STAFF PAPER

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Project	Leases		
Paper topic	Update on leases project		
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Introduction

1. This paper provides an update on the boards' recent decisions and also reports on the decisions that are expected to be discussed by the boards at the next meeting. The staff are seeking any feedback that you may have on the consequences of those decisions and your suggestions for any refinements that are needed to overcome any practical implementation challenges.

2. In addition, we are seeking your input on the presentation and disclosure of information about leases that are accounted for using an approach that results in a straight-line lease expense.

Tentative decisions to date

3. At the June 2012 meeting, the FASB and IASB tentatively decided that for lessee accounting there should be different lease expense recognition patterns for different types of lease. The boards tentatively decided that some leases should be accounted for using an approach based on the tentative decisions to date (interest approach), whereas other leases should be accounted for using an approach that results in a straight-line lease expense (straight-line approach).

4. The straight-line approach would continue to measure the lease liability in accordance with the boards' earlier tentative decisions (using the interest

approach), but the straight-line approach would straight-line the total cost of the lease (this cost would include lease payments, initial direct costs, lease incentives etc) over the lease term. Consequently, the subsequent measurement of the right-of-use asset becomes a balancing figure. The straight-line approach would also present the rent expense as a single line item in the income statement, rather than presenting amortisation and interest expense. Appendix 2 includes an illustrative example demonstrating the interest approach (Approach 1 in Appendix 2) and the straight-line approach (Approach 2 in Appendix 2).

5. The boards tentatively decided that a lessee should distinguish between the two different types of lease on the basis of whether the lessee consumes more than an insignificant portion of the underlying asset over the lease term. The thinking behind this distinction was taken from the underlying-asset approach that was considered, but then rejected, by the boards because of the difficultly of applying it in practice. The underlying-asset approach considers that there is a spectrum of leases, from those very close in nature to a sale (where the lessee has purchased a significant portion of the underlying asset), to those very close in nature to a service (where the lessee is merely paying to use the asset). This spectrum of leases is based on how much of the underlying asset the lessee consumes over the lease term. When there is no consumption, or very little, of the asset, the underlying-asset approach views that the lessee is paying a fixed charge to the lessor for use of the residual and hence a straight-line expense profile arises.

6. Given that there is a spectrum of leases, any line drawn to distinguish between different types of lease would not be able to capture all leases perfectly. However, the boards decided to draw a line based on the principle of consumption, in such a way that where there is no consumption, or very, little, of the underlying asset, a straight-line expense profile should arise, and when there is consumption of the underlying asset, the lessee has effectively purchased a portion of the underlying asset and, therefore, an interest expense profile should arise.

7. To remove some of the judgement that would be required when applying the principle of consumption, the boards thought that the consumption principle should be applied by using a practical expedient based on the nature of the underlying asset, as follows:

(a) Leases of property (land and/or a building or part of a building) should be accounted for using the straight-line approach, unless:

  (i) the lease term is for the major part of the economic life of the underlying asset; or

  (ii) the present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.

(b) Lease of assets other than property should be accounted for using the interest approach, unless:

  (i) the lease term is an insignificant portion of the economic life of the underlying asset; or

  (ii) the present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

8. The practical expedient assumes that there is little consumption of the underlying asset for leases of property, and that there is significant consumption of the underlying assets for leases of plant and equipment. However, the practical expedient has ‘unless’ clauses. The ‘unless’ clause for leases of property is based on the principle in IAS 17 *Leases*; the staff chose to use IAS 17 as a basis for this clause rather than create a new basis, because the IAS 17 principle is well known and is frequently used in practice. The ‘unless’ clause for leases of assets other than property can be thought of as the ‘inverse’ or ‘mirror image’ of the IAS 17 principle.

9. The boards also tentatively decided to apply the same practical expedients to the lessor accounting model to distinguish between:

  (i) leases to which the lessor would apply operating lease accounting; and

  (ii) the receivable and residual approach (eg an approach whereby the lessor would recognise a receivable from the lessee and a residual asset representing the lessor’s rights to the underlying asset).

Question 1

Do CMAC and GPF members have any initial thoughts on the consequences of the boards' recent decisions?

Presentation and disclosure for leases under straight-line approach

10. At the July 2012 joint board meeting, the staff are expecting the boards to discuss, in respect of the straight-line approach, presentation on the balance sheet, in the cash flow statement and the disclosures.

11. With respect to the statement of cash flows, the boards will need to decide whether to show the interest and repayment of the lease liability separately in the cash flow statement (in accordance with their tentative decisions so far) or as a single operating item, 'rent paid'.

12. The boards will also need to consider whether all items relating to leases that are presented in the balance sheet (for example, the right-of-use asset) or in the notes (for example, the reconciliation of the lease liability) should be:

    (i) presented together for all leases; or

    (ii) presented or disclosed separately for those leases to which the interest approach has been applied and those leases for which the straight-line approach has been applied.

13. The staff favour separate presentation, because IFRS normally requires disaggregation for different classes of assets and liabilities, especially when those assets or liabilities have been measured differently.

14. Appendix 1 contains all of the tentative decisions to date with regards to disclosures for lessees. The staff think that for the straight-line approach, the reconciliation of the right-of-use asset be removed, but most of the other disclosures should remain. The staff think that the reconciliation of the right-of-use asset is possibly no longer relevant or useful to users because, under the straight-line approach, the measurement of the right-of-use asset is a balancing figure.

15. A final point that was discussed frequently in our recent outreach is whether the interest expense should be disclosed in the notes, because, the straight-line approach does not present interest expense in the income statement. Many users

commented on the usefulness of the interest expense being disclosed. As part of the boards' tentative decisions, interest expense is disclosed as one of the reconciling items in the reconciliation of the lease liability. The staff are considering whether to retain this disclosure of interest expense for the straight-line approach.

16. Your views and thoughts on these issues will be very helpful in reaching conclusion on this topic.

Question 2

(a) How do members think the cash payments under the straight-line approach should be represented in the cash-flow statement (ie as rent paid or interest and repayment)?

(b) Do you think it would be useful to split the presentation and disclosures for those leases to which the straight-line approach has been applied, versus those leases to which the interest approach has been applied? If so, would you split all or only some of the disclosures?

(c) Do members think all of the lessee disclosures that are currently proposed by the boards are relevant under a straight-line approach? If not, which ones do you think are not relevant under a straight-line approach?

(d) Do members think any additional disclosures would be relevant under the straight-line approach?

(e) Do members think that the disclosure of interest expense in the notes is relevant for the straight-line approach?

Appendix 1—Disclosures

Information that identifies and explains the amounts in the financial statements

A1. An entity shall disclose:

a. the nature of its lease contracts, including:

i. a general description of those lease contracts.

ii. the basis and terms on which variable lease payments are determined.

iii. the existence and terms of options to extend or terminate the lease. A lessee shall provide narrative disclosure about the options that were recognised as part of the right-of-use asset and those that were not.

iv. the existence and terms of residual value guarantees.

v. the restrictions imposed by lease contracts, such as those relating to dividends, additional debt and further leasing.

b. information about the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations for the entity.

c. information about significant assumptions and judgements (and changes in significant assumptions and judgements) made in applying the requirements of this standard, which may include (and is not limited to):

i. the determination of whether the entity has a lease.

ii. the allocation of lease payments between lease and non-lease components.

iii. the determination of whether the lessee has a significant economic incentive.

iv. the determination of fair value of the underlying or residual asset.

v. the determination of the discount rate.

vi. amortisation methods.

A2. An entity shall identify the amount of significant subleases included in the disclosures provided in accordance with paragraph 65.

A3. A lessee shall disclose expenses recognised in the reporting period relating to leases, in a tabular format disaggregated into:

a. amortisation expenses;

b. interest expenses; and

c. expenses relating to variable lease payments not included in the liability to make lease payments.

A4. After the tabular disclosure requirements a lessee shall disclose the cash paid during the period for the principal and interest portions of the liability to make lease payments.

A5. A lessee shall disclose a reconciliation of opening and closing balances of right-of-use assets disaggregated by class of underlying asset. The reconciliation shall disclose items that are useful in understanding the movement in right-of-use assets, which may include but is not limited to:

a. additions from commencement of leases

b. disposals from termination of leases

c. amortisation

d. foreign currency translation adjustments

e. effects of business combinations

f. impairment

A6. A lessee shall disclose a reconciliation of opening and closing balances of liabilities to make lease payments. The reconciliation shall disclose items that are useful in understanding the movement in liabilities to make lease payments, which may include but is not limited to:

a. liabilities created due to leases commencing

b. liabilities cancelled due to leases terminating

c. accrued interest

d. cash paid

e. foreign currency translation adjustments

f. effects of business combinations

Information about the amount, timing and uncertainty of cash flows arising from leases

A7. Except as described in paragraphs A8 and A9, an entity shall disclose information relating to risks arising from a lease required by paragraphs 31–42 of IFRS 7 Financial Instruments: Disclosures.

A8. [IASB: In place of the maturity analyses required by paragraph 39(a) and (b) of IFRS 7,] a lessee shall disclose a maturity analysis of the liabilities to make lease payments showing the undiscounted cash flows on an annual basis for a minimum of the first five years and a total of the amounts for the remaining years. The maturity analysis shall be reconciled to the liability to make lease payments recognised in the statement of financial position.

A9. [FASB: A lessee shall disclose a maturity analysis of the future undiscounted cash flows on an annual basis for a minimum of the first five years and a total of the amounts for the remaining years related to commitments for non-lease components that are related to a lease].

Appendix 2—Illustrative example

Lessee Accounting - Uneven Payments

Lease Payments

1	70
2	85
3	100
4	115
5	130

Assumptions:

Lease term in years	5
Interest rate	6.00%

Periods	0	1	2	3	4	5
Approach 1						
Balance Sheet						
Right-of-use asset	414	331	248	166	83	-
Liability to make lease payments	414	369	306	224	123	-
Income Statement						
Interest on lease obligation		25	22	18	13	7
Amortisation expense		83	83	83	83	83
Total Lease Expense		**108**	**105**	**101**	**96**	**90**

Periods	0	1	2	3	4	5
Approach 2						
Balance Sheet						
Right-of-use asset	414	339	261	179	93	-
Liability to make lease payments	414	369	306	224	123	-
Income Statement						
Total Lease Expense		**100**	**100**	**100**	**100**	**100**

Total Lease Expense by Approach	1	2	3	4	5
Approach 1	**108**	**105**	**101**	**96**	**90**
Approach 2	**100**	**100**	**100**	**100**	**100**

<u>Example calculation of period 1 expense and change in liability and asset</u>

Expense each period equals the average payment each period
Total lease payments: 500
Lease term: 5 years
Annual expense: 100 (500/5)

Change in liability each period equals difference between payments and accretion (using discount rate)
Payments: 70
Accretion: 25 (414 * 6%)
Change in liability: 45 (70 - 25)

Change in asset each period equals difference between expense and accretion
Expense: 100
Accretion: 25
Change in asset: 75 (100-25)