

# AGENDA PAPER

IFRS Advisory Council Meeting

LONDON 22 – 23 October 2012

**Agenda ref 11**

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TOPIC Leases: Project update

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This paper has been prepared for discussion at a public meeting of the IFRS Advisory Council. The views expressed in this paper are those of the authors. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS.

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## **Leases: Project update**

**Presentation at the October 2012 IFRS Advisory Council meeting**

October 2012

## International Financial Reporting Standards



# Leases: Project update

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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## Agenda

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- Background
- 'Right-of-use' model
- Lessee accounting
- Lessor accounting
- Definition of a lease
- Costs and complexity
- Other aspects

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## Why a leases project?

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- Existing lease accounting does not meet users' needs
  - assets and liabilities are off-balance sheet
  - limited disclosure requirements
  - users adjust financial statements
- Structuring opportunities
  - current lease classification often based on bright lines
  - significant difference in accounting on either side of operating/finance lease line



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## Facts

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- Huge amounts of corporate debt off-balance sheet
- Impact on key financial ratios
- Users adjust financial statements
  - Rough estimation techniques used
  - Estimates can vary significantly
- Strong support for a new standard



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## Benefits

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- Greater transparency about true leverage of lessees
  - better information
  - reduced costs for users
- Greater comparability between leases and purchases
- Greater transparency about leverage of lessors



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## Main issues

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- Recognition of assets and liabilities by lessee
  - Leases are different from services
- One or two models
- Definition of a lease
- Cost and complexity
- Resistance from some interested parties



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## Leases are different from services

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- Control over ROU asset
  - Physical possession of (access to) underlying asset
  - Lessor cannot retrieve underlying asset
- Unconditional obligation to pay (lessee)
  - Lessee cannot return underlying asset (terminate lease), and avoid paying, without breaching contract

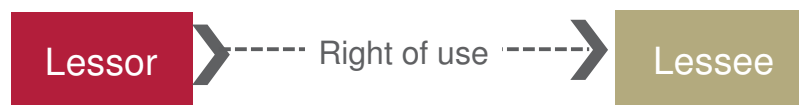


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## Right-of-use model

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- A lease contract is one in which the right to control the use of an asset (for a period of time) is transferred to the lessee.



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## Initial measurement (lessee)

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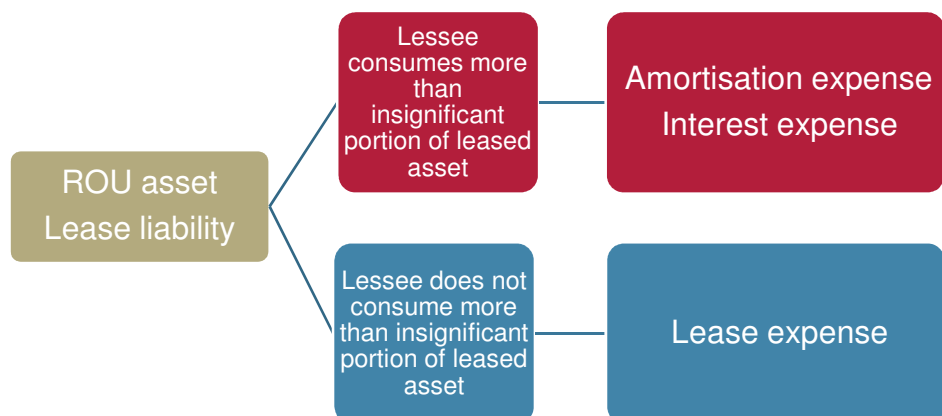
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## Lessee model

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Balance sheet

Income statement



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## The rationale

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- Importance of underlying asset
- What does right-of-use represent?
  - consumption of underlying asset + financing, OR
  - use of underlying asset
- Practical expedient
  - equipment versus property

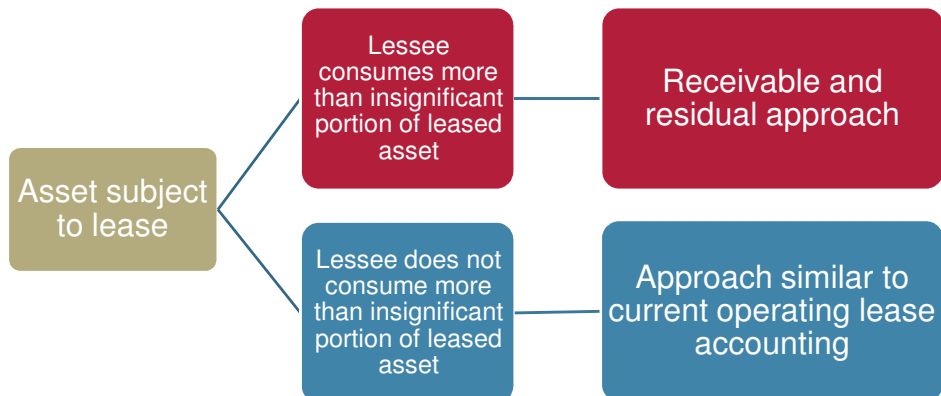


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## Lessor model

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### Lessor accounting approach



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## The rationale

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## Lessor receivable and residual approach

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Balance Sheet		Income Statement	
Right to receive lease payments <sup>1</sup>	X	Profit on transfer of right-of-use (gross or net based on business model)	X
Residual asset <sup>2</sup>	X	Interest income—on receivable and residual <sup>3</sup>	X

<sup>1</sup> Present value of lease payments, plus initial direct costs

<sup>2</sup> Measured at an allocation of carrying amount of leased asset

<sup>3</sup> Interest on residual based on estimated residual value—any profit on the residual asset is not recognised until asset sold or re-leased at end of lease term



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## Lessor approach similar to current operating lease accounting

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Balance Sheet		Income Statement	
Leased asset <sup>1</sup>	X	Rental income <sup>2</sup>	X
		Depreciation <sup>3</sup> , or	(X)
		Fair value changes <sup>4</sup>	X/(X)

<sup>1</sup> Lessor measures leased asset (eg property) at fair value or cost

<sup>2</sup> Rental income recognised on a straight-line basis or another systematic basis, if more representative of pattern of earning rentals

<sup>3</sup> If property measured at cost, rental income plus depreciation recognised

<sup>4</sup> If property measured at fair value, rental income plus fair value changes recognised



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## Classification of leases\*

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Lessee consumes more than insignificant portion of leased asset

- Leases of assets other than property *unless*:
  - Lease term is insignificant relative to economic life of asset
  - PV of lease payments is insignificant relative to FV of asset

Lessee does not consume more than insignificant portion of leased asset

- Leases of property (land and/or a building) *unless*:
  - Lease term is major part of economic life of asset
  - PV of lease payments is substantially all of FV of asset

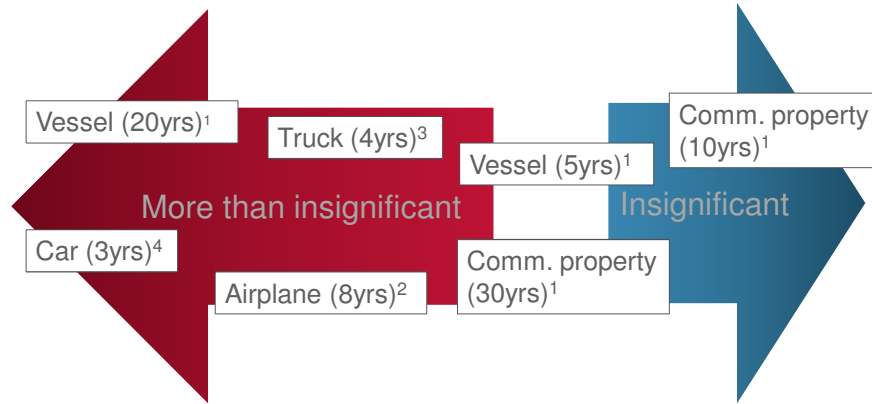
\* Both lessee and lessor



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## Classification of leases—examples

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Assumed economic life of:

<sup>1</sup> 40 years

<sup>2</sup> 25 years

<sup>3</sup> 10 years

<sup>4</sup> 6 years

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## Definition of a lease

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- ‘Contract in which the right to use an asset is conveyed, for a period of time, in exchange for consideration’
- Notion of control changed
  - ‘ability to direct the use’ and receive benefits
  - if entity obtains substantially all output ≠ control
    - pricing does not determine control

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## Definition of a lease

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- Identifiable asset
  - explicitly or implicitly specified
  - no substantive right to substitute asset
  
- Right to control the use during the lease term
  - decision-making authority over the use of the asset
  - receive substantially all benefits from use



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## Reducing complexity and cost

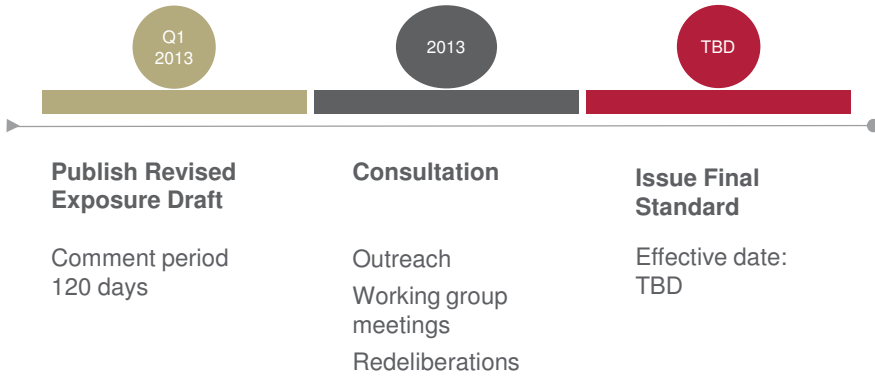
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	2010 ED	Post-ED simplifications
Options to extend the lease term (term options)	<ul style="list-style-type: none"> <li>• Included if more likely than not to occur</li> <li>• Reassessed</li> </ul>	<ul style="list-style-type: none"> <li>• Included if significant economic incentive to exercise</li> <li>• Reassessed other than for market conditions</li> </ul>
Variable lease payments	<ul style="list-style-type: none"> <li>• Included in lease liability on probability-weighted basis</li> <li>• Reassessed</li> </ul>	<ul style="list-style-type: none"> <li>• Excluded, unless based on index or rate</li> <li>• Accounted for as incurred</li> <li>• Reassessed for spot/index</li> </ul>
Short-term leases	<ul style="list-style-type: none"> <li>• Liability/asset recognised with no discounting</li> </ul>	<ul style="list-style-type: none"> <li>• No liability/asset recognised</li> <li>• Rent expense</li> <li>• IAS 17 operating lease model</li> </ul>

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# What happens next?



# Thank you



### Information on other aspects of the leases proposals



- Multi-element contracts
  - separately account for non-lease elements
  - lessee: allocate between lease and non-lease elements if observable prices or reliably estimable
  - lessor: allocate using revenue recognition guidance
- Residual value guarantees
  - lessee: include in lease payments amounts expected to be payable
  - lessor: considered when assessing residual asset for impairment but not recognised separately



## Redeliberations – other issues continued

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- Lessor impairment
  - financial asset impairment guidance for receivable
  - non-financial impairment guidance for residual asset
- Sale and leaseback transactions
  - if sale, account for as sale then leaseback



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## Redeliberations – lessee presentation

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- 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
  - lease payments when single lease expense recognised: operating
  - variable lease payments: operating
  - short term lease payments: operating



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## Redeliberations—lessor presentation

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- Balance sheet



- Statement of cash flows
  - cash inflows from leases → operating activities



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## Redeliberations – lessee disclosure

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- Required lessee disclosures will include:
  - qualitative information about leasing activities
  - ROU asset and liability to make lease payments roll-forward for both classes of lease
    - ROU asset roll-forward: disaggregated by asset class
  - maturity analysis for liability
  - disclose significant leases not yet commenced
  - disclose expense relating to variable lease payments not included in lease liability



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## Redeliberations—lessor disclosure

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- Reconciliation of lease receivable and residual asset\*
- Maturity analysis
- A table of all lease income, including short-term
- Details of contingent rentals and options
- Details on residual asset risk management including quantitative exposure\*
- Similar requirements for leases to which an approach similar to operating lease accounting is applied

\* Receivable and residual approach only

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## Redeliberations – transition\*

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- Retrospective approach but based on information available at beginning of earliest comparative period
- Reliefs available
  - use of hindsight
  - no evaluation of initial direct costs for contracts before effective date
  - lessee: use ‘portfolio level’ discount rate calculated at transition
- No requirement to make adjustments for leases currently classified as finance/capital leases

\* An entity can choose to fully retrospectively apply the new leases standard

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