use (ROU) model being developed by the boards is somewhat different from the framework of IAS 17 referred to in paragraph BC17 of that standard. IAS 17 requires a lessee to recognise a finance lease as an asset and liability at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The framework in IAS 17 effectively requires the recognition of the underlying asset at fair value (or an approximation of fair value) at the date of commencement.

20. The ROU model being developed focuses on recognising the right to use the underlying asset and the related obligation to make lease payments; the lessee does not recognise the underlying asset. Therefore the asset recognised by the lessee does not necessarily reflect the fair value of the underlying asset, particularly when the lease term is for a period shorter than the useful life of the asset. As such, there is no reason to require the lessee to measure the right-of-use asset and the liability to make lease payments at the date of inception. Accordingly, we think it is consistent with the ROU model to require recognition and initial measurement on the date of commencement when the underlying asset is available for use by the lessee.

Consequences

21. The following questions arise if the lessee and lessor initially measure lease assets and liabilities at the date of commencement:

    (a) If the lessee cannot readily determine the rate that the lessor charges the lessee in the lease contract, should the lessee use its incremental borrowing rate at the date of inception or the date of commencement when that rate is used to measure the lessee's liability to make lease payments? [see paragraphs 22-31 of this paper]

    (b) Does a lessee recognise anything before the date of commencement if it is involved with the construction of an asset that it subsequently leases (those contracts are typically build-to-suit leases)? [see paragraphs 32-38 of this paper]

    (c) How should a lessee and lessor account for any lease payments that the lessee makes before the date of commencement? [see paragraphs 40-45 of this paper]

    (d) How should a lessee and lessor account for any incentives provided by the lessor before the date of commencement? [see paragraphs 46-50 of this paper]

The discount rate

22. If the lessee measures its liability to make payments at the date of commencement using its incremental borrowing rate, should it use the rate at the date of inception or the rate at the date of commencement?

23. We think that there are arguments to support both approaches.

24. **Approach A—use the incremental borrowing rate determined at the date of inception:** If the lessee were to use its incremental borrowing rate to measure the present value of the lease payments, Approach A proposes that it would use the rate calculated at the date of inception.

25. This approach would result in measuring the liability on the basis of conditions existing at the date that the lessor and lessee agree to the terms of the contract. Those supporting this view would argue that it is inappropriate to calculate the lessee's incremental borrowing rate at a date other than the date of inception. This is because using any other date may incorporate factors that the lessor and the lessee did not take into account when negotiating the terms of the contract, eg if the credit standing of the lessee were to change between the date of inception and the date of commencement.

26. **Approach B—use the incremental borrowing rate determined at the date of commencement:** Others might support using the lessee's incremental borrowing rate calculated at the date of commencement because this is the recognition and measurement point. The ROU model is different from the framework in current standards because it measures the liability to make lease payments. The measurement of the right-of-use asset is then based on the measurement of that liability (and not vice versa as is the case in current standards). Therefore, supporters of Approach B would argue that the objective is simply to measure the liability to make lease payments at the present value of lease payments at the date of commencement. If the lessee is discounting those lease payments to the date of commencement, it would seem more appropriate to use the lessee's incremental borrowing rate calculated at that date.

27. As set out in paragraph B13 of the ED, the lessee's incremental borrowing rate would reflect the nature of the transaction and the specific terms of the lease

(such as lease payments, lease term, contingent rentals, etc.). Although that guidance proposes that a lessee consider the specific terms of the lease when calculating its incremental borrowing rate, it does not necessarily mean that the calculation must be done on the date that the contract is signed. A lessee will assess and reassess the lease term and other aspects of the contract at lease commencement and during the lease term. Approach B would propose that the lessee also assesses the terms of the lease in the context of calculating its incremental borrowing rate at the date of commencement.

28. Approach B may be more consistent with some lease contracts that allow for a change in lease payments to reflect interest rates at the date of commencement. A few respondents mentioned that a lease contract may permit the lessor to change lease payments to reflect interest rates at the date of commencement if time between the date of inception and the date of commencement is long. Such changes would be reflected in the initial measurement of the lessee's liability to make lease payments at the date of commencement if the lessee uses the rate charged by the lessor when discounting the lease payments.

Staff recommendation—incremental borrowing rate

29. For the reasons noted in paragraphs 24 and 25, the staff recommend **Approach A**—when a lessee uses its incremental borrowing rate to measure the present value of lease payments at the date of commencement, it should calculate that rate on the basis of information available at the date of inception, which includes reflecting the credit standing of the lessee, the nature of the transaction, and the specific terms of the lease at that date. The discount rate is applied to lease payments that are agreed to by the lessee and lessor at the date of inception. Therefore, we think it is appropriate to discount those lease payments using the lessee's incremental borrowing rate calculated at that date.

30. In addition, using the incremental borrowing rate calculated at the date of inception is most appropriate if the lessee is obliged to make lease payments before the date of commencement. As discussed in paragraphs 40-45 of this paper, we recommend that such payments should be accreted to the date of

commencement using the same rate that is applied to lease payments when measuring the liability to make lease payments.

31. However, if the contract permits the lessor to change future lease payments to reflect changes in interest rates between the date of inception and the date of commencement, we think that those changes should be reflected in the initial measurement of the liability to make lease payments. Consequently, in such cases, if the lessee cannot readily determine the rate the lessor charges the lessee, it should use its incremental borrowing rate calculated at the date of commencement.

Lessee's involvement in the construction of an asset before the date of commencement

32. The ED did not address issues specific to build-to-suit leases. In contrast, Topic 840 includes requirements relating to a lessee's involvement in the construction of an asset that the lessee will lease when constructed (such contracts are usually 'build-to-suit' leases). The guidance was initially written to address situations in which a lessee might attempt to keep assets 'off balance sheet' by leasing an asset that it had constructed from the owner of the asset—the owner of the asset was typically a variable interest entity (VIE).

33. Topic 840 states that when a lessee is involved in the construction of an asset that it will lease when constructed, the lessee is treated as the owner of the asset during construction if it has substantially all of the construction period risks (calculated using a 90 per cent maximum guarantee test that is similar to the 90 per cent minimum lease payment test for capital leases). The lessee is automatically treated as the owner of the asset during construction if the lessee commences construction activities before the date of inception. In such cases, the transaction is then subject to the sale and leaseback requirements.

34. There are no such requirements in IFRSs.

35. Some respondents from the United States noted the existing build-to-suit lease requirements in US GAAP and requested that some guidance be included in the final leases standard.

36. In the absence of specific requirements relating to a lessee's involvement in the construction of an asset, we think that such involvement would be outside the scope of the leases standard. The lessee would account for any costs relating to the construction of the asset incurred before the date of commencement in accordance with other applicable standards because they would not be lease payments or initial direct costs.[1]

37. We do not think that the final leases standard needs to include specific requirements relating to a lessee's involvement in the construction of an asset for the following reasons:

    (a) If a lessee incurs costs relating to the construction of an asset (eg if the lessee constructs the asset) that is owned or will be owned by the lessor, then the lessee would apply other standards to determine how to account for those costs. For example, the lessee would consider whether to apply the revenue recognition standard and, if so, whether the lessor obtains control of the asset continuously during the construction period or only when the asset is constructed. If the lessee does not apply the revenue recognition standard, the lessee would account for costs incurred during construction in accordance with IAS 2 *Inventories* (Topic 330 *Inventory*) or IAS 16 *Property, Plant and Equipment* (Topic 360 *Property, Plant and Equipment*), and automatically be considered the owner of the asset during construction. We believe that this accounting treatment is appropriate and consistent with the recommendations on sale and leaseback transactions set out in agenda paper 11C / memo 147.

    (b) Current US GAAP requirements were written to address 'off balance sheet' concerns at a time when VIEs were consolidated on the basis of a majority risks and rewards test, and when operating leases were not

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[1] Lease payments are defined in the ED as 'payments arising under a lease including fixed rentals and rentals subject to uncertainty, including, but not limited to, contingent rentals and amounts payable by the lessee under residual value guarantees and term option penalties. Initial direct costs are defined in the ED as 'recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made'.

recognised in the statement of financial position. We think that the changes proposed in this project to require recognition of an asset and liability for most leases and the changes to the consolidation requirements for VIEs in both US GAAP and IFRSs reduce the need for specific requirements in this area. For example, from a group perspective, if the lessor is a VIE that is controlled and consolidated by the lessee, there is no sale and leaseback transaction. The lessee would capitalise costs incurred in constructing the asset as part of the cost of that asset.

38. We recommend that the final leases standard does not include accounting requirements relating to a lessee's involvement in the construction of an asset, but that it should specifically state that construction costs incurred by the lessee before the date of commencement relating to the underlying asset are outside the scope of the leases standard. A lessee would apply the revenue recognition standard or other applicable standards (ie standards relating to inventories or property, plant and equipment) to assess how it should account for costs incurred in constructing an asset.

39. Nonetheless, existing US GAAP requirements in this area are linked directly to existing sale and leaseback requirements. Therefore, if the boards do not agree with the staff recommendation for sale and leaseback transactions in agenda paper 11C / memo 147 and wish to retain guidance similar to existing sale and leaseback requirements, some staff recommend that this issue is considered further by the boards at a future meeting.

Lease payments made by the lessee before the date of commencement

40. The ED does not address how to account for lease payments that are made before the date of commencement. Several respondents requested guidance on this topic, noting that a lessee can be obliged to make lease payments before the date of commencement, particularly in build-to-suit leases in which the underlying asset can take some time to construct.

41. If a lessee makes lease payments before the asset is available for its use, we do not think it would be appropriate for the lessee to recognise those payments as a right-of-use asset before the date of commencement, which is consistent with the ROU model. Nonetheless, we think that those payments are assets, albeit prepayments for the right to use the asset that the lessee will recognise as soon as the asset is available for its use.

42. With respect to such payments, we think that the lessee should:

    (a) recognise any lease payments it makes before the date of commencement as a prepayment.

    (b) at the date of commencement, measure the right-of-use asset at the amount of the liability to make lease payments, plus any initial direct costs plus <u>any lease payments made before the date of commencement</u>.

43. From the lessor's perspective, we think the lessor should treat any lease payments received before the date of commencement as prepaid lease payments until the date of commencement.

44. If the time value of money effect would be material (ie if the lease payments made are large and/or are made well in advance of the date of commencement), it would be appropriate for the lessee to accrete those lease payments to the date of commencement, using the rate that the lessee uses to measure the liability to make lease payments. That approach is consistent with existing US GAAP requirements addressing payments made by the lessee before the beginning of the lease term when the lease is a capital lease.

45. In our view, it would be helpful to include application guidance on this topic and we recommend doing so to reflect the accounting set out in paragraphs 42-44 of this paper.

Incentives provided by the lessor

46. SIC-15 *Operating Leases—Incentives* and Topic 840 provide guidance on how to account for incentives that the lessor provides for the lessee to enter into the lease contract when the contract is an operating lease. Those incentives include, for

example, upfront cash payments to the lessee, or the reimbursement or assumption of costs of the lessee (such as relocation costs, leasehold improvements, and costs associated with preexisting lease commitments of the lessee). They might also include rent-free or reduced rent periods.

47. Incentives provided by the lessor were not specifically addressed in the ED, and a number of respondents requested guidance on how such incentives should be accounted for under the ROU model.

48. We think that the accounting treatment applied by the lessee for incentives provided by the lessor depends on the nature of the incentives as follows:

(a) If the lessor reimburses the lessee for costs incurred and those costs meet the definition of initial direct costs (eg costs associated with a preexisting lease commitment), those receipts from the lessor would be considered together with the associated costs incurred by the lessee and accounted for in accordance with the analysis in agenda paper 11A / memo 145 (ie the receipts from the lessor would offset the initial direct costs incurred by the lessee).

(b) If the lessor reimburses the lessee for costs that the lessee would expense when incurred (eg relocation costs), the lessee would recognise such payments from the lessor directly in profit or loss (ie those payments would offset the costs incurred by the lessee).

(c) Any other upfront cash received from the lessor would be considered to relate to the right to use the asset. Accordingly, we think that the lessee should treat the cash received as part of the overall lease payments for use of the asset to which a discount rate is applied when the lessee measures its lease liability at the date of commencement. As a consequence, such cash receipts are also included in the initial measurement of the right-of-use asset (those receipts from the lessor would reduce the right-of-use asset initially measured).

49. From the lessor's perspective, we think that:

(a) amounts paid to the lessee that meet the definition of initial direct costs should be accounted for as such.

(b) other upfront cash payments to the lessee should:

(i) reduce the profit recognised by the lessor at the date of commencement if the lessor applies the derecognition approach; or

(ii) reduce the lessor's lease liability initially measured on the date of commencement, if the lessor applies the performance obligation approach.

50. In our view, it would be helpful to include application guidance on this topic and we recommend doing so to reflect the accounting set out in paragraphs 48 and 49 of this paper.

Questions for the boards
The staff recommend that the leases standard: (a) require a lessee and lessor to recognise and initially measure lease assets and liabilities (and derecognise any corresponding assets and liabilities, eg derecognise a portion of the underlying asset if using the lessor derecognition approach) at the <u>date of commencement</u> of the lease. (b) require a lessee to use its incremental borrowing rate calculated at the date of inception when using that rate to measure the liability to make lease payments. (c) state that costs incurred by the lessee before the date of commencement relating to the construction of the underlying asset are outside the scope of the leases standard. The lessee should apply other applicable standards when accounting for such costs. (d) include application guidance on how to account for lease payments made by the lessee before the date of commencement as set out in paragraphs 42-44 of this paper. (e) include application guidance on how to account for incentives provided by the lessor as set out in paragraphs 48 and 49 of this paper. (f) not include requirements that apply only to build-to-suit lease contracts. Do the boards agree? If not, why? What do you propose?

APPENDIX—preliminary draft wording relating to the issues discussed regarding the date of inception versus the date of commencement

The preliminary draft wording in this appendix has been prepared by the staff to help the boards in reaching decisions regarding issues associated with the date of inception versus the date of commencement. The preliminary draft wording starts with the relevant paragraphs in the leases ED, and 'marks-up' changes to reflect the staff recommendations in paragraph 2 of this paper.

Scope

9 Except as specified in paragraphs 30 and 46, an underlying asset in a lease, and any costs incurred by the lessee or lessor before the date of commencement relating to the construction of an underlying asset, is not within the scope of this Standard.

Lessee

Recognition

10 At the date of commencement of a lease, a lessee shall recognise in the statement of financial position a right-of-use asset and a liability to make lease payments.

Initial measurement

12 At the date of ~~inception~~ commencement of the lease, a lessee shall measure:

(a) the liability to make lease payments at the present value of the lease payments (see paragraphs 13-15), discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the date the lessor charges the lessee (see paragraphs B11 and B12).

(b) the right-of-use asset at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee plus any lease payments made by the lessee before the date of commencement (see paragraphs ~~B14 and~~ B15-B18).

Lessor: performance obligation approach

Recognition

30 At the date of commencement of a lease, a lessor shall recognise in the statement of financial position a right to receive lease payments and a lease liability. The lessor shall not derecognise the underlying asset.

Initial measurement

33 At the date of ~~inception~~ commencement of the lease, a lessor shall measure:

(a) the right to receive lease payments at the sum of the present value of the lease payments (see paragraphs 34–36), discounted using the rate the lessor charges the lessee (see paragraph ~~B12~~B13), and any initial direct costs incurred by the lessor (see paragraphs ~~B14~~B15 and ~~B15~~B16).

(b) the lease liability at the amount of the right to receive lease payments, less any payments made to the lessee before the date of commencement that are not initial direct costs.

Lessor: derecognition approach

Recognition

46 At the date of commencement of a lease, a lessor shall:

(a) recognise a right to receive lease payments in the statement of financial position.

(b) derecognise from the statement of financial position the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease (see paragraph 50).

(c) reclassify as a ***residual asset*** the remaining portion of the carrying amount of the underlying asset that represents the rights in the underlying asset that the lessor retains (see paragraph 50).

Initial measurement

49 At the date of ~~inception~~ commencement of the lease, a lessor shall measure:

(a) the right to receive lease payments at the sum of the present value of the lease payments (see paragraphs 51–53), discounted using the rate the lessor charges the lessee (see paragraph B12), and any initial direct costs incurred by the lessor (see paragraphs B14 and B15).

(b) the residual asset at an allocated amount of the carrying amount of the underlying asset (see paragraph 50).

Lessee and lessor: initial measurement

Discount rate

B11 The discount rate used to determine the present value of lease payments for lessees is the lessee's incremental borrowing rate or the rate the lessor charges the lessee if that rate can be reliably determined. The lessee's incremental borrowing rate may be the same as the rate the lessor charges the lessee. If the lessee uses its incremental borrowing rate to determine the present value of lease payments, the lessee shall calculate that rate on the basis of information available at the date of inception, unless paragraph B12 applies.

B12 The terms of the lease may permit the lessor to change future lease payments to reflect changes in interest rates between the date of inception and the date of commencement. In that case, if the lessee uses its incremental borrowing rate to determine the present value of lease payments, the lessee shall calculate that rate on the basis of information available at the date of commencement.

B1~~2~~3 The discount rate used to determine the present value of lease payments for lessors is the rate that the lessor charges the lessee. The rate the lessor charges the lessee could be, for example the lessee's incremental borrowing rate, the rate implicit in the lease (ie the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset) or, for property leases, the yield on the property.

B1~~3~~4 Both the lessee's incremental borrowing rate and the rate the lessor charges the lessee would reflect the nature of the transaction and the specific terms of the lease, such as lease payments, lease term, expected contingent rentals, expected payments under term option penalties and residual value guarantees, the expected value of the underlying asset at the end of the lease term and security attached to the underlying asset during and at the end of the lease term.

Initial direct costs

[after B14 and B15 of the ED]

Initial direct costs reimbursed by the lessor

B17 If a lessor reimburses the lessee for initial direct costs, the lessee shall account for those payments from the lessor as a reduction of the initial direct costs that are included in the initial measurement of the right-of-use asset.

Payments made before the date of commencement

B18 If the lessee makes lease payments to the lessor before the date of commencement, paragraph 12(b) requires a lessee to include those lease payments in the initial measurement of the right-of-use asset. The amount included in the initial measurement of the right-of-use asset shall take account of the time value of money. The lessee shall accrete the payments made to the lessor to the date of commencement using the same discount rate that the lessee uses to measure its liability to make lease payments.

Determining the amount of lease payments

[insert after B21 of the ED]

B22 If the lessee receives payments from the lessor that do not reimburse costs of the lessee, the lessee shall treat those payments as a reduction of lease payments to which a discount rate is applied when the lessee measures its liability to make lease payments. Consequently, those payments reduce the amount of the right-of-use asset initially measured at the date of commencement.