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STAFF PAPER

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Project	**Leases**		
Paper topic	Sweep issue—lease components and classification of leases		

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Background and objective of this paper

1. The revised *Leases* Exposure Draft (the ED) will include the following proposals requiring the identification and classification of a lease:
   - (a) Step 1: An entity is required to identify whether a contract contains a lease. In doing so, the entity applies the definition of a lease and accompanying guidance.
   - (b) Step 2: Having concluded that a contract contains a lease, an entity is required to allocate the consideration in a contract to each lease component of that contract. An entity accounts for each lease component as a separate lease.
   - (c) Step 3: Having identified the lease and allocated consideration to that lease, an entity then determines how to account for the lease by classifying it based on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. The ED proposes that this classification principle is applied differently depending on whether the underlying asset in the lease is property (ie land and/or a building (or part of a building)) or an asset other than property (ie equipment).

2. During the drafting of the ED, questions have arisen about the identification of lease components and the unit of account when applying the classification guidance. More specifically:

   (a) when a contract conveys the right to use more than one asset, how would an entity determine whether there is one or multiple lease components that should be accounted for separately?

   (b) how would an entity apply the classification guidance if the lessee obtains the right to use an asset or assets that incorporate both property and non-property elements?

   (c) if the lease is a property lease that incorporates land and building elements, is an entity required to apply the classification guidance separately to the land element and the building element, as is required in existing leases standards?

3. The objective of this paper is to address those questions and the possible clarifications that could be included in the ED to assist preparers when identifying and classifying leases. We are **not** asking the boards to reconsider their previous decisions regarding the identification and classification of leases and, therefore, the staff analysis and recommendations are made in the light of the decisions that the boards have already made.

4. This paper is structured as follows:

   (a) Summary of the staff recommendations (paragraph 6 of this paper)

   (b) Lease components (paragraphs 7-12 of this paper)

   (c) Classification of leases—property and non-property elements within one lease component (paragraphs 13-26 of this paper)

   (d) Classification of leases—land and building elements within one property lease component (paragraphs 27-46 of this paper).

5. For the purposes of this discussion, we refer to:

   (a) a lease for which the lessee recognises interest on the lease liability separately from amortisation on the right-of-use asset, and the lessor recognises a lease receivable and residual asset, as a **Type 1** lease.

   (b) a lease for which the lessee recognises a straight-line single lease expense, and the lessor continues to recognise the underlying asset, as a **Type 2** lease.

Summary of staff recommendations

6. The staff recommend:

   (a) including guidance in the ED on how to identify separate lease components that is similar to the guidance in paragraph 28 of the 2011 Revenue Recognition ED setting out how to identify separate performance obligations—a draft of the suggested guidance is included in paragraph 11 of this paper.

   (b) including guidance in the ED that states that an entity should determine whether a lease (that includes both property and non-property elements) is a property lease or a lease of assets other than property on the basis of the nature of the primary asset within the lease component.

   (c) *not* including a requirement to allocate lease payments between the land and building elements of a property lease when classifying that property lease.

Lease components

7. A lease is defined as ‘a contract that conveys the right to use an identified asset (the underlying asset) for a period of time in exchange for consideration’. Some contracts convey the right to use not just a single asset but a bundle of assets. For example, a lease of a port (incorporating land, warehouses and equipment (eg

cranes)), a lease of a farm (incorporating a farmhouse, a farmyard and buildings, farming land, and equipment (eg a milking parlour)), a lease of a manufacturing plant (incorporating the building, the land on which the building is situated and equipment installed in the plant) all involve bundles of assets. Further examples are set out in paragraph 12 of this paper.

8. The boards decided that an entity should allocate the consideration in a contract to each lease component and have provided guidance as to how to do that allocation. However, the ED (as currently drafted) does not include guidance on identifying when to bundle underlying assets together and treat them as the subject of one lease component, or when to consider the right to use a single asset as a separate lease component.

9. We think that it would be helpful to include some guidance in the ED to help entities assess whether, having concluded that a contract contains a lease, the contract contains one lease component or multiple lease components that should be classified and accounted for separately. Although one could argue that an entity already has to determine whether it has one or more lease components under existing standards (and it does so without any specific guidance in IFRSs and only limited guidance in US GAAP), we think that including such guidance in the ED would be helpful in the light of the changes being proposed regarding the classification of leases. We also understand that there are issues in practice today in this respect.

10. We recommend using the proposals in the revenue recognition project regarding the identification of separate performance obligations for the purpose of identifying separate lease components, ie the guidance in the revenue recognition proposals identifying when a good or service is distinct—Appendix A to this paper includes the relevant extract from the 2011 Revenue Recognition ED. We view the identification of separate lease components in a lease contract as a requirement that is similar to the identification of separate performance obligations in a revenue contract—in both circumstances, an entity is trying to identify when a customer/lessee is contracting for multiple separate deliverables versus when it is contracting for one deliverable that may incorporate a number of

different assets. We think that the revenue recognition guidance regarding the identification of separate performance obligations would work well if the boards agree that guidance should be added to the ED regarding the identification of separate lease components. In our view, this is a better solution than attempting to develop new guidance within the leases standard.

11. Accordingly, we would propose to include guidance similar to the following in the ED:

> An entity would consider the right to use an identified (underlying) asset to be a separate lease component if the lessee can benefit from the use of the identified asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events).
>
> An entity would account for each separate lease component as a separate lease, subject to the guidance on the allocation of consideration in a contract within the leases ED.

12. The following examples illustrate how we would anticipate this principle being applied:

> *Example 1* *Lessee leases a specified floor of a building. The lease provides access to the floor via a lift and heating/air-conditioning from the centralised heating/air-conditioning system.*
>
> The contract contains one lease component. An entity could not benefit from using the floor independently of the lift or heating/air-conditioning, nor from using the lift or heating/air-conditioning independently of the floor.
>
> *Example 2* *Lessee leases a building without any surrounding land but the lease of the building incorporates the land on which building is situated.*
>
> The contract contains one lease component. It is not possible to benefit from the use of the building independently of the land on which it is situated.
>
> *Example 3* *Lessee leases an 'out-of-town' retail space with surrounding land for parking and deliveries. Because the lease is for a retail location, a retailer would not lease the building without space for parking and deliveries.*
>
> The contract contains one lease component. A retailer could not benefit from the use of the retail space independently of the surrounding land for parking and deliveries, and vice versa.

Example 4 Lessee leases a retail space with surrounding land for parking and deliveries, plus an additional plot of land which, for example, could be redeveloped independently of the retail space.

The contract contains two lease components. The retail space with surrounding land for parking and deliveries is one lease component, and the additional plot of land another. An entity could benefit from the use of the additional plot of land on its own (eg by sub-leasing or redeveloping the plot for another purpose).

Example 5 Lessee leases a manufacturing plant with two large pieces of manufacturing equipment installed. The lessor does not lease or sell the equipment separately but other suppliers do.

The contract contains three lease components—the manufacturing plant (ie the plant and the land on which it is situated) is one lease component, and the two items of equipment are two separate lease components. An entity could benefit from the use of each item of equipment on its own because it can be purchased or leased separately. Because of this, an entity can also benefit from the use of the plant on its own (ie the equipment needed to facilitate using the plant for manufacturing purposes could be purchased or leased separately and installed in the plant). In this example, an entity would conclude that the plant and the equipment are separate lease components, even if the lessor has stipulated that the plant cannot be leased without also leasing the equipment.

Example 6 Lessee leases a large turbine housed in a building plus the land on which the turbine is situated. The building exists only to house the turbine, and the life of the building is directly tied to the life of the turbine (ie when the turbine can no longer be used and is dismantled, the building will be demolished).

The contract contains one lease component. An entity could not benefit from the use of the turbine independently of the building and land on which it is situated, and vice versa.

Example 7 Lessee leases an oil storage tank, including the land on which the tank is situated and the surrounding area to access the tank.

The contract contains one lease component. It is not possible to benefit from the use of the storage tank independently of the land on which it is situated.

Example 8 Lessee leases space on a telecommunications tower, including (indirectly) a piece of the land on which the tower is situated.

The contract contains one lease component. It is not possible to benefit from the use of the space on the tower independently of the land on which it is situated, and vice versa.

Example 9 Lessee leases an identified space of 15,000 square feet in a building for 5 years. After 5 years, the space being leased increases to 25,000 square feet (the original 15,000 square feet plus an additional identified *space of 10,000 square feet in the same building) and the contract continues for a further 5 years.*

The contract contains two lease components—one lease for the original space of 15,000 square feet for 10 years, and a second lease for the additional space of 10,000 square feet for 5 years, commencing 5 years after the commencement of the first lease. An entity could benefit from the use of the original space of 15,000 square feet on its own—it does so for the first 5-year period. An entity can also benefit from the additional space of 10,000 square feet on its own because it is a discrete portion of space, physically distinct from other space within the building.

Staff recommendation and question for the boards

Question 1 - Separate lease components

We recommend that the ED includes guidance on how to identify separate lease components that is similar to the guidance in paragraph 28 of the 2011 Revenue Recognition ED setting out how to identify separate performance obligations—a draft of the suggested guidance is included in paragraph 11 of this paper.

Do the boards agree with the staff recommendation?

Classification of leases—property and non-property elements within one lease component

13. In June 2012, the boards decided that the recognition of lease-related expenses by a lessee and the accounting applied by a lessor would depend on whether a lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

14. To simply the application of that classification principle, the boards decided to propose that the principle be applied differently to leases of property (ie land and/or a building (or part of a building)) than to leases of assets other than property (eg equipment and vehicles). Appendix B summarises the boards' decisions regarding lease classification.

15. The staff recommendation in paragraphs 7-12 above proposes that an entity would account for each separate lease component identified as a separate lease.

Accordingly, an entity would apply the classification guidance to each separate lease component.

16. Because the lease classification guidance is different depending on whether the underlying asset is property, some have questioned how an entity would determine whether the underlying asset is property when the underlying asset within one component contains both property and non-property elements. Some examples are included in paragraph 26 of this paper. US GAAP also states that equipment integral to real estate is regarded as real estate when the real estate is sold—some have also asked whether such equipment is regarded as property under the leases proposals.

Nature of the primary asset

17. One way to address this issue would be to include guidance stating that an entity would determine the nature of the underlying asset (ie whether the underlying asset is property) on the basis of the nature of the primary asset in the component. The primary asset would be the predominant asset for which the lessee has contracted for the right to use—the main purpose of leasing other assets that form part of the overall lease component might be to facilitate the lessee obtaining benefits from use of the primary asset.

18. If the primary asset is land and/or a building (or part of a building), an entity would classify the entire lease component using the property lease classification proposals. If the primary asset is anything other than land or a building, an entity would classify the entire lease component using the classification proposals for leases of assets other than property.

19. If an entity were unable to identify the primary asset, this may indicate that there is more than one lease component in the contract, which should each be classified and accounted for separately.

20. The ED could include guidance by way of examples that illustrate how to identify the primary asset—paragraph 26 of this paper includes some examples. Those examples illustrate that more leases are likely to be regarded as leases of assets

other than property under this approach than under the approach discussed below in paragraphs 22-25.

21. The advantages of this approach are that it should be relatively straight-forward to apply and should result in conclusions that follow the nature of most leases—ie it is a qualitative assessment that would require entities to conclude on what is the most important element of a lease, which we would expect to be relatively clear in most situations. The disadvantage is that there may be some leases (eg leases of telecommunications towers) that are priced similarly to more traditional property leases, which would be classified on a basis different from those more traditional property leases. This is because, under this approach, we think that the primary asset in a lease of a telecommunications tower would be the tower itself and, thus, an asset other than property—refer to the examples in paragraph 26 of this paper.

Property lease if any property element

22. An alternative approach would be to include guidance in the ED stating that a lease component is regarded as a property lease for classification purposes if that component includes any property element (ie if the lease either directly or indirectly includes a land or building element because the lessee has the right to use an asset or assets that occupy space on, or are fixed to, land or a building).

23. This approach is likely to result assets that are currently regarded as integral equipment under US GAAP being regarded as property under the leases proposals, assuming that the integral equipment is *not* considered to be the subject of a separate lease component. Integral equipment is defined in US GAAP as 'any physical structure or equipment attached to real estate that cannot be removed and used separately without incurring significant cost'. Integral equipment is regarded as real estate when it is sold and, thus, an entity applies the requirements relating to real estate sales when such equipment is sold together with the real estate to which it is attached.

24. Again, the ED could include guidance by way of examples that illustrate how this approach should be applied—paragraph 26 of this paper includes some examples.

Those examples illustrate that more leases are likely to be regarded as property leases under this approach than under the primary asset approach discussed above in paragraphs 17-21.

25. This approach should also be straight-forward to apply in that it should be clear for most leases whether the lease component incorporates a land or building element. However, the disadvantage is that a lease that is, for all intents and purposes, a lease of equipment, priced similarly to leases of other equipment, could be regarded as a property lease for the purposes of classification. This is because a lease would be regarded as a property lease even when the land and/or building elements are an immaterial portion of the overall lease (for example, the turbine example included in the table below).

26. Using the same examples that were discussed previously in paragraph 12 of this paper, the following illustrates how we would anticipate both of these approaches being applied:

Example	***Lease components***	***Primary asset approach***	***Property element approach***
<u>Example 1</u> Lessee leases a specified floor of a building. The lease provides access to the floor via a lift and heating/air-conditioning from the centralised heating/air-conditioning system.	One lease component	Primary asset is the floor of the building. Property lease.	Property lease.
<u>Example 2</u> Lessee leases a building without any surrounding land but the lease of the building incorporates the land on which building is situated.	One lease component	Primary asset is the building. Property lease.	Property lease.
<u>Example 3</u> Lessee leases an 'out-of-town' retail space with surrounding land for parking and deliveries. Because the lease is for a retail location, a retailer would not lease the building without space for parking and deliveries.	One lease component	Primary asset is the retail space. Property lease.	Property lease.
<u>Example 4</u> Lessee leases a retail space with surrounding land for parking and deliveries, plus an	Two lease components—the retail space	Primary asset in both lease components is property.	Two property leases.

Example	***Lease components***	***Primary asset approach***	***Property element approach***
additional plot of land which, for example, could be redeveloped independently of the retail space	with surrounding land is one component; the additional plot of land another.	Two property leases.	
<u>Example 5</u> Lessee leases a manufacturing plant with two large pieces of manufacturing equipment installed. The lessor does not lease or sell the equipment separately but other suppliers do.	Three lease components—manufacturing plant (including the land on which it is situated) is one; the two items of equipment are two separate lease components.	Component 1: Primary asset is the plant. Property lease. Components 2 and 3: Primary asset is the equipment. 2 equipment leases.	Component 1: Property lease. Components 2 and 3: 2 equipment leases.
<u>Example 6</u> Lessee leases a large turbine housed in a building plus the land on which the turbine is situated. The building exists only to house the turbine, and the life of the building is directly tied to the life of the turbine (ie when the turbine is dismantled, the building will be demolished).	One lease component	Primary asset is the turbine. Equipment lease.	Property lease—the lease incorporates a land element and building element.
<u>Example 7</u> Lessee leases an oil storage tank, including the land on which the tank is situated and the surrounding area to access the tank.	One lease component	Primary asset is the storage tank—lessee leases the land on which the tank is situated only as a means to obtain the right to use the tank. Equipment lease.	Property lease—the lease incorporates a land element.
<u>Example 8</u> Lessee leases space on a telecommunications tower, including (indirectly) a piece of the land on which the tower is situated and the surrounding area to access the tower.	One lease component	Primary asset is the space on the telecommunications tower—the lessee leases the land on which the tower is situated only as a means to obtain the right to use the tower. Equipment lease.	Property lease—the lease incorporates a land element.

Example	***Lease components***	***Primary asset approach***	***Property element approach***
Example 9 Lessee leases an identified space of 15,000 square feet in a building for 5 years. After 5 years, the space being leased increases to 25,000 sq ft (the original 15,000 sq ft plus an additional identified space of 10,000 sq ft in the same building) and the contract continues for a further 5 years.	Two lease components—one lease for the original space of 15,000 sq ft for 10 years; another for the additional space of 10,000 sq ft for 5 years, commencing 5 years after the commencement of the first lease.	Primary asset for both components is the space in the building. 2 property leases.	2 property leases.

Staff recommendation and question for the boards

Question 2 - Identifying property and non-property leases

On balance, the staff recommend including guidance in the ED to clarify how an entity should determine whether a lease (that includes both property and non-property elements) is a property lease or a lease of assets other than property for classification purposes.
For the reasons noted in paragraphs 21 and 25 of this paper, we recommend that an entity should determine the nature of the underlying asset on the basis of the nature of the primary asset within a lease component.

Do the boards agree with the staff recommendation? If not, what do you propose?

Classification of leases— land and building elements within one property lease component

27. As noted previously, in June 2012, the boards decided that the recognition of lease-related expenses by a lessee and the accounting applied by a lessor would depend on whether a lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

28. To simplify the application of that classification principle, the boards decided to propose that the principle be applied in the following way to leases of property (defined as land and/or a building (or part of a building)):

> A property lease is classified as a Type 2 lease, unless one of the following two criteria is met:
> (i) The lease term is for the major part of the economic life of the underlying asset.
> (ii) The present value of the lease payments accounts for substantially all of the fair value of the underlying asset.
> If either criterion above is met, the lease is a Type 1 lease

Appendix B summarises the boards' decisions regarding lease classification more holistically.

29. The guidance regarding the practical application of the classification principle to property leases uses the wording from IAS 17 when assessing whether a lease transfers substantially all of the risks and rewards incidental to ownership of the underlying asset to the lessee, ie IAS 17 uses the phrases 'major part of the economic life' and 'substantially all of the fair value'. Accordingly, by including the 'unless' criteria referring to the economic life and fair value of the underlying asset, the classification guidance is intended to ensure that property leases that are classified as finance leases according to IAS 17 (or capital leases according to US GAAP) would be classified as Type 1 leases under the leases proposals.

30. The existing guidance in both IFRSs and US GAAP for property leases, however, also requires an entity to allocate lease payments between the land and building elements of a property lease when applying the classification requirements, with some exclusions. Lease payments are allocated in proportion to the relative fair values of the leasehold interests in the land and building elements. US GAAP is more prescriptive than IFRSs regarding the scope of property leases to which the requirements relate. For example, a US GAAP preparer is not required to allocate lease payments between the land and building elements of a property lease when the fair value of the land is less than 25 per cent of the total fair value of the leased property, and there is also relief for multi-tenanted properties. When the allocation between land and building is required, US GAAP also allows a lessee to

determine the portion of the lease payments relating to the land element as the fair value of the land multiplied by the lessee's incremental borrowing rate.

31. The requirements in paragraphs 15A-18 of IAS 17 appear to be more onerous in that an entity is required to allocate lease payments between the land and building elements of a property lease 'whenever necessary in order to classify and account for a lease of land and buildings', although this is not required if the land element is immaterial or if it is clear that both elements are either finance or operating leases.

32. Because it is included in existing leases standards, there is a question as to whether this requirement to allocate lease payments between the land and building elements of a property lease should also be carried forward into the ED.

Include the allocation of lease payments requirements in the ED

33. If the ED were to include a requirement to allocate lease payments between the land and building elements of a property lease, an entity would be required to do the following:

    (a) For lease classification purposes, allocate lease payments between the land and building elements of a property lease in proportion to the relative fair values of the right of use relating to the land and building elements. An entity would be required to do so even when it has concluded that there is only one lease component in the contract.

    (b) If the entity concludes that the land element is a Type 2 lease and the building element is a Type 1 lease, account for the lease as two separate leases.

    (c) If the entity concludes that both the land and building elements of a property lease are classified in the same way, account for the lease as a single lease.

Arguments for including the requirements

34. The existing guidance is there for a reason. There are some longer-term property leases (including some sale and leaseback transactions) the economics of which are that the lessee is, in effect, purchasing the building and leasing the land on which it is situated. For example, a 20-year lease of a manufacturing plant (which embeds the lease of the land on which it is situated) for which the plant is expected to have very little, if any, remaining service potential at the end of the 20-year period; however the land may not be consumed to any real extent over that 20-year period. If the lease payments were not allocated to the land and building elements separately, the result might be that the entire lease would be classified as an operating lease today, or a Type 2 lease under the leases proposals. This might result if the fair value of the land element represents a substantive proportion of the fair value of the leased property. In that case, the present value of the overall lease payments may not account for substantially all of the fair value of the leased property. If the lease were classified as a Type 2 lease, the accounting would not reflect the economics of the transaction.

35. If the guidance is not carried forward in the ED, there is a risk that some leases of buildings that are classified as finance/capital leases under existing requirements would *not* be classified as Type 1 leases under the proposals. It would appear to be counterintuitive to conclude that a lessee does *not* consume more than an insignificant portion of the economic benefits embedded in a building when, under existing standards, an entity would conclude that the lessee obtains substantially all of the risks and rewards of ownership of the building.

36. Although the requirements appear to be very onerous, both IFRS and US GAAP preparers have to apply those requirements today. Even though IAS 17 does not specifically exclude any property leases from the scope of the requirements to allocate lease payments to land and building elements, in practice the exercise is typically performed only when it is clear that the building element may be a finance lease and the land element an operating lease. So, for example, the allocation would not typically be done for 3-year, 5-year, 10-year and even 15-

year leases for which it is clear that the underlying building has a much longer economic life.

Exclude the allocation of lease payments requirement from the ED

37. In the absence of the allocation of lease payments requirement for property leases, the ED would propose that each lease component is classified and accounted for as a single lease, but there would be no requirement to split one lease component into land and building elements for classification or accounting purposes.

38. Under this approach, when classifying a property lease (with land and building elements) using the guidance set out in paragraph 28 of this paper, we would recommend that the economic life of the building would be regarded as the economic life of the property.

Arguments for excluding the requirements

39. Simplicity—the classification proposals would be much simpler to apply without requiring the lease payments within one lease component to be allocated between elements within that component. We have been informed by some in the property leasing industry that it would be impossible to do an allocation for all property leases that include both land and building elements (for example, how would an entity allocate lease payments to the land element embedded in the lease of the 20^{th} floor of an office building?). The boards could decide to narrow the scope of property leases to which the allocation requirements would apply. However, this would complicate the classification requirements, creating the need to distinguish between different property leases.

40. It could be argued that there is little benefit from including a requirement to allocate lease payments for the following reasons:

    (a) Both the land and building elements of most property leases will be classified as Type 2 leases, regardless of whether an entity is required to allocate lease payments to the land and building elements of a property lease for classification purposes. There is little, if any, benefit in requiring the allocation if an entity would classify both the land and the building elements in the same way.

(b) Building leases that are classified as finance/capital leases under existing standards are likely to be classified as Type 1 leases under the leases proposals because of the economic life criterion within the classification proposals. The proposed classification guidance (set out in paragraph 28 above) states that a property lease would be classified as a Type 1 lease if *either* the economic life criterion *or* the fair value criterion is met. When the economics of the lease are such that the lessee is, in effect, purchasing the building, we would expect the lease term to be for at least the major part of the remaining economic life of the building. Accordingly, we would expect any finance/capital leases of buildings under existing standards to be classified as Type 1 leases under the proposals, regardless of whether the allocation of lease payments requirement is included in the ED. For example, in the 20-year manufacturing plant example in paragraph 34 of this paper whereby the lease is such that the lessee is, in effect, purchasing the plant, we would expect the 20-year lease term to be regarded as a major part of the economic life of the plant.

41. Excluding the allocation of lease payments requirement would be more consistent with the approach regarding the identification of lease components set out in paragraphs 7-12 of this paper. Under this approach, an entity would be required to account for a lease of land and buildings separately only if the land and buildings are separate lease components (ie only if the lessee could benefit from use of the land independently of the use of the building, and vice versa). The proposals would not require an entity to split one lease component into a number of elements.

42. Nonetheless, it is worth noting that *not* requiring the allocation of lease payments between the land and building elements of a property lease means that the entire lease will be classified as either a Type 1 or Type 2 lease, whereas the land and buildings elements could be classified differently if lease payments were to be

allocated to those elements. Using the 20-year manufacturing plant lease as an example, we would anticipate the lease being classified as a Type 1 lease in its entirety under this approach. Some may view the classification of the land element as a Type 1 lease to be inappropriate in the light of the classification principle based on consumption. Assuming that the land can be used for some considerable time beyond the 20-year lease term (and possibly can be used indefinitely), the lease could be viewed as incorporating two distinct elements—a lease of the plant for which the lessee will consume almost all, if not all, of the plant, and a lease of land for which the lessee will consume very little, if any, of the land.

Staff recommendation and question for the board

43. Having considered the costs and benefits of each approach, we recommend excluding the allocation of lease payments requirement in existing standards from the ED. In reaching this conclusion, we also note that the classification guidance in the leases proposals would no longer determine whether a lessee recognises leases on-balance sheet, as it does in existing standards. Accordingly, we think that the benefit of including the guidance is reduced given the changes being proposed to lessee accounting.

44. There are, however, two concerns that some might have with this recommendation:

    (a) Some building leases classified as finance/capital leases under existing standards could be classified as Type 2 leases under the leases proposals. We think that this should be a relatively rare occurrence given that a property lease will be classified as a Type 1 lease if the lease term is for a major part of the economic life of the building. If the boards agree with our recommendation to exclude the allocation of lease payments requirement, we would recommend that the classification proposals for property leases clarify that a property lease is a Type 1 lease if the lease term is for a major part of the remaining economic life of the property.[1] In addition, when the property contains both land and building elements, the economic life of the property would be regarded as the economic life of the building.

(b) Leases of land embedded within longer term building leases will be classified and accounted for as Type 1 leases when that element of the lease may have been priced assuming that the lessee will consume little, if any, of the land.

45. If the boards are concerned about the issue raised in paragraph 44(b) above but would not wish to require the allocation of lease payments to elements within all property leases, a solution would be to require an entity to allocate the lease payments to the land and building elements of a property lease *only* when it has concluded that the entire property lease component is a Type 1 lease. Under this approach:

(a) an entity would, as a first step, apply the classification guidance to the entire property lease component. If the entity concludes that the lease is a Type 2 lease, nothing further needs to be done.

(b) If the entity concludes that the lease is a Type 1 lease, then the entity would, as a second step, reassess whether the land element is a Type 1 or Type 2 lease by allocating the lease payments to the land and building elements in proportion to the relative fair values of the right-of-use relating to the land and building elements.

46. If the boards disagree with the staff recommendation and decide to include the allocation of lease payments requirement in the ED, we recommend that the guidance permit a lessee to calculate the lease payments attributable to the land element as the fair value of the land multiplied by the lessee's incremental borrowing rate, as is permitted in existing US GAAP. We understand that this approach is often permitted in practice when applying the requirements in IFRSs.

[1] It is worth noting, however, that when classifying leases of assets other than property, the ED will propose that the economic life of the asset would be the total economic life of the asset, assuming that the asset is new at lease commencement.

Although using the lessee's incremental borrowing rate may not result in a strictly accurate allocation of lease payments, the ED proposes to permit the use of the lessee's incremental borrowing rate as an alternative to the rate charged by the lessor when measuring lease assets and liabilities. Consequently, we do not see any reason to prevent its use when allocating lease payments to elements within one lease component for the purposes of classification.

Question 3 - Land and building elements of a property lease

The staff recommend *not* including a requirement to allocate lease payments between the land and building elements of a property lease when classifying that property lease.

Do the boards agree with the staff recommendation? If not, what do you propose and why?

APPENDIX A—Extract from the 2011 Revenue Recognition ED

27 If an entity promises to transfer more than one good or service, the entity shall account for each promised good or service as a separate performance obligation only if it is distinct. If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or service until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in an entity accounting for all the goods or services promised in a contract as a single performance obligation.

28 Except as specified in paragraph 29, a good or service is distinct if either of the following criteria is met:

(a) the entity regularly sells the good or service separately; or

(b) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer. Readily available resources are goods or services that are sold separately (by the entity or by another entity) or resources that the customer has already obtained (from the entity or from other transactions or events).

29 Notwithstanding the requirements in paragraph 28, a good or service in a bundle of promised goods or services is not distinct and, therefore, the entity shall account for the bundle as a single performance obligation if both of the following criteria are met:

(a) the goods or service in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and

(b) the bundle of goods or service is significantly modified or customised to fulfil the contract.

APPENDIX B—Boards' lease classification decisions

B1 An entity would classify a lease as a Type 1 lease or a Type 2 lease on the basis of whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

B2 When the underlying asset is property (ie land and/or a building (or part of a building)), a lease is classified as a Type 2 lease, unless one of the following two criteria is met:

(a) The lease term is for the major part of the economic life of the underlying asset.

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

If either criterion above is met, the lease is a Type 1 lease.

B3 When the underlying asset is an asset other than property, a lease is classified as a Type 1 lease, unless one of the following two criteria is met:

(a) The lease term is for an insignificant part of the economic life of the underlying asset.

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

If either criterion above is met, the lease is a Type 2 lease.