



Staff
Paper

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FASB
Memorandum **169**

Project

Leases

Topic

**Contract modifications or changes in circumstances after
the date of inception of the lease**

Purpose

1. The purpose of this paper is to discuss how to account for changes after the date of inception of the lease, including:
 - (a) a modification to the contractual terms of a contract (a contract modification);
 - (b) a change in circumstances that would affect whether a contract is, or contains, a lease; and
 - (c) a change in circumstances that would affect whether a lease should be accounted for as a finance or other-than-finance lease.
2. Changes in accounting estimates relating to the existing lease (eg reassessment of options, purchase options, discount rates and variable lease payments) and changes to the lease term as a result of exercising an option that exists in the existing lease are not addressed in this paper.

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

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

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3. This paper is structured as follows:
 - (a) Summary of staff recommendations
 - (b) Background
 - (c) Summary of feedback
 - (d) Staff analysis and recommendations
 - (e) Appendix A – preliminary draft wording relating to changes after the date of inception of the lease
 - (f) Appendix B – guidance in the existing standards.

Summary of staff recommendations

4. The staff recommend that the final *leases* standard includes guidance for accounting for modifications to the contractual terms of a contract or changes in circumstances after the date of inception of the lease.
5. The guidance should clarify as follows:
 - (a) A modification to the contractual terms of a contract that is a substantive change to the existing contract should result in the modified lease being accounted for as a new lease (ie the existing lease should be accounted for as if it were terminated and the modified lease should be accounted for as if it were a new lease).
 - (b) A change in circumstances that would affect the assessment of whether a contract is, or contains, a lease should result in a reassessment by the lessee and the lessor as to whether the contract is, or contains, a lease. If a contract is reassessed and is determined to contain a lease (or not contain a lease), the lessee and lessor should apply (or cease to apply) lease accounting from the date of the change in circumstances giving rise to the reassessment.

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- (c) A change in circumstances that would affect whether a lease should be accounted for as a finance or other-than-finance lease should not result in a reassessment by the lessee and the lessor as to how the lease should be accounted for, ie not change the accounting approach after the date of inception of the lease.

Background

Leases exposure draft

- 6. Paragraph 29 of the *Leases* exposure draft (the ED) states that a lessor should not change the lessor accounting approach after the date of inception of the lease. Consequently, this addresses the accounting for a change in circumstances that would affect whether a lease should be accounted for as a finance or other-than-finance lease (under the proposed single lessee accounting model, this was not needed for a lessee). However, the ED does not provide any other guidance on accounting for:
 - (a) a modification to the contractual terms of a contract (a contract modification); or
 - (b) a change in circumstances that would affect whether a contract is, or contains, a lease.

Existing IFRSs and US GAAP

- 7. Existing guidance in Section 840-10-15 in the *FASB Accounting Standards Codification*® (formerly EITF Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease*) and IFRIC 4 *Determining whether an Arrangement contains a Lease* states that a lessee and a lessor should determine whether a contract is, or contains, a lease when there is either:
 - (a) a modification to the contractual terms of a contract (unless the modification only renews or extends the arrangement); or

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- (b) a change in circumstances that would affect whether a contract is, or contains, a lease (reassess only if there is a change in any one of three circumstances described in existing guidance, which is set out in paragraph B1 of Appendix B to this paper).
- 8. IAS 17 and Topic 840 *Leases* state that the determination of whether a lease should be accounted for as a finance/capital or operating lease should be made at the date of inception of the lease. This determination is updated only when there is a modification to the contractual terms of a contract. This determination is not reassessed when there is a change in other circumstances.
- 9. That guidance in existing IFRSs and US GAAP is included in Appendix B of this paper.

Summary of feedback

- 10. Because the ED did not address how to account for modifications to the contractual terms of a contract (contract modifications) or changes in circumstances after the date of inception of the lease, few respondents commented on this issue. Those who responded to this issue (mostly preparers and accounting firms) requested additional guidance on what they described as ‘lease contract modifications and extinguishments’, noting the guidance in existing IFRSs and US GAAP described in paragraphs 7–9 above.
- 11. Some respondents also noted that the proposal in the ED not to reassess whether a lessor should account for a lease using the proposed derecognition or performance obligation approaches after the date of inception of the lease is inconsistent with the existing guidance in IFRSs and US GAAP when there is a modification to the contractual terms of a lease contract.

How do you account for a modification of a lease? Should it be treated as an extinguishment of one lease and recognition of a new lease, or as an extension of an existing lease with revised terms? (CL #451)

We believe that the Exposure Draft needs to provide guidance for lease modifications. For example, when should modifications or changes to the

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original lease agreement be accounted for as part of the original lease as opposed to being treated as a new lease for accounting purposes? If the boards proceed with a hybrid approach to lessor accounting, the final ASU should also make clear whether the prohibition in paragraph 29 against changing the lessor accounting approach after the date of inception of the lease applies even if a lease has been modified substantially, or whether there are any situations in which a substantial modification may warrant a change in the lessor accounting approach (CL #692).

Staff analysis

12. The staff agree with those respondents' comments that more guidance should be provided in the new leases standard than the ED on how to account for modifications to the contractual terms of a contract (contract modifications) or changes in circumstances after the date of inception of the lease. This is because it is important to differentiate between contracts that are leases and contracts that are services, and between a finance and other-than-finance lease because there is a significant difference in the accounting.
13. If changes after the date of inception of the lease result in the modified contract being accounted for as a new lease, the existing lease should be accounted for as if it were terminated.
14. The following section discusses:
 - (a) a modification to the contractual terms of a contract (a contract modification);
 - (b) a change in circumstances that would affect whether a contract is, or contains, a lease; and
 - (c) a change in circumstances that would affect whether a lease should be accounted for as a finance or other-than-finance lease.

A modification to the contractual terms of a contract (a contract modification)

15. After the date of inception of the lease, a modification to the contractual terms of a contract could change how the contract should be accounted for.

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16. The existing guidance in IFRSs and US GAAP requires a subsequent determination of whether a contract is, or contains, a lease after the date of inception of the contract, if the contractual terms of that contract change (see paragraphs B1 and B2 of Appendix B for details).
17. Existing IFRSs and US GAAP state that if the modification to the contract leads to a different determination of whether a contract is, or contains, a lease, or whether a lease is a finance or operating lease, then the lessee and the lessor should account for the modified contract as a new lease.
18. For example, in the rail car example discussed at the February 2011 and April 2011 joint meetings (IASB Agenda Paper 5D/FASB Memo 132 and IASB Agenda Paper 1D/FASB Memo 158-appendix, respectively), the staff analysis showed how substitution rights affect whether a contract is, or contains, a lease.
19. If, at the date of inception, the contract includes substantive substitution rights, a lessee and a lessor may determine that the contract does not contain a lease. However, if, after the date of inception, the contractual terms are modified such that the supplier no longer has a substantive right to substitute any of the rail cars for a rail car of the same specification, the contract might be determined to contain a lease.
20. The staff think that modifications to the contractual terms of a contract after the date of inception should be reflected in the accounting for the contract. The staff think that this would better reflect the economics of the contract and would avoid structuring opportunities that may exist if the accounting does not reflect the economics of those modifications.
21. Therefore, the staff think that guidance similar to existing IFRSs and US GAAP should be carried forward into the final *Leases* standard. The final *Leases* standard should include a principle that, if there is a modification to the contractual terms of a contract after the date of inception of the contract (a contract modification such as changing lease payments, adding or removing

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extension options, purchase options or residual value guarantees), the lessee and the lessor should determine whether the substance of the existing contract has changed. If the substance of the existing contract has changed, the modified contract should be accounted for as a new contract.

22. The substance of the existing contract is determined to have changed if the modified contract would result in a different determination from the existing contract of whether:
 - (a) the contract is, or contains, a lease; or
 - (b) the lease should be accounted for as a finance lease instead of an other-than-finance lease.

A change in circumstances that would affect whether a contract is, or contains, a lease

23. A change in circumstances (other than a modification to the contractual terms of a contract) after the date of inception may affect whether a contract is, or contains, a lease.
24. This is because circumstances may change the determination of whether:
 - (a) fulfilment of the contract depends on the use of a specified asset; and/or
 - (b) the contract conveys the right to control the use of a specified asset for a period of time.
25. The existing guidance in IFRSs and US GAAP requires a subsequent reassessment of whether a contract is, or contains, a lease after the date of inception of the lease in some circumstances (see paragraphs B1-B2 of Appendix B for details).
26. This conclusion is different from the requirements for reclassifying a lease in IAS 17 and Topic 840 that a change in circumstances should not result in a reassessment by the lessee and the lessor as to whether a lease should be accounted for as a finance or operating lease. This was because the objective is different. Assessing whether a contract is, or contains, a lease affects the scope

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of the leases standard. If, after the date of inception, circumstances change such that the contract now contains a lease, it would appear appropriate to account for that contract under the leases standard, and vice versa. Therefore, the staff think that if the assessment of whether a contract is, or contains, a lease changes as a result of a change in circumstances, the lessee and lessor would apply (or cease to apply) lease accounting as appropriate. In contrast, a change in circumstances (other than a modification to the contractual terms of a contract) is unlikely to affect the classification of a lease (ie whether the lessor has transferred substantially all the risks and rewards incidental to ownership of an asset)—this is discussed further in paragraphs 30-38 of this paper.

27. However, the staff also note that requiring a subsequent reassessment of whether a contract is, or contains, a lease after the date of inception of the lease in some circumstances might be burdensome. This is because it might require a lessee to continuously reassess whether contracts, that were previously considered not to contain leases, might now contain leases based solely on changes in circumstances (other than modifications to the contractual terms of those contracts).
28. In addition, the staff think that the boards' tentative decisions to amend the existing definition of a lease means that there are likely to be a limited number of factors that would give rise to a change in circumstances (other than a modification to the contractual terms of a contract) that would affect whether a contract is, or contains, a lease. In fact, the staff have struggled to think of an example of a circumstance that would lead to a change in the assessment of whether a contract is, or contains, a lease.
29. Nonetheless, the staff think that guidance similar to existing IFRSs and US GAAP should be carried forward into the final *Leases* standard, ie a change in circumstances (other than a modification to the contractual terms of a contract) that would affect the assessment of whether a contract is, or contains, a lease should result in a reassessment by the lessee and the lessor because:

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- (a) it is consistent with the existing guidance in IFRSs and US GAAP, and therefore it would be familiar to constituents;
- (b) the assessment should not be burdensome given that factors that would give rise to a change in circumstances (other than a modification to the contractual terms of a contract) after the date of inception that would affect whether a contract is, or contains, a lease, would be limited; and
- (c) it would be logical to require subsequent reassessment of whether a contract is, or contains, a lease after the date of inception in some circumstances since this depends on factors related to the definition of a lease, and therefore reassessment should be required if those factors change.

A change in circumstances that would affect whether a lease should be accounted for as a finance or other-than-finance lease

- 30. A change in circumstances (other than a modification to the contractual terms of a contract) after the date of inception of the lease may affect whether the lease should be accounted for as a finance or other-than-finance lease by either the lessee or the lessor.
- 31. The existing guidance in IFRSs and US GAAP does not require a subsequent determination after the date of inception of whether the contract should be accounted for as a finance or other-than-finance (operating) lease if there is a change in circumstances.
- 32. This existing guidance in IFRSs and US GAAP is consistent with the proposals in paragraph 29 of the ED when there is a change in circumstances (other than a modification to the contractual terms of a contract) after the date of inception of the lease.
- 33. For example, consider a 5-year equipment lease, for an underlying asset that has an estimated useful life of 10 years at the date of inception of the lease.

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34. The lessee and the lessor may determine at the date of inception that the lease should be accounted for as an other-than-finance (operating) lease.
35. However, in the third year of the lease, there are significant technology advances that change the estimated useful life to 5 years.
36. In applying existing IFRSs and US GAAP and the ED proposals, the lessee and the lessor would account for the lease as an other-than-finance lease throughout the duration of the lease, even though the lessee and the lessor have determined that, after the third year of the lease, the lease term was, in fact, for the entire useful life of the asset. Such a change in the useful life of the asset would not change the fact that the lessor had not transferred substantially all the risks and rewards incidental to ownership of the asset (or whether the lessor retains exposure to significant risks or benefits associated with the underlying asset).
37. The staff think that guidance similar to existing IFRSs and US GAAP should be carried forward into the final *Leases* standard to clarify that only a modification to the contractual terms of a contract, not a change in other circumstances, results in a reassessment of whether a lease should be accounted for as a finance or other-than-finance lease.
38. This is because the staff think that requiring a lessee and a lessor to change the accounting approach after the date of inception of the lease due to a change in circumstances would be costly and complex to apply, would create structuring opportunities and may not provide useful information. For example, lessees and lessors:
 - (a) may frequently move between accounting for a lease as a finance or other-than-finance lease during the lease term when significant judgement is required at the date of inception to determine whether the lease should be accounted for as a finance or other-than-finance lease;
 - (b) would have to determine how to account for changes in profit or loss arising from the reassessment (eg the accounting for any ‘day one’ gains

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previously recognised by lessors and for any changes in the pattern of amortisation of a right-of-use asset by lessees); and

- (c) would need additional guidance on which circumstances may result in the reassessment of whether the lease should be accounted for as a finance or other-than-finance lease. For example, would a purchase option that is at fair value at the date of inception, but becomes significantly 'in the money', lead to a reassessment?

Staff recommendations

- 39. The staff recommend that the final *leases* standard includes guidance for accounting for modifications to the contractual terms of a contract or changes in circumstances after the date of inception of the lease.
- 40. The guidance should clarify as follows:
 - (a) A modification to the contractual terms of a contract that is a substantive change to the existing contract should result in the modified contract being accounted for as a new lease (ie the existing lease should be accounted for as if it were terminated and the modified lease should be accounted for as if it were a new lease).
 - (b) A change in circumstances that would affect the assessment of whether a contract is, or contains, a lease should result in a reassessment by the lessee and the lessor as to whether the contract is, or contains, a lease. If a contract is reassessed and is determined to contain a lease (or not contain a lease), the lessee and lessor should apply (or cease to apply) lease accounting from the date of the change in circumstances giving rise to the reassessment.
 - (c) A change in circumstances that would affect whether a lease should be accounted for as a finance or other-than-finance lease should not result in a reassessment by the lessee and the lessor as to how the lease should be

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accounted for, ie not change the accounting approach after the date of inception of the lease.

Question

The staff recommend that the leases standard should provide guidance on how to account for a modification to contractual terms of a contract and a change in circumstances after the date of inception of the lease as described in paragraph 40 above.

Do the boards agree?

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Appendix A: preliminary draft wording relating to changes after the date of inception of the lease

The preliminary draft wording in this appendix has been prepared by the staff to help the Boards in reaching decisions regarding changes after the date of inception of the lease. The Boards have not yet made decisions about the views reflected in this appendix, and, therefore, the wording is subject to change. The preliminary draft wording takes some of the wording from paragraphs 10 and 11 of IFRIC 4 Determining whether an Arrangement contains a Lease and paragraph 13 of IAS 17 Leases. Paragraph 13 of Section 840-10-15 in the FASB Accounting Standards Codification®. (formerly EITF Issue No. 01-8) has similar wording to IFRIC 4 and Section 840-10-35 in the FASB Accounting Standards Codification®. has similar wording to IAS 17 :

Contract modifications after the date of inception of the lease

- A1. After the date of inception of the lease, if there is a modification to the contractual terms of an existing contract, an entity shall determine whether the substance of the existing contract has changed. If the substance of the existing contract has changed, the lessee and lessor shall account for the modified contract as a new contract.

The substance of the existing contract is determined to have changed if the modified contract leads to a different determination from the existing contract of whether:

- (a) the contract is, or contains, a lease; or
- (b) the lease is classified as a finance or other-than-finance lease after lease classification is made at the inception of the lease.

- A2. Changes in estimates (for example, of lease term, of the economic life or of the residual value of the leased asset) do not give rise to a modification to the contractual terms of a contract. Instead, changes in estimates after the date of inception of the lease may trigger a reassessment of the existing lease (see paragraph X).

A change in circumstances after the date of inception of the lease

- A3. A lessee and lessor shall reassess a contract when there is a change in circumstances after the date of inception of the lease that would affect the determination of whether a contract is, or contains, a lease. If a contract is reassessed and is determined to contain a lease (or not contain a lease), the lessee and lessor shall apply (or cease to apply) lease accounting from the date of the change in circumstance giving rise to the reassessment.

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- A4. A lessee and lessor shall not reassess a contract when there is a change in circumstances after the date of inception of the lease, when that change would affect the determination of whether a lease is a finance or other-than-finance lease.
- A5. Changes in estimates (for example, of lease term, of the economic life or of the residual value of the leased asset), do not give rise to a change in circumstances. Instead, changes in estimates after the date of inception of the lease may trigger a reassessment of the existing lease (see paragraph X).

Application Guidance

- A6. Any of the following may indicate a modification to the contractual terms of the existing contract after the date of inception of the lease:
 - (a) there is a change in the amount of consideration exchanged.
 - (b) a renewal or extension of the lease that was not initially included in the existing contract is agreed to by the parties to the contract.
- A7. Any of the following may indicate a change in circumstances after the date of inception of the lease:
 - (a) there is a change in the determination of whether fulfilment is dependent on a specified asset.
 - (b) there is a change in the determination of whether the lessee has the right to control the use of the specified asset.

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Appendix B: guidance in existing standards

Excerpt from IFRIC 4¹

- B1. The assessment of whether an arrangement contains a lease shall be made at the inception of the arrangement, being the earlier of the date of the arrangement and the date of commitment by the parties to the principal terms of the arrangement, on the basis of all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if any one of the following conditions is met:
- (a) There is a change in the contractual terms, unless the change only renews or extends the arrangement.
 - (b) A renewal option is exercised or an extension is agreed to by the parties to the arrangement, unless the term of the renewal or extension had initially been included in the lease term in accordance with paragraph 4 of IAS 17. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement shall be evaluated under paragraphs 6–9 (the definition of a lease) only with respect to the renewal or extension period.
 - (c) There is a change in the determination of whether fulfilment is dependent on a specified asset.
 - (d) There is a substantial change to the asset, for example a substantial physical change to property, plant or equipment.
- B2. A reassessment of an arrangement shall be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) would not trigger a reassessment. If an arrangement is reassessed and is determined to contain a lease (or not to contain a lease), lease accounting shall be applied (or cease to apply) from:
- (a) in the case of (a), (c) or (d) in paragraph B1, when the change in circumstances giving rise to the reassessment occurs;
 - (b) in the case of (b) in paragraph B1, the inception of the renewal or extension period.

Excerpt from IAS 17²

- B3. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria if the changed terms had been in

¹ US GAAP has a similar guidance in Section 840-10-15 in the *FASB Accounting Standards Codification*®.

² US GAAP has a similar guidance under Topic 840 in the *FASB Accounting Standards Codification*®.

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effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term.