Leases: Project Update

Global Preparers Forum

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Reminder: why a leases project?

- Existing lease accounting doesn't meet users' needs
  - Accounting depends on classification
  - Contractual rights and obligations (assets and liabilities) are off-balance sheet
  - Users forced to adjust financial statements
- Complexity
  - Dividing line between finance and operating is arbitrary. Is there an underlying principle?

Leases project timeline

2009

March 2009
Discussion Paper
Leases: Preliminary Views

Comment period 4 months
302 comment letters received
Primarily focused on lessee accounting

2010

August 2010
Exposure Draft
Leases

Comment period 4 months
786 comment letters received
Contained proposals for both lessees and lessors

2012

H1 2012
Second Exposure Draft
Leases

Re-expose proposals
Focus on revisions to 2010 proposals

Will contain proposals for both lessees and lessors
Two boards fully converged

2012

2012
Final Standard
Leases

Effective date: TBD

Will contain guidance for both lessees and lessors

Proposed right-of-use model

A lease contract is one in which the right to control the use of an underlying asset is transferred from the lessor to the lessee

2010 ED proposals for lessees

'Right of use' accounting model: Lessee has acquired the right to use an underlying asset and is obligated to pay for that right with its lease payments

Right of use model for lessees			
Balance Sheet		**Income Statement**	
Right-of-use asset	X	Amortisation expense	X
Liability to make lease payments*	X	Interest expense	X

* Discount using the rate lessor charges the lessee or lessee's incremental borrowing rate if lessor rate not available

2010 ED – lessor accounting

Does the lessor retain significant risks or benefits of the underlying asset?

No

Derecognition approach:

- Derecognise underlying
- Recognise residual asset
- Profit on amount derecognised & interest income

Yes

Performance Obligation approach:

Recognise underlying

Recognise performance obligation

Lease income, depreciation and interest income

Both approaches: recognise lease receivable

Consultation on 2010 ED

- 786 comment letters received
- Extensive outreach across all major geographical regions conducted during 4-month comment period
  - 7 roundtables in London, Hong Kong, Chicago and Norwalk (attended by representatives from over 80 interested parties)
  - 15 preparer workshops in London, Tokyo, Seoul, Melbourne, São Paulo, Toronto and Norwalk (attended by over 90 organisations)
  - Over 200 meetings (1,500 organisations, 2,300 individuals, including over 500 users)
  - Preparer questionnaires (completed by over 250 lessors and over 400 lessees)
  - 4 project webcasts and podcasts (each 500-1000 participants)
- Targeted outreach during re-deliberations with over 70 organisations

Feedback received

- General support for a right-of-use model
  - basic lessee accounting principle widely accepted, ie leases create assets and liabilities
- Concerns about complexity and cost of model as applied to lessees
- Conceptual concerns about how model applied to lessors
  - representation of economics
  - relationship to lessee model
  - little support for performance obligation model

Redeliberations - definition of a lease

- ‘Contract in which the right to use an asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration’
  - Underlying asset = Identifiable (physically distinct)
  - Right to control use of underlying asset
- Notion of control changed
  - ‘Ability to direct the use’ and receive benefits
  - Change from EITF 01-8/IFRIC 4/ED:
    - if entity obtains substantially all output ≠ control
    - pricing does not determine control

Redeliberations - lessee model

- Feedback
  - ‘frontloading’ expense in P&L
  - elimination of rent expense
- Boards considered a dual accounting approach
  - finance lease (in substance purchase) – as ED
  - other than finance lease (operating lease) – on balance sheet, but straight-line rental expense
- Boards decided to affirm single approach as in 2010 ED

Redeliberations: Lessee model

	Initial Measurement	Subsequent Measurement
Liability for lease payments	PV of lease payments discounted using rate lessor charges the lessee*	Amortised cost – no revision of discount rate unless there is a change in payments
Right-of-use asset	Cost (=obligation to make lease payments)**	Amortised cost – option to revalue

*This can be the rate implicit in the lease, incremental borrowing rate. Use implicit rate if available

** Plus initial direct costs, if any

Redeliberations - lessor model

All leases (except short-term leases and leases of investment property*)			
Balance Sheet		**Income Statement**	
Residual asset**	X	Profit on transfer of right-of-use (gross or net based on business model)	X
Right to receive lease payments	X	Accretion of residual	X
		Interest income	X

* During October 2011 meeting, the boards tentatively decided to scope out all lessors of IP, including those who measure IP at cost.

** Measured as an allocation of carrying amount of underlying asset. This includes fair value of residual asset, less the deferred profit on residual.

Redeliberations: Lessor measurement

	Initial Measurement	Subsequent Measurement
Right to receive lease payments	PV of lease payments discounted using the rate charged in the lease*	Amortised cost
Residual asset	Allocated carrying value (Fair value of residual less deferred profit)	Accretion** using lease discount rate, adjustment for variable lease payments***

* Plus initial direct costs, if any

** Fair value of residual is accreted, the deferred profit remains constant.

*** If the rate lessor charges the lessee reflects an expectation of VLPs, the residual asset should be adjusted when those VLPs are recognised.

Application example – equipment lease

Assumptions and lessee workings:

• Carrying amount	CU7,500
• Fair value	CU10,000
• Lease term	3 years
• Residual (future value)	CU4,770
• Annual rental, in arrears	CU2,400
• Rate implicit in lease	7.9%
• No initial direct costs	
• PV of lease payments	CU6,200
• Residual (current value)	CU3,800

Lessor workings:

- Net residual asset = underlying CA – (underlying CA x lease receivable/FV of underlying)
- *CU7,500 – (CU7,500 x CU6,200/CU10,000)*
  = CU7,500 – CU4,500
  = CU2,850 (net residual asset)
- Deferred profit = Fair value of residual – net residual asset
- CU3,800 – CU2,850 = CU950 (deferred profit)
- Profit at commencement = Lease receivable income – cost of underlying asset recognised
- CU6,200 – (CU7,500-CU2,850) = CU1,550 *(profit at commencement)*

Application example – equipment lease continued

Lessee presentation

	Balance sheet		Income statement		
Year	Right of use asset	Lease liability	Amortisation of ROU asset	Interest expense	Net Income
0	6,200	6,200			
1	4,133	4,288	(2,067)	(488)	**(2,554)**
2	2,067	2,225	(2,067)	(337)	**(2,404)**
3	-	-	(2,067)	(175)	**(2,242)**
TOTAL			**(6,200)**	**(1,000)**	**(7,200)**

Lessor presentation

	Balance sheet				Income statement		
Year	Lease Receivable	Gross residual Interest	Deferred profit	Net residual interest	Interest Income	Residual Accretion	**Net Income**
0	6,200	3,800	(950)	2,850			**1,550**
1	4,288	4,099	(950)	3,149	488	299	**787**
2	2,225	4,422	(950)	3,472	337	323	**660**
3	-	4,770	(950)	3,820	175	348	**523**
TOTAL					**1,000**	**970**	**3,520**

Reducing complexity and cost

	2010 ED	Post-ED simplifications
Options to extend the lease term (term options)	• Longest possible lease term more likely than not to occur • Reassessed	• Option period included if lessee has significant economic incentive to exercise • Reassessed other than for market conditions
Variable lease payments	• Included in lease liability on probability-weighted basis • Reassessed	• Excluded from liability (unless in-substance fixed or based on an index or rate) and accounted for as incurred • Reassessed for spot/index
Short-term leases (lease term ≤ 12 mths)	• Liability/asset recognised with no discounting	• No liability/asset recognised • Rent expense • Today's IAS 17 / FAS 13 operating lease model

Redeliberations – lessee other issues

- **Multi-element contracts**
  - Separately account for non-lease elements
  - Allocate between lease and non-lease elements if there are observable prices
- **Lessee residual value guarantees**
  - Include in lease payments amounts expected to be payable
- **Sale and leaseback transactions**
  - If sale, account for as sale then leaseback

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Redeliberations – lessor other issues

- **Impairment**
  - Financial asset impairment guidance for receivable
  - Non-financial impairment guidance for residual asset
- **Residual value guarantees**
  - Not recognised separately
  - Considered when assessing residual asset for impairment
- **Multi-element contracts**
  - Separately account for non-lease elements
  - Allocate using revenue guidance (selling price)

Redeliberations – lessee presentation

- **Balance sheet**
  – RoU asset presented as if owned
  – Liability to make lease payments
- **Statement of cash flows:**
  – Lease payments relating to principal: financing
  – Lease payments relating to interest: as other interest payments are presented
  – Variable lease payments not included in RoU asset: operating
  – Short term lease payments: operating

Redeliberations – lessee disclosure

- Objective
  - Enable users to evaluate the nature, amount, timing, and uncertainty of cash flows arising from lease contracts and how the entity manages those cash flows
- Required lessee disclosures will include:
  - RoU asset and liability to make lease payments roll-forward
    - RoU asset roll-forward: disaggregated by asset class
  - Maturity analysis for liability
  - Disclose significant leases not yet commenced
  - Disaggregation of expenses related to leases
  - Information about material changes to short-term leases

Redeliberations – lessor presentation

- **Statement of comprehensive income**
  - Accretion of residual as interest income
  - Lease income and lease expense either gross or net, depending on the lessor's business model
- **Balance sheet**
  - Receivable and residual presented together as ‘lease assets’ on balance sheet
  - Separate presentation of receivable and residual either on face of balance sheet or in notes
- **Statement of cash flows**
  - Lessor classifies cash inflows from leases as operating activities

What happens next?

Fall 2011	H1 2012	2011 2012	2012
Wrap up redeliberations*	**Publish Revised Exposure Draft**	**Consultation**	**Issue Final Standard**
Converged decisions and words	Comment letter period TBD	Outreach	Effective date: TBD
		Working group meetings	
		Redeliberations	

***Remaining issues :**

- IAS 40 consequential amendments
- Comment period

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged.
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