STAFF PAPER

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Prepared for joint Capital Markets Advisory Committee and Global Preparers Forum meeting

Project	**Leases**		
Paper topic	Revised Exposure Draft—costs and benefits of lessee accounting proposals		
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Introduction and background

1. On 16 May 2013, the IASB and the FASB (the boards) published a revised Exposure Draft *Leases* (the 2013 ED) for public comment. The comment period is open until 13 September 2013.

2. The objective of the project is to improve the quality and comparability of financial reporting by providing greater transparency about leverage, the assets a company uses in its operations, and the risks to which it is exposed from entering into lease transactions.

3. The boards are interested in your views on the proposals and, in particular at this meeting, on the benefits and costs of the lessee accounting proposals.

4. The 2013 ED is available on the IASB's website here: http://go.ifrs.org/leases. The IASB has included its preliminary views on the costs and benefits of the proposals in the 2013 ED—the effects analysis prepared by the IASB is available in paragraphs BC329-BC466 of the Basis for Conclusions (beginning at page 92 of the Basis for Conclusions)—that effects analysis is reproduced as Agenda Paper 4B.

5. Agenda Paper 4A is the Leases Snapshot, which provides a high-level overview of the proposals.

Information about the Capital Markets Advisory Committee (CMAC) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/CMAC/Pages/CMAC.aspx

Information about the Global Preparers Forum (GPF) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/Pages/Global-preparers-forum.aspx

The lessee accounting proposals

The balance sheet

6. Leases create assets and liabilities for a lessee and the boards are of the view that those assets and liabilities should be reported on a lessee's balance sheet.

7. Consequently, similarly to the proposals in the 2010 *Leases* Exposure Draft (the 2010 ED), the lessee accounting proposals in the 2013 ED are based on a 'right-of-use' model. The model reflects that, when the lessee takes possession of an asset at the start of a lease, the lessee obtains a right to use the asset (the underlying asset) for a period of time, and the lessor has provided or delivered that right.

8. Accordingly, the 2013 ED proposes that a lessee would recognise a right-of-use asset and a lease liability for *all* leases of more than 12 months (the 12 months providing practical relief to preparers). A lessee can choose to recognise a right-of-use asset and a lease liability for leases of 12 months or less but is not required to do so.

9. In response to concerns raised about the cost and complexity of the measurement proposals in the 2010 ED, the boards have simplified how lease assets and liabilities are measured. The right-of-use asset and lease liability are initially measured at the present value of the (contractual) lease payments. The right-of-use asset also includes any costs incurred that are directly related to entering into the lease. The lease payments to be included in the measurement of lease assets and liabilities:

   (a) exclude variable lease payments linked to future sales or use;

   (b) exclude payments in optional renewal periods unless the lessee has a significant economic incentive to exercise the option; and

   (c) include variable lease payments linked to an index or a rate but measured based on the spot rate at the reporting date. The lessee would remeasure the lease liability during the lease term when the index-linked or rate-linked lease payments change.

10. Page 4 of the Snapshot (Agenda Paper 4A) provides an overview of the lessee accounting model.

Question 1: the balance sheet

Question 1: Recognition of assets and liabilities arising from a lease
Do you agree that leases create assets and liabilities for a lessee and that those assets and liabilities should be reported on a lessee's balance sheet, ie do you agree with the boards that the benefits of including lease assets and liabilities on the balance sheet substantially exceed the costs of doing so, bearing in mind the simplifications made regarding the measurement of lease assets and liabilities? Please provide specific examples and reasons to support your views. It would be useful if preparers could discuss this question within the context of the systems that they already have in place to account for finance leases and the systems used to prepare the note disclosures already required today by IAS 17 *Leases* for operating leases. Refer to paragraphs BC346-BC413 of the Basis for Conclusions of the 2013 ED for more information on the IASB's views in this respect. In particular, paragraphs BC346-BC374 discuss the benefits for users of financial statements and other potential effects from the proposals, and paragraphs BC403-BC412 discuss the expected costs for preparers of applying the proposals. These paragraphs are available in Agenda Paper 4B.

Dual approach to the recognition of lease expense and cash flows

11. The 2013 ED proposes a dual approach to the recognition, measurement and presentation of expenses and cash flows arising from a lease, to better reflect the differing economics of different lease contracts. The boards introduced a dual approach in responses to feedback on the 2010 ED. Many noted that a single lessee accounting model would not reflect the differing economics of the wide variety of lease contracts.

12. The principle in the 2013 ED for determining which approach to apply is based on the amount of consumption of the underlying asset. This reflects that there is a difference between a lease for which the lessee pays for the part of the underlying asset that it consumes (or uses up) during the lease term, and a lease for which the

lessee merely pays for use of the asset. That difference forms the basis of the dual approach, which leads to different recognition of lease expense for most equipment and vehicle leases (for which a part of the underlying asset would be consumed by the lessee) and most property (real estate) leases (for which there would be little consumption of the property by the lessee).

13. A lessee would account for most equipment and vehicle leases similarly to how it accounts for finance leases today, ie a lessee would typically amortise the right-of-use asset on a straight-line basis, and recognise interest on the lease liability, which would typically be higher in the earlier years of a lease. In the statement of cash flows, the lessee would include the repayments of the principal portion of the lease liability within financing activities and would classify the unwinding of the discount on the lease liability in accordance with the requirements in IAS 7 *Statement of Cash Flows*.

14. A lessee would account for most property leases (ie leases of land and/or a building) by recognising a single lease expense (which combines the amortisation of the right-of-use asset and interest on the lease liability) on a straight-line basis. The amount of the amortisation and interest would be disclosed separately in the notes. In the statement of cash flows, the lessee would include payments arising from those property leases within operating activities.

15. In summary:

    (a) for most equipment and vehicle leases currently considered to be operating leases, a lessee's balance sheet, income statement and cash flow statement would change. Consequently, all three of the main statements presented by a lessee that leases a significant amount of operating leases of equipment or vehicles would be expected to change under the proposals (eg airlines, transport companies); and

    (b) for property leases currently considered to be operating leases, only a lessee's balance sheet would change—the income statement and cash flow statement would remain unchanged. Consequently, only the balance sheet presented by a lessee that predominantly leases property would be expected to change although that change could be significant (eg retailers, hotel chains, restaurant chains).

16. Pages 5-7 of the Leases Snapshot (Agenda Paper 4A) provides more information about the consumption principle and the accounting proposed for most equipment and vehicle leases (often referred to as 'Type A' leases in the 2013 ED) and most property leases (often referred to as 'Type B' leases in the 2013 ED).

Question 2—the dual approach

17. In response to feedback received, the boards have introduced a dual approach to the recognition of lease expenses and cash flows by a lessee to better reflect the differing economics of lease contracts. In introducing the dual approach, the boards have attempted to reduce the costs associated with applying the dual approach by, for example, simplifying the application of the consumption principle. Nonetheless, the dual approach adds complexity to the proposals compared to having a single lessee accounting approach. That is because it requires a lessee to classify its leases and, if the lessee has both types of leases, to develop systems to account for leases in two different ways. Both of these steps would not be required under a single approach.

Question 2A: dual approach to recognising lease expenses and cash flows (investors and analysts)

Do you agree that the resulting accounting would provide useful information to users of financial statements if, in the income statement, a lessee would account for:

(a) most equipment and vehicle leases similarly to finance leases today, presenting amortisation of the right-of-use asset separately from interest expense on the lease liability; and

(b) most property leases similarly to operating leases today, presenting a single lease expense on a straight-line basis (with amortisation and interest disclosed in the notes to the financial statements)?

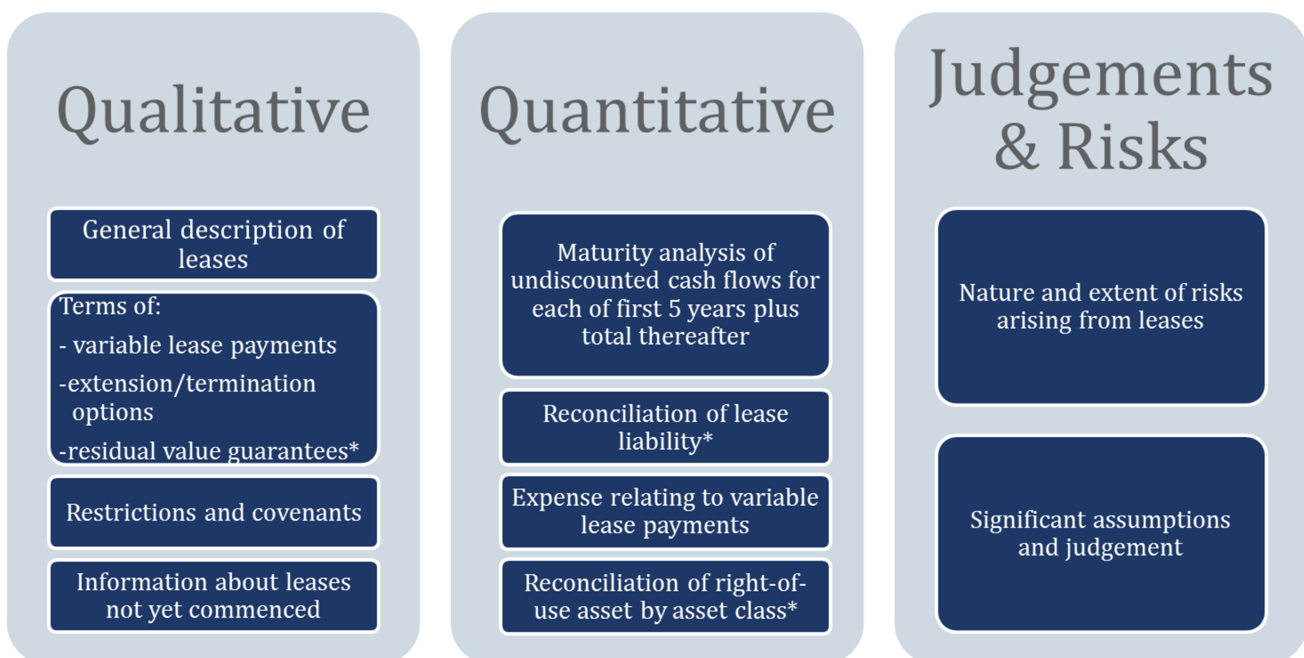
Is the additional benefit worth adding complexity to the lessee accounting proposals by introducing a dual approach?

Please provide specific examples and reasons to support your views.

Question 2B: dual approach to recognising lease expenses and cash flows (preparers)
Do you think that the dual approach would add a significant amount of cost when implementing the proposals compared to a single approach, considering in particular the lease classification proposals in paragraphs 28-34 of the 2013 ED (reproduced in the appendix to this paper) and whether you expect to predominantly have Type A leases only, Type B leases only or both? Please provide specific examples and reasons to support your views, including reference to your leasing activities and the systems you currently have in place to account for, for example, finance leases or items of property, plant and equipment.

Disclosures in the notes to the financial statements

18. The following table provides an overview of the proposed disclosure requirements for lessees:



19. Most of the qualitative disclosures are already required by IAS 17, as is the disclosure of the expense relating to variable lease payments. The 2013 ED proposes to require more detail in the maturity analysis of undiscounted cash flows than is currently required by IAS 17 (ie undiscounted cash flows for each of the first five years after the reporting date) and requires a reconciliation of the

opening to closing balance of the right-of-use asset by asset class and the lease liability (separately for most property leases and most other leases).

Question 3—disclosures in the notes to the financial statements

Question 3A: disclosures in the notes to the financial statements (investors and analysts)
When considering the package of information in the main statements (balance sheet, income statement and cash flow statement), together with the disclosures: **- What is missing?** **- What is included but not particularly useful for your analysis?** Please provide specific examples and reasons to support your views. In particular, we are interested in your views on: - the qualitative disclosure proposals in the 2013 ED, which are similar to the qualitative disclosure requirements in IAS 17. We are aware that, today, some companies with a significant amount of leases provide very little information about their leases, including companies that have leases with extension options and variable lease payments. Should the boards, for example, ask for the qualitative information by class of underlying asset, or by class of underlying asset and by territory (geographical location)? Should the boards specifically ask for information about the range of lease terms or average lease terms for each class or subclass of underlying asset? Do you have other suggestions? - the quantitative disclosure proposals in the 2013 ED. The IASB has been informed in the past that reconciliations of the opening to closing balance of assets and liabilities are useful for users of financial statements but we have also heard from some preparers that these reconciliations are costly to prepare and disclose. We are trying to determine whether the benefit of the reconciliations exceed the costs associated with preparing that information.

Question 3B: disclosures in the notes to the financial statements (preparers)

Do you anticipate that the costs of providing any of the proposed disclosure requirements will be significant and potentially exceed the benefit?

Please provide specific examples and reasons to support your views, referring to each proposed disclosure requirement for which you think the costs would outweigh the benefit.

The qualitative information provided today by some lessees with a significant amount of leasing activities is extremely limited. Without additional requirements or guidance, some fear that the qualitative information provided by lessees may not be sufficient to provide users of financial statements with the information that they require to perform their analyses, particularly in the light of the measurement simplifications proposed in the 2013 ED. Do you have any suggestions as to how the boards could ensure that better qualitative information is provided by lessees about their leasing activities, including information about lease terms, extension options and variable lease payments, without increasing the costs for lessees excessively?

Appendix A: Classification guidance in the 2013 ED

Classification of leases

28 At the commencement date, an entity shall classify a lease as either a Type A lease or a Type B lease. An entity shall not reassess the classification after the commencement date.

29 If the underlying asset is not *property*, an entity shall classify a lease as a Type A lease unless one of the following two criteria is met:

(a) the lease term is for an insignificant part of the total *economic life* of the underlying asset; or

(b) the present value of the *lease payments* is insignificant relative to the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type B lease.

30 If the underlying asset is property, an entity shall classify a lease as a Type B lease unless one of the following two criteria is met:

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

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

If either criterion above is met, the lease is classified as a Type A lease.

31 Notwithstanding the requirements in paragraphs 29–30, a lease is classified as a Type A lease if a lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

32 If a lease component contains the right to use more than one asset, an entity shall determine the nature of the underlying asset on the basis of the nature of the primary asset within the lease component. An entity shall regard the economic life of the primary asset to be the economic life of the underlying asset when applying the classification criteria in paragraphs 29–30.

33 Notwithstanding the requirements in paragraph 32, if a lease component contains both land and a building, an entity shall regard the economic life of the building to be the economic life of the underlying asset when applying the classification criteria in paragraph 30.

34 When classifying a sublease, an entity shall evaluate the sublease with reference to the underlying asset (for example, the item of property, plant or equipment that is the subject of the lease), rather than with reference to the right-of-use asset.