# Effects analysis for leases (IASB-only)[1]

BC329 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely ongoing associated costs and benefits of each proposed IFRS—the costs and benefits are collectively referred to as 'effects'. The IASB gains insight on the likely effects of the proposals for new or revised IFRSs through its formal exposure of proposals, analysis and consultations with relevant parties.

BC330 The following sections describe those considerations. There are separate sections discussing effects on lessees and lessors, respectively.

## Summary

### Changes being proposed to the accounting requirements

BC331 Lease accounting (ie IAS 17 *Leases* within IFRS) has historically focused on identifying when a lease is economically similar to purchasing the asset being leased (the 'underlying' asset). When a lease is determined to be economically similar to purchasing the underlying asset, the lease is classified as a finance lease and is reported on the lessee's statement of financial position, and the lessor recognises a receivable from the lessee. All other leases are classified as operating leases and are not reported on the lessee's statement of financial position. Operating leases are accounted for like service contracts, with the lessee reporting a rental expense and the lessor reporting rental income (typically on a straight-line basis) in each period of the lease.

BC332 This Exposure Draft proposes significant changes to how a lessee accounts for operating leases of more than 12 months. For all practical purposes, the accounting for finance leases for both lessees and lessors would remain unchanged.

BC333 A lessee would recognise assets and liabilities for all leases of more than 12 months. The recognition and presentation of lease-related expenses in a lessee's statement of profit or loss and other comprehensive income, and cash paid for leases in the statement of cash flows, would largely depend on the nature of the underlying asset. The main effects are set out in the following paragraphs.

BC334 For most leases of equipment or vehicles (for example aircraft, ships, mining equipment, cars and trucks), a lessee would:

(a) recognise a right-of-use asset and a lease liability, initially measured at the present value of lease payments;

(b) recognise amortisation of the right-of-use asset separately from interest on the lease liability over the lease term; and

(c) separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).

BC335 Accordingly, a lessee's statements of financial position, profit or loss and other comprehensive income and cash flows would change for leases of equipment or vehicles classified as operating leases according to IAS 17.

BC336 For most leases of property (ie land and/or a building), a lessee would:

(a) recognise a right-of-use asset and a lease liability on a discounted basis, in the same way as it does for equipment and vehicle leases;

(b) recognise a lease expense on a straight-line basis over the lease term; and

(c) present the cash paid within operating activities.

BC337 Accordingly, only a lessee's statement of financial position would generally be expected to change for leases of property classified as operating leases according to IAS 17.

BC338 This Exposure Draft proposes less significant changes to how a lessor accounts for leases. For all practical purposes, there is little change for finance leases and operating leases of property. For lessors that enter into operating leases of equipment or vehicles, however, the changes proposed are significant. In summary, a lessor of most equipment and vehicle leases would:

[1] The Basis for Conclusions on the FASB's Exposure Draft includes the FASB's cost benefit analysis.

(a) recognise a lease receivable and a retained interest in the underlying asset (the residual asset), rather than recognising the underlying asset itself; and

(b) recognise interest income on both the lease receivable and the residual asset over the lease term.

BC339 In addition, if the lessor were a manufacturer or dealer lessor, the lessor might also recognise profit on the lease at the commencement date.

## Benefits for users of financial statements

BC340 The IASB expects the proposals in this Exposure Draft to improve the quality of financial reporting significantly for a number of reasons:

(a) for many lessees, the assets and liabilities that arise from operating leases are significant. Recognising assets and liabilities for all leases of more than 12 months would provide a more faithful representation of the financial position of a lessee and, together with enhanced disclosures, greater transparency about the lessee's leverage. Providing information about a lessee's undiscounted future lease payments only in the notes to the financial statements (as is required by IAS 17) is:

    (i) misleading for some users of financial statements (who rely on an entity's statement of financial position to provide information about leverage); and

    (ii) provides insufficient information for others (who often estimate a lessee's lease liabilities using makeshift techniques that produce estimates that can vary widely and may not be accurate—see paragraph BC352 for further information).

(b) recognising and presenting lease expenses arising from most equipment leases differently from those arising from most property leases would reflect the differing economics of most equipment leases and property leases.

(c) accounting for most equipment leases differently from most property leases from a lessor's perspective would reflect that, broadly speaking, a property lessor's business model is different from an equipment lessor's business model.

## Costs for preparers

BC341 Lessees with operating leases are expected to incur costs in implementing the proposals, the significance of which will depend on the terms and conditions of leases, the size of the lease portfolio and the systems already in place to manage leasing activities. Those costs would arise from, for example:

(a) the need to determine a discount rate for each lease of more than 12 months; and

(b) if a lessee enters into leases with variable lease payments that depend on an index or a rate, the need to remeasure the lease liability on the basis of the index or rate at the end of each reporting period.

Lessees would also incur costs to educate staff and update internal procedures. In providing the disclosures required by IAS 17, lessees are already required to have an inventory of leases and information about the lease term and future lease payments for each lease. Accordingly, costs are not expected to increase in this respect.

BC342 Lessees that have less sophisticated systems in place to manage and track leases are expected to incur more significant costs than lessees that have sophisticated systems.

BC343 Equipment and vehicle lessors that enter into operating leases are also expected to incur costs in enhancing and updating their accounting systems. Although most of those lessors would be expected to have the information required to apply the proposed accounting within their leasing businesses, that information may reside outside the accounting departments and there are likely to be costs associated with obtaining the information for accounting purposes.

## Conclusions of the IASB

BC344 On the basis of the information obtained about the effects of the proposals in this Exposure Draft, the IASB is of the view that the benefits that would arise from the proposals substantially exceed the expected costs.

BC345 The following sections discuss in more detail all of the following:

(a) the expected changes to the quality of financial reporting;

(b) the expected changes to amounts reported in the financial statements of those applying IFRS; and

(c) the expected costs of implementation for preparers and users.

## The likely effects for lessees

### Expected changes to the quality of financial reporting

#### *How the changes would provide more relevant information about, and a more faithful representation of, lease transactions*

BC346 According to the *Conceptual Framework*, if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. Information is relevant if it has predictive or confirmatory value. These characteristics are referred to as the fundamental qualitative characteristics of financial information.

BC347 Providing information about lease assets and lease liabilities as would be required under the proposals will make financial reporting more relevant than it is today under IAS 17. That is because a lessee would be required to recognise a right-of-use asset and lease liability for all leases over 12 months. Information about lease liabilities has predictive value because it provides information about minimum future cash outflows in relation to leases, which is useful for decision-making.

BC348 Although the disclosure of future lease payments required by IAS 17 has predictive value, that information alone is not as useful as the information provided under the proposals because it is shown only on an undiscounted basis. This makes it less comparable with information provided about other financial liabilities recognised in an entity's statement of financial position and measured on a discounted basis.

BC349 The IASB is of the view that a lease gives rise to a liability and an asset for the lessee and that liability and asset should be reported in the financial statements. The IASB does not view the commitments that arise from operating leases to be different from the commitments that arise from finance leases.

BC350 The IASB thinks that disclosure in the notes to the financial statements is not a substitute for recognising lease assets and lease liabilities, even when those disclosures aim to provide some of the information that would be provided if those assets and liabilities were to be recognised. This is because not recognising the assets and liabilities arising from leases provides a misleading picture in the statement of financial position of a lessee's leverage and the assets that the lessee uses in its operations.

#### *User needs regarding a lessee's lease assets and lease liabilities*

BC351 At present, many users of financial statements make adjustments to a lessee's financial statements to capitalise operating leases on a discounted basis and use those adjusted financial statements for their decision-making. In the user outreach that the IASB has conducted throughout the life of the project (meeting with users including buy- and sell-side equity analysts, credit analysts and representatives of investor groups), almost all users of financial statements said that they adjust lessees' statements of financial position by recognising lease assets and lease liabilities for operating leases.

BC352 The adjustments made by users of financial statements regarding operating leases are, however, based on estimates and short cuts because the information available about operating leases in the notes to the financial statements under IAS 17 is insufficient to allow them to make reliable adjustments. The adjustments can, therefore, be incomplete and inaccurate. Adjustment techniques are often not updated even though the economic environment surrounding lease transactions changes constantly, and, in more recent years, has changed dramatically. This means that the adjustment techniques employed may have little to do with the lessee's actual lease portfolio. This can result in users of financial statements making different adjustments, even when those users are attempting to measure the same amounts.

BC353 The IASB is of the view that the proposals for leases would significantly improve the quality of information provided to users of financial statements. This is because the information would provide a measure of all lease liabilities (incorporating fixed lease payments) on a discounted basis, as well as undiscounted cash flow information in the notes, prepared by lessees in a consistent manner. The measurement basis would also be consistent with the measurement of other similar financial liabilities, thereby providing better information about a lessee's leverage in the statement of financial position.

### *How the changes improve the comparability of financial information*

BC354 One of the biggest criticisms of IAS 17 is the significant difference in accounting between operating leases and finance leases. This means that two very similar transactions from an economic perspective could be reported very differently, which reduces comparability between entities.

### Statement of financial position

BC355 The proposals will significantly improve the comparability of financial information reported in the statement of financial position. Assets and liabilities for all leases of more than 12 months will be recognised, and all lease liabilities will be measured in the same way.

BC356 Under IAS 17, the majority of leases are classified as operating leases and, thus, do not result in the recognition of assets and liabilities.[2] Consequently, lessees with very different operating lease portfolios may look very similar both in terms of their reported financial position and performance. For example, if a lessee changes its lease portfolio in such a way that the portfolio consists of 10-year operating leases rather than two-year operating leases, this significant difference in the economic position and commitments of the lessee is not reflected in the reported assets and liabilities of the lessee, nor might it be evident from its profit or loss (it might be reflected only in the disclosures of operating lease commitments). In contrast, when a lessee changes the size of its lease portfolio by, for example, deciding to sell assets that it owns and leasing those assets back under operating leases, this significantly changes the lessee’s reported assets and liabilities when economically the change might not be very significant. The entity may continue to use the same asset base and have significant financial commitments under those operating leases, and yet its statement of financial position would imply a smaller asset base and very little financial debt.

BC357 According to the proposed requirements, accounting between leases and purchases will be more comparable because assets and liabilities arising from leases will be recognised. Nonetheless, entities that buy assets would not report the same amounts in the statements of financial position and profit or loss and other comprehensive income as those who lease assets, unless the lease is for all of the economic life of the underlying asset. The IASB concluded that this is appropriate because, even though economically similar, leases and purchases are not the same transactions. A lessee controls the right to use the underlying asset, not the underlying asset itself, and has a liability only for payments specified in the lease contract. However, recognising assets and liabilities arising from purchases as well as leases aids comparability and provides clarity about an entity’s financial liabilities.

BC358 In addition, the proposed requirements would provide better information when a lessee changes its financial flexibility by extending or shortening the length of its leases. According to the proposed requirements, any change in a lessee’s lease portfolio (for example, a change from two-year leases to 10-year leases as described in paragraph BC356) would be reflected in a lessee’s statement of financial position. Such a change would be reflected in a lessee’s statement of financial position under IAS 17 only if the leases were classified as finance leases or the leases changed from being operating leases to finance leases or vice versa.

### *Optional and variable lease payments*

BC359 The IASB considered whether the information provided about lease assets and lease liabilities in accordance with the proposals would be incomplete because:

(a) most variable lease payments are excluded from the measurement of lease assets and lease liabilities; and

(b) there is a high threshold for recognising lease payments that would be payable in optional renewal periods.

BC360 The simplified approach proposed regarding the measurement of such amounts means that lease assets and lease liabilities might be viewed as incomplete in some cases. The proposed requirements for variable lease payments and options could be viewed as causing the accounting for some economically similar contracts to be less comparable. For example, assume a lessee enters into a five-year lease with an option to extend for three years. The lessee intends to exercise the option but does not have a significant economic incentive to do so. Under the proposed requirements, the lessee would report different lease assets and lease liabilities arising from this lease than a lessee who enters into a lease for eight years. Those two contracts could be viewed as being economically similar transactions, for which the same assets and liabilities should be reported. There is, however, an important difference between the two contracts with respect to the financial

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2 Some surveys suggest that up to 80 per cent of leasing transactions today are operating leases, although the actual figures vary depending on the industry sector, region and entity.

flexibility provided by one contract but not by the other. The IASB concluded that this financial flexibility is best reflected by reporting different assets and liabilities for those two contracts.

BC361 To take another example, two leases of a similar retail outlet may be for the same lease term, with lease payments being fixed for one lease and linked to sales for the other, and the variable lease payments for the second lease are expected to be about the same as the fixed payments for the first lease. According to the proposed requirements, those two leases would be reported differently. Those two contracts could be viewed as economically similar transactions that would be best reported in the same way. However, even though both leases may result in the same cash outflows, the lessees are in different economic positions. For example, if there is an economic downturn resulting in lower than expected sales, the lessee with variable lease payments would make correspondingly smaller lease payments than the lessee with fixed lease payments. The opposite would apply in the case of significant growth. The IASB concluded that this difference in the contractual commitments of a lessee is best reflected by reporting different assets and liabilities for those two contracts.

### Statements of profit or loss and other comprehensive income and cash flows

BC362 The proposals retain a dual approach in relation to the recognition and presentation of lease expenses and cash flows for lessees, which means that there would not be comparability across all leases in the statements of profit or loss and other comprehensive income and cash flows. Some would prefer that comparability and would suggest having a single lessee accounting approach. Indeed, proposing a dual lessee accounting approach increases the complexity of the proposals compared to a single approach. That is because it requires a lessee to classify its leases and, if the lessee has both types of lease, to develop systems to account for leases in two different ways. Both of these steps would not be required under a single approach.

BC363 However, not all leases have the same economic characteristics. The different recognition and presentation of lease expenses and cash flows reflects the differing economics of different leases and, thus, is expected to provide useful information to users of financial statements. Leases of property are generally priced differently from equipment leases, largely because of the difference in the nature of the underlying asset and the amount of the underlying asset expected to be consumed over the lease term.

BC364 The proposal to require different recognition and presentation of lease expenses has been supported by feedback the IASB received from some users. A number of retail and restaurant analysts have informed the IASB that, whilst they support the recognition of lease assets and lease liabilities in a lessee's statement of financial position, they would find it most useful to have a single rent expense for property leases, similar to the operating lease expense recognised today for those leases. Those analysts tend not to adjust the reported expenses of lessees, but only adjust the reported assets and liabilities of lessees. A number of analysts that follow lessees that have operating leases of equipment (for example airline analysts), however, request that the accounting for leases of equipment be consistent with the accounting for purchases of equipment. They already adjust a lessee's profit or loss by allocating rent expense (which is typically an operating expense) between operating and financing expenses. Some users of financial statements allocate the rent expense using a set rate (for example, 33 per cent of rent expense allocated to interest expense and 67 per cent of rent expense allocated to depreciation expense), while other users allocate the expense by estimating the interest expense corresponding to the estimated lease liability, using the lessee's estimated borrowing rate. The proposed requirements should eliminate the need for some of those adjustments.

## Other potential effects

BC365 During its deliberations, the IASB also considered the following potential effects of the leases proposals:

(a) behavioural changes and structuring that may arise;

(b) increased cost of borrowing for lessees as a result of higher reported leverage; and

(c) increased regulatory capital requirements for banks and the effect on debt covenants.

Each of these is addressed below.

### *Behavioural changes and structuring*

BC366 The IASB considered whether the proposals might give rise to behavioural changes and provide incentives to structure transactions to achieve desired accounting outcomes. Examples include structuring leases as service contracts, reducing the length of lease terms and making lease payments variable, all in an attempt to recognise smaller lease liabilities.

BC367 The IASB expects some changes to the structure of leases but thinks a major reason for this would be the removal of the incentive in IAS 17 to structure a lease as an operating lease in order to achieve off-balance-sheet accounting.

BC368 According to research on lease accounting, some leases are currently structured to achieve a desired outcome, which is often operating lease accounting for lessees. For example, the SEC report on off-balance-sheet activities issued in 2005 says the following:

> "…when the FASB issued a standard in 1976 that required some lease obligations to be recorded on the balance sheet as liabilities, many lessees immediately began to restructure their leases to avoid recognizing liabilities. Their efforts were aided by parties who sought to profit from offering their expertise in structuring leases in ways that provided "preferable" accounting. Such structuring tends to reduce transparency. Indeed, oftentimes that is its point… The fact that lease structuring based on the accounting guidance has become so prevalent will likely mean that there will be strong resistance to significant changes to the leasing guidance, both from preparers who have become accustomed to designing leases that achieve various reporting goals, and from other parties that assist those preparers."

BC369 The proposals to recognise assets and liabilities for all leases over 12 months would remove the incentive to structure transactions to achieve off-balance-sheet accounting. Nonetheless, differences in the recognition and presentation of expenses for the two types of leases might give rise to some lessees trying to achieve a particular outcome in profit or loss. This incentive for structuring, however, is expected to be small because the differences in accounting are less fundamental. For example, when a lessee has a lease portfolio that is evenly distributed (ie the same number of leases with similar terms and conditions commence and expire during a period), there would be little, if any, effect on a lessee's profit or loss from applying Type A lease accounting or Type B lease accounting (see Appendix C for further information regarding the effects of the proposals on a portfolio of leases).

BC370 There may be a desire for some lessees to structure their contracts as services in order to achieve off-balance-sheet accounting. The IASB already expects that there will be fewer leases identified under the proposals than under IAS 17 because of the changes proposed to the guidance on the definition of a lease. In addition, the IASB expects that some contracts may be restructured to be service contracts because the customer genuinely requires a service and not a lease. The IASB does not, however, expect the proposed guidance on the definition of a lease to be easy to structure around if an entity wishes to obtain the right to use an asset. This is because the guidance is based on a principle—the lessee's right to control the use of an asset—and does not include bright lines. Typically, to avoid the proposed lease accounting, an entity would need to introduce changes to a contract that result in real economic differences, and those differences would in turn justify different accounting.

BC371 The IASB expects that some entities will re-examine their leasing activity as a result of applying the new requirements. This may result in changes to the lengths of leases, changes in payment terms or changes in lease versus buy decisions. This, however, is not always expected to be the result of a desire for structuring but also as a result of the greater transparency of information under the proposals. Although lessees, as parties to leases, might already be expected to have all relevant information about their leases, it is possible that some lessees do not pay as much attention to the efficiency of their leases, especially if lease decisions are decentralised. Because the proposals would require the recognition of lease assets and lease liabilities, entities will, for example, need to determine the discount rates charged in the lease and possibly identify scope for improvements in how they finance and operate their business. These changes would therefore be genuine business decisions, rather than changes motivated solely by accounting outcomes.

### *Increased cost of borrowing for lessees*

BC372 The IASB considered the effect the proposals might have on the cost of borrowing for lessees because lessees would report higher financial liabilities under the proposals. The IASB's outreach confirmed that many (including all of the credit rating agencies that participated in the outreach) already consider operating leases to be financial liabilities of a lessee, and already estimate the effect of the consequential leverage. Consequently, capitalising leases should not generally have an effect on the cost of borrowing that is equivalent to the effect of the total change in a lessee's reported financial liabilities. Instead, the IASB is of the view that any effect would reflect differences arising from more accurate information about the amount of borrowing relating to leases. It is possible that the cost of borrowing for some lessees may increase. Equally the cost of borrowing may actually decrease, depending on how different the lessee's recognised lease liabilities are from those that had been estimated by users of financial statements. Such changes (if they occur) would, therefore, result from improved decision-making based on improved transparency about the lessee's leverage.

### *Effects on covenants and regulatory capital*

BC373 The IASB also considered the effects the proposals might have on debt covenants and regulatory capital requirements. If debt covenants are linked to the amounts recognised in a lessee's IFRS financial statements, some entities may no longer comply with those covenants upon adoption of the proposed requirements and without changes to the terms and conditions of the covenants. In addition, the proposed requirements might increase the amount of risk weighted assets and thus affect the regulatory capital needs of lessees that are financial institutions.

BC374 The IASB has concluded that the proposed accounting requirements provide a more faithful representation of lease transactions. Accordingly, the IASB would expect amendments to be made to any requirements that depend on the accounting in IAS 17. The IASB is also aware that many debt covenants define their terms and conditions independently of accounting requirements and, thus, a change in accounting requirements would not affect the provisions of those covenants. Although the IASB's role includes considering the effects of its proposals, it does not include addressing territory-specific or entity-specific regulations, nor prudential regulations. However, the IASB will continue working to raise awareness of potential issues so they can be addressed on a timely basis. The IASB has an ongoing dialogue on the project with prudential regulators.

## The likely effect of proposed changes on how leasing activities would be reported in the financial statements of lessees applying IFRS

BC375 The proposals in this Exposure Draft would result in significant changes to how a lessee reports leases that are currently classified as operating leases. For all leases over 12 months, the proposals would require lessees to recognise the assets and liabilities that arise upon entering into a lease. There are also some changes to how lessees would report leases currently classified as finance leases, but those changes are not significant.

BC376 Because operating leases account for the majority of leasing transactions, the proposed requirements would have an effect on the financial statements of many lessees, especially lessees that have a large volume of, or high value, operating leases. The overall effect would be different for individual entities, depending on factors such as the capital intensity of the business, their lease versus buy policies, the proportion of leases accounted for as operating leases under IAS 17, and the average lease terms. However, most reporting entities applying IFRS would be affected to some extent because leasing is a common transaction in most countries throughout the world.

BC377 However, some leases classified as operating leases in accordance with IAS 17 would not be affected by the proposed requirements, such as some capacity contracts (for example some power purchase agreements) and other contracts that involve the use of a portion of an asset for which the lessee does not control the use of that asset. This is because the definition of a lease in this Exposure Draft would capture a somewhat smaller population of contracts than the scope of IAS 17.

BC378 In addition, lessees who enter into leases for 12 months or less would be able to choose not to apply the proposed requirements and instead simply recognise lease payments in profit or loss on a straight-line basis over the lease term (and not recognise lease assets and lease liabilities for those short-term leases).[3]

### *Effects for leases currently classified as operating leases*

BC379 Except as noted in paragraphs BC377–BC378, leases classified as operating leases would be within the scope of the proposals and would be classified as one of two new categories of leases: Type A leases or Type B leases.

### Effect on the statement of financial position

BC380 The biggest effect on the statement of financial position for former operating leases would be the recognition of a right-of-use asset and lease liability. According to the proposals in this Exposure Draft, the newly recognised right-of-use asset would be a non-current non-financial asset, and the lease liability would be part of current and non-current financial liabilities, depending on the timing of lease payments.

BC381 For leases classified as operating leases, shareholders' equity is usually not affected because the lessee does not recognise a lease asset or lease liability. The effect of the proposals on shareholders' equity would depend on whether the lease is classified as a Type A lease or Type B lease, as follows:

3 Research suggests that such leases currently account for between one and ten per cent of all leases, depending on the region and industry sector, and the type of asset being leased.

(a) for a lease classified as a Type A lease, the carrying amount of the right-of-use asset would, under the proposals, typically reduce more quickly than the carrying amount of the lease liability. This in turn would result in a reduction in reported shareholders' equity compared to operating lease accounting in IAS 17. The level of the reduction would depend on the length of the lease, the discount rate and the point in the lease term. The effect on equity is discussed further in Appendix B.

(b) for a lease classified as a Type B lease, the carrying amount of the lease asset and liability will often be the same or similar throughout the lease term. Consequently, the IASB expects that there would be little effect of Type B lease accounting on reported shareholders' equity compared to operating lease accounting in accordance with IAS 17.

### Effect on the statement of profit or loss and other comprehensive income

BC382 The effect on the statement of profit or loss and other comprehensive income would depend on whether the lease is classified as a Type A lease or a Type B lease, as set out below.

#### *Operating leases classified as Type A leases*

BC383 The presentation in the statement of profit or loss and other comprehensive income of the expenses associated with a Type A lease would be different from that for operating leases in IAS 17. The proposals would require a lessee to recognise interest on the lease liability separately from amortisation of the right-of-use asset. A lessee would be expected to present interest expense as a part of finance costs and amortisation expense within a similar line item to that in which it presents lease expenses for operating leases. For a lessee with operating leases classified as Type A leases, the lessee would be expected to report increased profit before interest (for example operating profit/EBIT) according to the proposals. This is because the lessee would report the interest element of lease payments below that profit measure whereas the entire amount of lease payments would be reported within that profit measure when applying operating lease accounting.

BC384 For an individual Type A lease, the total expense recognised would be different from the expense recognised under IAS 17 in any individual reporting period. According to the proposals in this Exposure Draft, the sum of the interest expense and the amortisation expense during the first half of the lease term would generally be higher than a straight-line operating lease expense recognised in accordance with IAS 17. The opposite is true in the second half of the lease term—ie the sum of the interest expense and the amortisation expense during the second half of the lease term would generally be lower than a straight-line operating lease expense. Over the lease term, the total amount of expense recognised would be the same.

BC385 Lessees typically hold a portfolio of leases at any one time, and the size of the effect of adopting the proposals on the statement of profit or loss and other comprehensive income would depend on the terms and conditions of the leases held by the lessee and how far those leases are into their respective lease terms.

BC386 For example, if the lessee's lease portfolio is evenly distributed (ie the same number of leases commence/expire during a period and the lessee enters into new leases under the same terms and conditions as the leases that expire), then the overall effect on profit or loss from adopting the proposed requirements would be neutral. If the composition of the portfolio is not evenly distributed, either because of a change in the number of leases or because new leases have terms and conditions that are different from the leases that expire, then there would be an effect on profit or loss from adopting the proposed requirements. However, those factors would have to be significant to have a noticeable effect on profit or loss. This is illustrated in Appendix C.

BC387 Finally, because differences between the proposed accounting and tax accounting are often expected to arise for a Type A lease, there is likely to be an effect on the amount of deferred tax recognised.

#### *Operating leases classified as Type B leases*

BC388 For an operating lease accounted for in accordance with IAS 17, a lessee typically recognises lease expense arising from minimum lease payments during the lease term on a straight-line basis. The lessee recognises any other expenses (for example variable lease payments) as they are incurred. For a lease classified as a Type B lease in accordance with the proposals, a lessee would recognise a lease expense (excluding most optional and variable lease payments) on a straight-line basis. Consequently, the proposals for Type B leases would generally result in little change to the statement of profit or loss and other comprehensive income.

### Effect on the statement of cash flows

BC389 Differences in accounting guidance do not cause a difference in the amount of cash transferred between the parties to a lease (to the extent that there are no differences in behaviour created by the proposals). Consequently, there would be no effect on the total amount of cash flows reported, although adoption of the proposed requirements would have an effect on the presentation of cash flows if the lease is a Type A lease (there is no change in presentation for Type B leases).

BC390 For Type A leases, lessees would be required to split cash payments for leases between principal and interest payments. Lessees would present principal repayments as financing activities and interest payments in accordance with IAS 7 *Statement of Cash Flows*. Consequently, a lessee of operating leases that are recognised as Type A leases would be expected to report higher cash inflows from operating activities on adoption of the proposals because some lease cash outflows, ie repayments of the lease principal would be presented in the financing section of the statement of cash flows rather than the operating section. Conversely, those lessees would be expected to report higher cash outflows from financing activities.

### Disclosures about leasing activities

BC391 The proposals in this Exposure Draft would result in a lessee providing enhanced disclosures as compared with the disclosures required by IAS 17.

BC392 The additional disclosures proposed include:

(a) a more detailed maturity analysis of the lease liability that shows the undiscounted cash flows on an annual basis for each of the first five years;

(b) a narrative description of the terms and conditions of any residual value guarantees and options recognised as part of the right-of-use asset;

(c) information about any significant assumptions and judgements made in applying the proposals; and

(d) a reconciliation of opening and closing balances of right-of-use assets (by class of underlying asset) and of lease liabilities.

## *Effects for leases currently classified as finance leases*

BC393 The IASB expects almost all leases classified as finance leases in accordance with IAS 17 to be classified as Type A leases according to this Exposure Draft.

BC394 Although lease assets and lease liabilities are recognised for both finance leases in IAS 17 and Type A leases in accordance with the proposals, there are some differences in how they would be measured and reported. Such differences would result in the following effects on the financial statements of a lessee.

### Effect on the statement of financial position

BC395 The main difference between the accounting for finance leases in IAS 17 and Type A leases in this Exposure Draft relates to residual value guarantees. In accordance with IAS 17, a lessee in a finance lease recognises the maximum amount of any residual value guarantees provided to the lessor as part of the lease asset and lease liability. In contrast, this Exposure Draft proposes that the lessee would recognise only amounts expected to be payable under residual value guarantees, not necessarily the maximum amount guaranteed. Consequently, a lessee that provides a residual value guarantee to a lessor would recognise a smaller amount of lease assets and lease liabilities when applying the proposals in this Exposure Draft if the guarantee is expected to result in cash outflows for the lessee that are lower than the maximum amount.

### Effect on the statement of profit or loss and other comprehensive income

BC396 A lessee recognises interest expense on the lease liability and depreciation/amortisation of the lease asset for both finance leases in IAS 17 and Type A leases in accordance with the proposals. Because the IASB does not expect any significant differences in the amounts recognised in the statement of financial position, there would be no significant difference in the interest and depreciation/amortisation expenses in the statement of profit or loss and other comprehensive income.

### Statement of cash flows

BC397 Cash payments for both finance leases in IAS 17 and Type A leases in accordance with the proposals are split between repayment of principal and payment of interest. Principal payments are presented as financing activities and interest payments are presented in accordance with IAS 7. Consequently, the IASB does not expect any effect on the statement of cash flows.

### Disclosures about leasing activities

BC398 There are some disclosures provided by lessees of finance leases in accordance with IAS 17 that would not be provided for Type A leases under the requirements in this Exposure Draft. They include a description of purchase options that exist in leases and a maturity analysis of the present values of minimum lease payments.

BC399 This Exposure Draft also proposes that a lessee provide some disclosures for Type A leases that are currently not provided by lessees of finance leases in accordance with IAS 17. Those disclosures are listed in paragraph BC392.

### *Effects on key financial ratios*

BC400 For leases currently classified as finance leases, there would be no significant change to the key financial ratios derived from a lessee's financial statements unless the lessee provides significant residual value guarantees that are not expected to result in cash outflows (see paragraph BC395 above).

BC401 However, for leases currently classified as operating leases, there could be significant changes in some financial ratios if those ratios are based on figures reported in the financial statements.[4] The potential changes include the following:

(a) For all leases, recognising a liability that was previously unrecognised will lead to higher reported debt, thus increasing reported leverage (gearing).

(b) For all leases, recognising an asset that was previously unrecognised will lead to a higher reported asset base, which will affect ratios such as asset turnover.

(c) For Type A leases, recognising amortisation and interest instead of operating lease expense will lead to higher reported operating results (because interest is typically excluded from operating expenses). Similarly, profit measures that exclude interest and amortisation but include operating lease expense, such as EBIT and EBITDA, would be higher for Type A leases than under IAS 17.

BC402 The effect of the proposals on some of the most frequently used ratios when analysing a lessee's financial statements is illustrated in Appendix A.

## The likely effect on compliance costs for lessees

BC403 The IASB expects lessees with leases classified as operating leases in IAS 17 to incur costs when first implementing the proposals in this Exposure Draft. The significance of the costs will depend on the extent to which a lessee uses leases to obtain access to assets, the terms and conditions of those leases and the systems already used to manage leases. Case studies A–C in Appendix D provide further information about the potential costs associated with implementing the proposals. The IASB expects costs to be only marginally higher on an ongoing basis compared to those incurred in applying IAS 17 once a lessee has updated its systems to provide the information required by the proposals (refer to the table of information required by the proposals below).

BC404 The IASB does not expect costs to be higher for lessees with leases classified as finance leases in IAS 17, either when first implementing the proposals or on an ongoing basis. This is because the accounting for those leases would not change significantly as described in paragraphs BC393–BC399.

BC405 In addition, the IASB expects lessees to apply a similar materiality threshold to leases as it does to items of property, plant and equipment. This would result in a lessee not applying the proposals to leases considered to be immaterial on a basis similar to that applied to items of property, plant and equipment, whereby an entity does not capitalise the costs of purchasing items of property, plant and equipment when that cost is less than a particular amount.

BC406 The following table provides a summary of information that a lessee would require to apply the proposals, indicating the information that the lessee would already require to apply IAS 17.

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4 The effects on ratios will be smaller to the extent that adjustments are already made to the amounts reported by lessees.

| Information | Required to apply the proposals | Required to apply IAS 17 |
|---|---|---|
| Inventory of leases (separate from non-lease components of contracts) | Yes<br>Non-lease (service) components of contracts are required to be separated only if the lessee has observable stand-alone prices. | Yes<br>There are some contracts considered to contain leases under IAS 17 that would not contain leases under the proposals.<br>Non-lease (service) components of contracts containing operating leases may not be separated by some lessees when preparing the note disclosures required by IAS 17. |
| Terms and conditions of each lease | Yes | Yes |
| Classification of leases: economic life of the underlying asset and/or fair value of the underlying asset for each lease | Yes | Yes<br>IAS 17 requires a lessee to separate the land and building elements of some property leases when classifying leases.<br>This is not required under the proposals. |
| Lease term and lease payments for each lease | Yes<br>The proposals regarding the lease term and lease payments are similar to the requirements in IAS 17. | Yes |
| Initial direct costs | Yes<br>Not required for leases commencing before the effective date. | Yes—required for finance leases.<br>No—not required for operating leases. |
| Discount rate for each lease | Yes<br>Required for all leases over 12 months.<br>On transition, a lessee can determine the discount rate for a portfolio of leases with similar characteristics. | Yes—required for finance leases.<br>No—not required for operating leases. |
| Index or rate at the end of each reporting period when variable lease payments depend on that index or rate | Yes | No—not required for accounting purposes but likely to be required to determine or monitor lease payments being made. |

BC407 There are some specific areas that the IASB has identified as likely to result in compliance costs for lessees. These are:

(a) the identification of leases;

(b) the separation of lease and non-lease components;

(c) the reassessment of the lease liability; and

(d) systems changes.

### *Identifying a lease*

BC408 The IASB expects some lessees to incur costs in assessing whether contracts contain a lease. Any costs, however, are expected to relate mainly to developing a process to assess whether a contract contains a lease and, accordingly, would be expected to be incurred only when first implementing the proposals. Consequently, the IASB expects costs to be higher on implementing the proposals with ongoing costs for this aspect of the proposals being no higher than they are today in complying with IAS 17.

### *Separating lease and non-lease components*

BC409 The IASB expects some lessees to incur costs to separate lease components within multiple-element contracts when first implementing the proposals. Lessees applying IAS 17 are required to separate lease components and non-lease components of a contract. However, the accuracy of the separation and allocation of payments to components would become more important under the proposals given the proposed differences in accounting for services and leases. The IASB expects that, for many contracts, practice will evolve whereby lessors would provide the information required by lessees. Consequently, the IASB expects any costs to be higher on first implementing the proposals with ongoing costs for this aspect being little higher than they are today in complying with IAS 17.

### *Reassessing the lease liability*

BC410 The IASB expects some lessees to incur costs to reassess options and to remeasure the lease liability on an ongoing basis. Such costs would mainly arise from leases that include variable lease payments that depend on an index or a rate. However, for many leases there would be no need for remeasurements during the lease term (for example leases without options and without variable lease payments that depend on an index or a rate). In addition, even when a lease contains options, reassessment is unlikely to be onerous because the threshold for recognition is high. Accordingly, changes to the assessment of options are expected only in a small number of cases.

### *Systems changes*

BC411 Many lessees already have systems in place to manage and track leases, which should help to mitigate the costs of implementing the proposals in this Exposure Draft. This is because the information required to provide the note disclosures required by IAS 17 is similar to that required to apply the proposals, except that a lessee must also determine the discount rate for each lease under the proposals. Accordingly, the systems in place are likely to already provide most of the information required to apply the proposals.

BC412 Other lessees do not have sophisticated systems in place to manage and track leases. For those lessees, the costs of implementing the proposals are likely to be higher. Those lessees may have to implement or upgrade IT systems. Software vendors offer lease management systems, some of which are being adapted to take account of the lessee accounting proposals.

### The likely effects on costs of analysis for users

BC413 The IASB expects the cost of analysis for users of a lessee's financial statements to remain the same. Some users of financial statements may rely solely on the improved information provided in the financial statements. However, other users would be expected to continue to make adjustments to suit their needs, but those adjustments would be made on the basis of better quality information available in a lessee's financial statements.

## The likely effects for lessors

BC414 This Exposure Draft proposes that a lessor would account for Type A leases by:

(a) recognising a lease receivable and a residual asset (and derecognising the underlying asset); and

(b) recognising interest income on both the lease receivable and the residual asset over the lease term.

In addition, if the lessor were a manufacturer or dealer lessor, the lessor might also recognise profit on the lease at the commencement date.

BC415 A lessor would account for Type B leases similarly as for leases classified as operating leases in IAS 17 by:

(a) continuing to recognise the underlying asset; and

(b) recognising rental income over the lease term, typically on a straight-line basis.

BC416 The IASB expects that most equipment and vehicle leases would be classified as Type A leases and most property leases would be classified as Type B leases.

### Expected changes to the quality of financial reporting

BC417 The largest lessors of equipment and vehicles are financial institutions, subsidiaries of manufacturers that operate similarly to financial institutions or independent asset financing entities. Accordingly, those lessors typically view and operate their leasing activities as the provision of finance to customers—ie a lease is a way of providing secured funding to a customer and, for some lessors, is also an alternative means of providing goods to customers. The pricing of equipment and vehicle leases is often driven by assumptions about asset values at the beginning and the end of the lease term and the cost of financing. Accordingly and subject to market constraints, a lessor often prices those leases to provide a particular return on its investment in the equipment or vehicle—ie the lessor calculates lease payments so as to recover the expected decline in the service potential or value of the equipment or vehicle over the lease term and to provide a return on the lessor's total investment in that asset (the lease embeds an implicit interest rate).

BC418 In contrast, many lessors of property view their leasing activities as an important component of their broader investment strategy to invest in particular types of assets. Leases provide a means of allowing a customer to have access to, or use of, the lessor's property in return for a fee, with the expectation of the return of the property in a similar condition to that which was leased after a specified period of time. Subject to market constraints, their pricing is driven by desired yields based on the fair value of the property.

BC419 The application of the lease classification requirements in IAS 17 results in most property lessors applying one accounting model, ie operating lease accounting. However, IAS 17 requires many lessors of equipment and vehicles to apply two different accounting models to their leases (ie both finance and operating lease accounting), even though those lessors may view their entire leasing business as the provision of secured funding to customers. Because the accounting for operating and finance leases is very different, this results in a lack of comparability within a lessor's financial statements.

BC420 The proposed lease classification in this Exposure Draft is expected to be more closely aligned with a lessor's business model and, therefore, to better reflect the way a lessor manages its business. This should make the financial information prepared by equipment and vehicle lessors more comparable. It should also result in financial statements that more faithfully represent the leasing activities of a lessor.

### *User needs*

BC421 The underlying asset in most property leases meets the definition of investment property in IAS 40 *Investment Property*. Lessors of investment property applying IFRS must either measure their investment property at fair value or, if measured at cost, disclose the fair value of the investment property. Some users of financial statements have confirmed that the fair value of an entire investment property gives them more useful information than other measurements. Rental income and changes in fair value are inextricably linked as integral components of the performance of the lessor and having both pieces of information (ie rental income and fair value changes) results in a lessor reporting performance in a meaningful way. Consequently, the IASB concluded that there was no need to change the existing lessor accounting requirements for leases of property.

BC422 The main concern from users of financial statements about lessor accounting in IAS 17 is the lack of transparency of residual values of equipment and vehicles that are subject to operating leases. The IASB has been informed by some analysing the financial statements of equipment lessors that they would find it beneficial to distinguish credit risk (embedded in the lease receivable) from asset risk (embedded in the residual asset).

BC423 Users of financial statements are interested in understanding the assumptions lessors make about the residual values in leases of equipment and vehicles, particularly when those residual values are significant (which they can be in leases currently classified as operating leases). The proposals would help provide that information for all leases classified as Type A leases by requiring disclosure of the carrying amounts of the residual asset and a reconciliation of changes during the period, as well as disclosures about the lessor's risk management strategy regarding residual assets (including the amounts of any residual value guarantees).

BC424 In addition, providing information about Type A lease receivables, and a detailed maturity analysis of lease payments for both Type A leases and Type B leases, would help users of financial statements better assess future cash flows. Although a maturity analysis is also required by IAS 17, the information required is less detailed than proposed in this Exposure Draft.

## The likely effect of proposed changes on how leasing activities would be reported in the financial statements of lessors applying IFRS

BC425 IAS 17 requires lessors to classify their leases as either operating or finance leases. For leases classified as operating leases, a lessor continues to recognise the underlying asset that is subject to a lease and recognises lease income over the lease term, typically on a straight-line basis. For finance leases, a lessor derecognises the underlying asset, and recognises a net investment in a lease comprised of a lease receivable and a residual asset, both measured on a current value basis, as well as any related gain or loss. Over the lease term, a lessor in a finance lease recognises interest income on its net investment in a lease.

### *Operating leases classified as Type A leases*

BC426 The most significant change in lessor accounting would arise for leases classified as operating leases under IAS 17 but that, under the proposals, would be classified as Type A leases. The IASB expects this would mainly occur for existing operating leases of equipment and vehicles. For those leases, lessors would no longer retain the underlying asset on the statement of financial position. Instead, at the commencement date a lessor would recognise a lease receivable measured on a current value basis (ie at the present value of lease payments), and a residual asset measured on a cost basis.

BC427 In terms of the statement of financial position, the lease receivable and residual asset recognised for a Type A lease at the commencement date could be higher than the amortised cost carrying amount of the underlying asset for operating leases in IAS 17. This is more likely to be the case for manufacturer or dealer lessors for which the cost of the underlying asset might be lower than its fair value at the commencement date. A manufacturer or dealer lessor is also more likely to recognise profit at the time of entering into a Type A lease as well as interest income over the lease term, whereas they do not recognise profit at the time of entering into operating leases in IAS 17 and recognise rental income over the lease term. A lessor (for example, a financial institution) that purchases an underlying asset at, or close to, the commencement date is expected to have little change in the value of assets reported before and after entering in a Type A lease, and is unlikely to recognise any profit on entering into the lease. Instead, it would only recognise interest income over the lease term.

BC428 The pattern of income recognition would also be different. Instead of recognising lease income on a typically straight-line basis as is the case for an operating lease in IAS 17, a lessor would recognise interest income on both the lease receivable and the residual asset. For a Type A lease with even lease payments, interest income recognised in the early years of the lease term would be higher than the interest income recognised in the later years. If a lessor, however, has a reasonably balanced portfolio of leases without significant changes from year to year, there would be no significant difference in the income pattern at a portfolio level (see portfolio discussion regarding lessees in Appendix C).

### *Finance leases classified as Type A leases*

BC429 The IASB expects leases classified as finance leases in accordance with IAS 17 to be Type A leases in accordance with proposals. The main differences between the accounting proposed for Type A leases and finance lease accounting in IAS 17 is as follows:

(a) a lessor would not recognise any profit associated with the residual asset arising from a Type A lease at the commencement date, whereas it would when applying finance lease accounting in IAS 17. Because the residual asset is typically not material for existing finance leases (unless its value is guaranteed), this change would not be expected to result in a significant change in practice for leases classified as finance leases in accordance with IAS 17.

(b) a lessor would exclude residual value guarantees from the measurement of a Type A lease receivable, whereas the maximum amount of any residual value guarantee provided to a lessor is considered to be part of the lease payments and included within the lease receivable for finance leases in IAS 17. Nonetheless, according to the proposals, a lessor would include as part of the Type A lease receivable any lease payments structured as residual value guarantees for which the lessee has taken on all exposure to residual asset risk.

(c) a lessor accounts for the lease receivable and residual asset separately, although it would present those two amounts together, as lease assets, in its statement of financial position. According to IAS 17, those two amounts are embedded within the net investment in a lease and are not disclosed separately.

### *Operating leases classified as Type B leases*

BC430 There would be very little change to the accounting for existing operating leases classified as Type B leases in accordance with the proposals. The main change relating to those leases would be the additional disclosures proposed, which include more detailed disclosures of future lease payments (showing undiscounted payments for each of the first five years after the reporting date) and narrative descriptions of the terms and conditions of the lease.

## The likely effect on compliance costs for lessors

BC431 The IASB expects that the implementation of the lessor accounting proposals in this Exposure Draft would not result in higher costs for many lessors than would be incurred in complying with IAS 17. This applies in particular to property lessors, for which there is very little change proposed to the way they account for leases, other than providing some additional disclosures about future lease payments. This is also the case for lessors of finance leases in IAS 17.

BC432 Lessors of equipment and vehicles, which apply operating lease accounting in IAS 17 and are expected to apply Type A lease accounting in this Exposure Draft, would incur costs because the accounting applied to those leases would change significantly. Case study D in Appendix D provides further information about the potential costs associated with implementing the proposals.

BC433 The following table provides a summary of information that a lessor would require to apply the proposals for Type A leases. The table sets out the information that a lessor would already require to apply IAS 17 and the information already required to price leases, assuming the lessor prices its leases as financing transactions (by estimating the fair value and residual value of the asset being leased at the commencement date, and incorporating an implicit interest rate).

| **Information** | **Required to apply the Type A lease accounting proposals** | **Required to apply IAS 17** | **Required to price leases if priced as financing transactions** |
|---|---|---|---|
| Inventory of leases (separate from non-lease components of contracts) | Yes<br>Non-lease (service) components of contracts are required to be separated in accordance with the revenue recognition proposals. | Yes | Yes |
| Terms and conditions of each lease | Yes | Yes | Yes |
| Classification of leases: economic life of the underlying asset and/or fair value of the underlying asset for each lease | Yes<br>Fair value of the underlying asset may also be required periodically if the lease receivable or residual asset are potentially impaired. | Yes | Yes |
| Estimated residual value of the underlying asset at the commencement date (and periodically if the asset is potentially impaired) | Yes | Yes-required for finance leases.<br>No-not required for operating leases. | Yes |
| Lease term and lease payments for each lease | Yes<br>The proposals regarding the lease term and lease payments are similar to the requirements in IAS 17. | Yes | Yes |
| Initial direct costs | Yes<br>Not required for leases commencing before the effective date. | Yes-required for finance leases.<br>No-not required for operating leases. | Yes |

| **Information** | **Required to apply the Type A lease accounting proposals** | **Required to apply IAS 17** | **Required to price leases if priced as financing transactions** |
|---|---|---|---|
| Discount rate for each lease | Yes<br>Required for all leases over 12 months. | Yes-required for finance leases.<br>No-not required for operating leases. | Yes |
| Index or rate at the end of each reporting period when variable lease payments depend on that index or rate | Yes<br>This feature is not expected to exist in many Type A leases. | No-not required for operating leases. | Yes |
| Risk management strategy regarding residual asset risk, including residual value guarantees and other means of reducing this risk | Yes | No | Yes |

## Costs of implementation

BC434 The IASB expects that most lessors of existing operating leases that will be classified as Type A leases under the proposed requirements (ie most equipment and vehicle lessors) would be likely to have the information required to apply the proposed requirements. This is because the changes proposed to the accounting are expected to be consistent with the way in which most equipment and vehicle lessors price their leases as set out in the table above. Nonetheless, even when that information is already available within a lessor's business, that information may reside within different systems (for example those used to price and manage the leases), rather than within the accounting systems. There are likely to be costs associated with obtaining that information for accounting purposes. In addition, those lessors are also likely to need to enhance or replace their accounting systems in order to apply Type A lease accounting under the proposals. The costs associated with changes to accounting systems would depend on the terms and conditions of the leases held by the lessor and the sophistication of the systems already in place to manage and account for leases. For example, if a lessor already has a system in place to account for finance leases in IAS 17, that system may only need to be enhanced rather than replaced to apply Type A lease accounting.

BC435 The IASB is also aware that there are some lessors who may be required to apply Type A lease accounting who do not already have information about interest rates and residual values for each individual lease. Those lessors might include services within contracts that contain leases, with those contracts being priced as a package. Such lessors are likely to incur more significant costs than other lessors in applying the proposals. They would be required to separate lease components from non-lease components of a contract and account for them separately, estimate the fair value and residual value of assets subject to a Type A lease at transition and calculate the interest rate charged in the lease. Those lessors are likely to need to invest in systems to collect data and account for leases in accordance with the proposals.

## Costs of ongoing application

BC436 The IASB expects the ongoing costs of applying the lessor accounting proposals to be only marginally higher than those incurred to comply with IAS 17 once a lessor has set up the systems required to apply Type A lease accounting.

BC437 Although lessors are required to make reassessments during the lease term, particularly in relation to the lease term, the IASB expects that reassessments will be relatively infrequent because such reassessments relate to optional periods and the threshold for recognition of payments in optional periods is high. In addition, although the proposals would require regular remeasurement of lease receivables with respect to payments linked to an index or a rate, the IASB does not think these features are common in Type A leases. Accordingly, those proposals should not create ongoing costs for lessors that are higher than complying with IAS 17.

BC438 There may be indirect costs of the proposals for some lessors. This is because some customers (ie lessees) would be likely to require more information about leases to account for them according to the proposals. This might include information about the pricing assumptions, the rate charged in the lease and the prices of lease components and non-lease components when contracts contain multiple elements. At the same time, the proposals might provide those lessors with an opportunity to earn additional revenue by providing additional services to lessees (for example, accounting or lease management services).

## The likely effects on the costs of analysis for users

BC439 The IASB expects the cost of analysis for users of a lessor's financial statements to remain the same. Users may change how they perform their analyses of an equipment or a vehicle lessor's activities on the basis of the new information available under the proposals. The proposals should provide much better information about those leasing activities, and in particular about a lessor's exposure to credit risk and asset risk.

# Appendix A
# Effect of the proposals on key financial ratios of a lessee with operating leases (IASB-only)

These ratios are based on the information that would be reported in accordance with IAS 17 and with this Exposure Draft and do not take into account any subsequent adjustments to reported amounts that would be made by users. Those adjustments may mean that the changes arising from these proposals are less pronounced. The table compares the accounting for leases classified as operating leases according to IAS 17 with the accounting for Type A and Type B leases according to the proposals.

| Name of ratio | What it measures | How it is calculated | Applicable to which class of leases | Expected effect using reported information | Explanation |
|---|---|---|---|---|---|
| **Gearing** | long-term solvency | liabilities/equity | All | increase | increase because reported debt increases (and equity would decrease for Type A leases) |
| **Current ratio** | liquidity | current assets/current liabilities | All | decrease | decrease because current lease liabilities would increase while current assets would not |
| **Asset turnover** | profitability | sales/total assets | All | decrease | decrease because lease assets will be reported |
| **Interest cover** | long-term solvency | profit before interest and tax/interest expense | Type A (no change for Type B) | depends | depends on whether the ratio of lease amortisation/lease interest expense is higher or lower than the existing ratio (short-term leases have higher ratios than long-term leases), and on the proportion of total interest that relates to lease interest (higher proportion will have a larger effect) |
| **EBIT** | profitability | profit before interest and tax | Type A (no change for Type B) | increase | increase because the amortisation added is lower than the operating lease expense eliminated |
| **EBITDA** | profitability | profit before interest, tax, depreciation and amortisation | Type A (no change for Type B) | increase | increase because there will be no operating lease expense included |
| **EBITDAR** | profitability | profit before interest, tax, depreciation, amortisation and operating lease expense | All | no change | no change because all lease-related expenses are excluded |

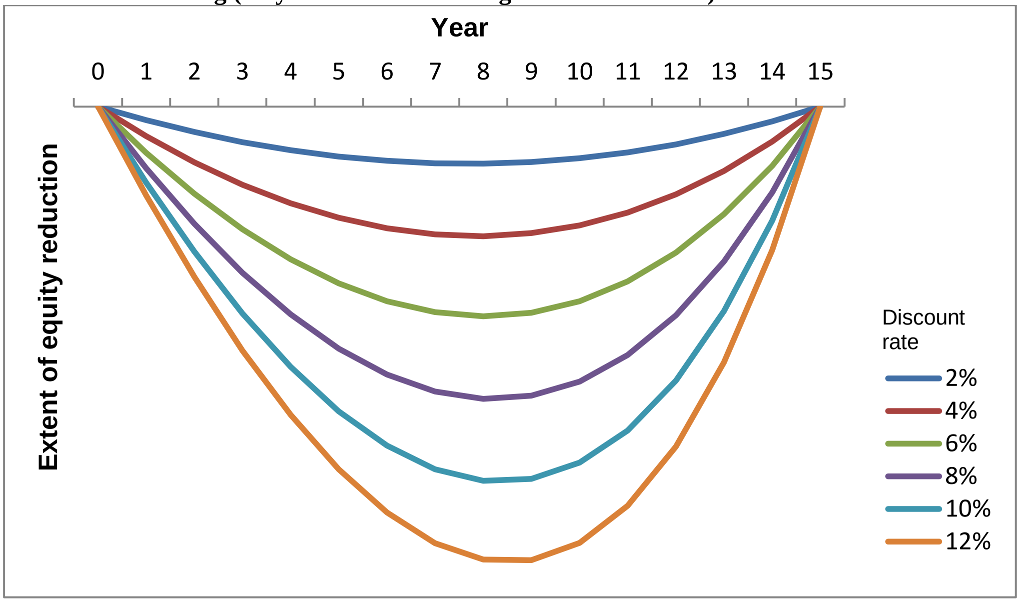
| Name of ratio | What it measures | How it is calculated | Applicable to which class of leases | Expected effect using reported information | Explanation |
|---|---|---|---|---|---|
| **Operating profit** | profitability | n/a | Type A (no change for Type B) | increase | increase because the amortisation added is lower than the operating lease expense eliminated, ie interest would be reported below the operating profit line |
| **Net income** | profitability | n/a | Type A (no change for Type B) | depends | depends on the characteristics of the lease portfolio and the tax rate |
| **EPS** | shareholder | net income/number of shares in issue | Type A (no change for Type B) | depends | depends on the effect on net income, which depends on characteristics of the lease portfolio and the tax rate |
| **ROCE** | profitability | EBIT/total assets less current liabilities | All | depends | the ROCE ratio may need to be adjusted because lease assets reported are not comparable with purchased assets for leases shorter than the economic life of the underlying asset—ie for those leases, the lease asset reported will be smaller than the asset reported if the underlying asset were purchased. For Type B leases, the entire lease expense will also be included in EBIT (ie part of the lease payments is not reported as interest) whilst the lease liability is a financial liability |
| **ROE** | profitability | net income/equity | Type A (no change for Type B) | depends | depends on the effect on net income, which depends on the lease portfolio—if there is no effect on net income, then the ratio will be higher because reported equity will decrease |
| **Operating cash flow** | profitability | n/a | Type A (no change for Type B) | increase | increase because at least part of the lease payments (those payments relating to the principal) will be moved to the financing section |
| **Net cash flow** | profitability | n/a | All | no change | no change because the proposals do not affect cash |

# Appendix B
# Effect on a lessee's reported equity of accounting for operating leases as Type A leases (IASB-only)

BC440 The amount of a lessee's right-of-use assets for Type A leases would typically be lower than the amount of the lease liability throughout the lease term, except at lease commencement and at the end of the lease term. Because a lessee does not generally recognise assets or liabilities for operating leases, applying Type A lease accounting would result in a reduction in reported equity when compared to operating lease accounting. (This analysis of equity effects assumes all other factors that might affect equity are constant, for example, a lessee's dividend policy would remain the same, the lessee does not have any new capital, etc.)

BC441 The effect on equity is shown in the following chart, using a 15-year lease to illustrate:

**Figure 1 Equity reduction (as a percentage of the lease liability) compared to operating lease accounting (15-year lease with a range of discount rates)**



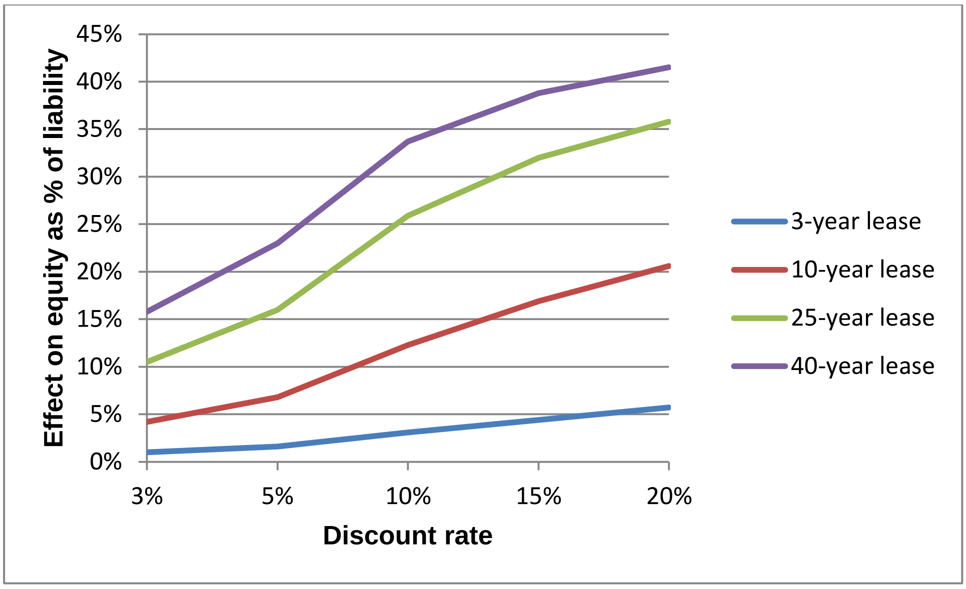

BC442 The chart shows the following:

(a) The size of the reduction in reported equity (when compared with operating lease accounting) increases during the lease term until about the mid-point of the lease (this is the same point at which the total lease expense for Type A leases is equal to the straight-line lease expense for operating leases).

(b) The higher the discount rate, the higher the reduction in reported equity.

BC443 At a portfolio level, because equity would be lower (when comparing Type A lease accounting with operating lease accounting) throughout the lease term of each individual lease, equity would also be lower for every portfolio of Type A leases. This is shown in the following chart, which compares various evenly-distributed portfolios of Type A leases (an evenly-distributed portfolio being a portfolio with the same number of leases terminating and commencing in any one period, with the same terms and conditions):

**Figure 2 Equity reduction as a percentage of the lease liability (before tax effects)**




BC444 The chart shows that the effect on equity (ie the amount by which lease liabilities would be higher than lease assets) as a proportion of the lease liability increases as the lease term lengthens and the discount rate increases.

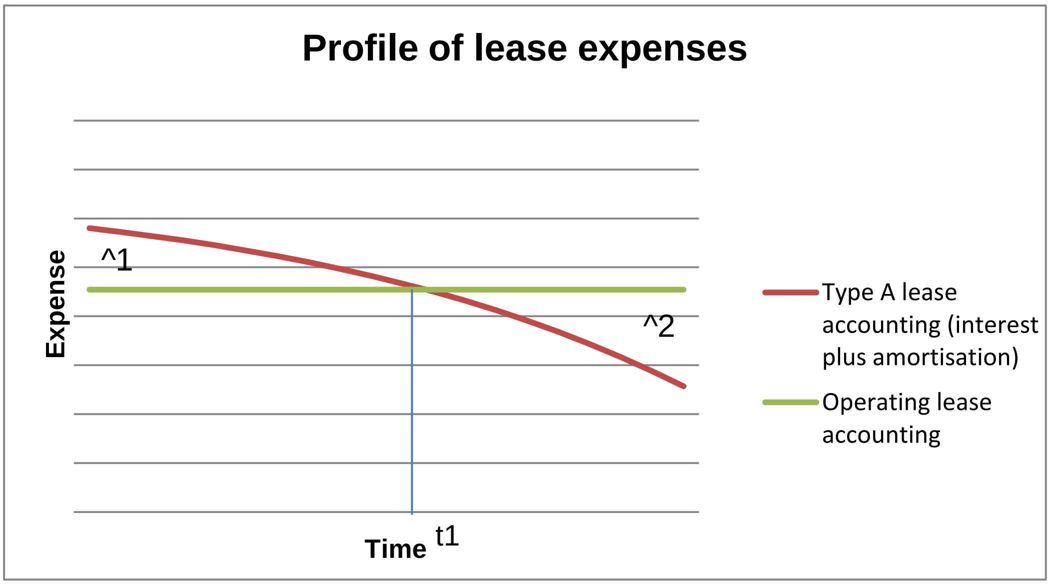
BC445 The diagram in Figure 2 ignores the effect of tax. Because lease assets and lease liabilities would be different throughout the lease term, this might give rise to a deferred tax asset, which would reduce the effect on equity.

BC446 The analysis above considers the effect on equity relative to the lease liability. The actual effect on a lessee's reported equity of applying Type A lease accounting to leases classified as operating leases would depend on the lessee's leverage (gearing), and on the ratio of the lease liability to equity. This in turn depends on the proportion of assets the lessee owns, the proportion of assets leased and how the lessee finances its operations.

# Appendix C
# Effect on a lessee's profit or loss of accounting for operating leases as Type A leases (IASB-only)

## Effect on profit or loss—individual lease

BC447 For an individual lease, the lease expense recognised when applying operating lease accounting is typically the same in each period throughout the lease term, ie a lessee recognises operating lease expenses typically on a straight-line basis (excluding variable lease payments). In contrast, the pattern of expense recognition for Type A leases would depend on the length of the lease term, the timing of lease payments and the rate charged in the lease. Type A lease accounting and operating lease accounting patterns are shown in the following chart for an individual lease (assuming lease payments are even throughout the lease term):




BC448 The chart shows the following:

(a) The sum of the interest and amortisation expenses on a Type A lease is higher than a straight-line operating lease expense at the beginning of the lease term and lower at the end of the lease term.

(b) The point at which interest plus amortisation is equal to the straight-line operating lease expense (t1 in the chart above) occurs somewhere after the mid-point of the lease. This is also the point at which the difference between the carrying amounts of the right-of-use asset and the lease liability is greatest and, thus, the point at which there is the greatest effect on a lessee's equity compared to IAS 17.

(c) The difference between the sum of interest and amortisation expenses for Type A leases and the straight-line operating lease expense at the beginning of the lease term (^1) is lower than the difference at the end of lease term (^2).

BC449 In our analysis, the conclusions noted above were consistent for a range of lease terms from three to 40 years and using a range of discount rates from 2 to 20 per cent. However, the relative difference between the two expenses (^1 and ^2 in the chart), as well as the point at which they become equal (t1 in the chart), depends upon the length of the lease term and the rate charged in the lease.

## Effect on profit before interest

BC450 The expense pattern for Type A leases would be expected to be the same as the expense pattern for operating leases with respect to the effect on a lessee's profit before interest (for example operating profit)—ie for both Type A leases and operating leases, a lessee would recognise lease expenses within operating profit typically on a straight-line basis. A lessee's operating profit would, however, increase when applying Type A lease accounting. This is because, for Type A leases, a lessee would report lease payments as two expenses—a lessee would be expected to report amortisation of the right-of-use asset within operating expenses and interest on the lease liability within finance costs (below the operating profit line).

In contrast, for operating leases, a lessee would be expected to report lease payments within operating expenses in their entirety.

## Portfolio effect

BC451 Because lessees usually have many leases at any time, the following section considers the change in the expense pattern for a portfolio of Type A leases that are classified as operating leases in accordance with IAS 17.

BC452 If a lessee's lease portfolio is evenly distributed (ie the same number of leases begin and end in any one period, and new leases have the same terms and conditions as the leases they replace), then there would be no difference between the sum of amortisation and interest expenses for Type A leases compared to a straight-line expense for operating leases. For example, if a lessee had a portfolio of three-year Type A leases, one third of that portfolio would have an expense 5 per cent higher than a straight-line operating lease expense, one third would be 5 per cent lower and one third would be the same. Consequently, the overall effect on lease expenses is neutral, assuming that all of those contracts have equal lease payments.

BC453 However, such an evenly distributed portfolio rarely exists in practice. Consequently, the following paragraphs consider the following scenarios:

(a) new leases that have different terms and conditions to leases that they replace;

(b) the size of the lease portfolio changes; and

(c) the discount rate changes.

BC454 For simplicity and to illustrate the effect, in each of the examples below, the starting point is an evenly-spread lease portfolio whereby only one factor varies and all others remain the same.

BC455 In summary, the findings in paragraphs BC456–BC465 illustrate that when a lessee has a portfolio of Type A leases that is constantly evolving, with leases expiring and new leases being added, there may be relatively little overall effect on the lessee's profit or loss from applying the proposed requirements.

## Change in lease term

BC456 For example, consider a lessee that has an equally distributed portfolio of 10-year Type A leases, at a rate of 6 per cent. Consequently, the total lease expense (ie the sum of amortisation and interest) for those leases is equal to a straight-line operating lease expense. At the beginning of Year 1, the lessee renews 10 per cent of the lease portfolio under the same conditions, except that the new leases are for only five years (the leases continue to be Type A leases). This means that leases that account for 10 per cent of the portfolio would have a Year 1 expense that is higher than a straight-line operating lease expense (the difference is calculated to be 10 per cent). If those leases had been renewed for a 10-year term, the Year 1 expense for those leases would have been 18 per cent higher than a straight-line operating lease expense. Consequently, the total expense for that part of the lease portfolio is now 8 per cent (18 per cent less 10 per cent) lower than if the lessee had entered into 10-year leases. The effect on the overall lease portfolio would be an expense that is 0.8 per cent lower than a straight-line operating lease expense (because new leases account for one tenth of the portfolio (ie 8 per cent x 10 per cent of the portfolio = 0.8 per cent)). Consequently, the lessee's total expense in Year 1 would be 0.8 per cent lower than a straight-line operating lease expense.

BC457 The effect increases if the new policy of replacing expired leases with shorter-term leases continues into Year 2, making the overall expense 1.7 per cent lower than a straight-line operating lease expense in Year 2.

BC458 If the lessee continues to apply its new policy and ultimately changes its entire portfolio of 10-year Type A leases to five-year Type A leases, the maximum difference between the total lease expense under the proposals for Type A leases and a straight-line operating lease expense would be 5.3 per cent, in Year 5. That difference would reduce over time to zero in the year that the lessee again has an evenly-spread portfolio of five-year leases.

BC459 The opposite conclusion would apply when a lessee replaces shorter-term leases with longer-term leases, in which case the total expense recognised would be higher than a straight-line operating lease expense. If the example above is reversed (ie if the lessee replaces five-year Type A leases with 10-year Type A leases), in year 1 the total expense would be 1.6 per cent higher (8 per cent difference × 0.2, with 0.2 representing the proportion of the portfolio that consists of new leases because, in an evenly-spread portfolio of five-year leases, one-fifth of those leases would be renewed in each year).

## Change in the size of the lease portfolio

BC460 Suppose that, as in the previous example, a lessee has an evenly-spread portfolio of 10-year Type A leases, at a rate of 6 per cent. The lessee increases its lease portfolio by 10 per cent in Year 1. This means that the lessee would have 10 per cent more leases that have a total lease expense that is 18 per cent higher than a straight-line operating lease expense in Year 1. The overall effect, therefore, would be that the total Type A lease expense is 1.8 per cent higher than the straight-line operating lease expense (18 per cent × 0.1) in Year 1.

BC461 The effect increases if the new policy of increasing the portfolio by 10 per cent continues into Year 2, making the total Type A lease expense 3.2 per cent higher than a straight-line operating lease expense in Year 2.

BC462 The opposite conclusion applies when a lessee reduces the size of its Type A lease portfolio. Using the example above, if none of the leases that expired in Year 1 were replaced (ie if the Type A lease portfolio were reduced by 10 per cent), the total lease expense in Year 1 would be 1.8 per cent lower than a straight-line operating lease expense.

## Change in discount rate

BC463 Using the same example, assume that the lessee has the same portfolio of 10-year Type A leases, but that the rate charged for the new leases decreases from 6 per cent to 4 per cent. This would result in 10 per cent of leases having a total lease expense that is 14 per cent higher than a straight-line operating lease expense, instead of 18 per cent higher if they had been renewed using a rate of 6 per cent. Consequently, the lessee's total lease expense in Year 1 would be 0.4 per cent lower than a straight-line operating lease expense in the first year of change (the difference of 4 per cent × 0.1).

BC464 The effect increases if the lower rate continues into Year 2, resulting in a total Type A lease expense 0.7 per cent lower than a straight-line operating lease expense.

BC465 The opposite conclusion applies when the rate increases. In the scenario above, if the rate were increased from 4 per cent to 6 per cent, the total Type A lease expense would be 0.4 per cent higher than a straight-line operating lease expense.

# Appendix D
# Case studies (IASB-only)

BC466 The following case studies illustrate the information that an entity would be required to have, and the drivers of the costs that an entity might incur, when applying the proposals in this Exposure Draft.

**Case study A**

*Lessee A is an entity that operates in a number of countries.*

*It has approximately 20,000 leases of vehicles (ie cars and trucks) throughout the group, with non-cancellable lease terms of between three and five years. Many of these contracts include purchase or extension options priced at market rates. Lessee A has systems in place to manage its vehicle leases, for example to monitor when and whether to return a vehicle or extend a lease, or when lease payments should be stopped on return of a vehicle.*

*Lessee A also has a relatively small number of property leases (approximately 60) used for corporate purposes, with non-cancellable lease terms of between five and 12 years. Many of these leases include variable lease payments that depend on an index or a rate. Lessee A does not have sophisticated systems to manage its property leases—the management of those leases are decentralised within subsidiaries, each of which has only a few property leases.*

*Lessee A classifies all of its leases as operating leases in accordance with IAS 17. 1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessee A first applies [draft] IFRS X; the effective date is 1 January 20X2.*

**Implementing the proposals**

***At or before transition***

Steps to be taken at transition

Lessee A prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. Lessee A classifies all of its leases of vehicles as Type A leases, and all of its leases of property as Type B leases.

Lessee A obtains the following information at 1 January 20X1:

(a) For property leases, the remaining lease term and remaining lease payments, including variable lease payments determined using the index or rate as at 1 January 20X1.

(b) For vehicle leases, the remaining lease term, remaining lease payments and original lease term.

Lessee A also determines a discount rate for each portfolio of leases with similar characteristics.

Costs on transition

Lessee A incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:

(a) Lessee A already prepares disclosures about operating leases required by IAS 17 (ie the disclosure of future minimum lease payments under non-cancellable operating leases). Lessee A, therefore, already has an inventory of all of its leases, including information about the remaining lease term and the remaining lease payments.

(b) Lessee A has systems in place to manage its vehicle leases.

(c) Classifying the vehicle and property leases is straightforward given Lessee A's lease portfolio. A three-year lease of any car or truck is more than an insignificant part of the economic life of that car or truck. Even a 12-year lease of property is expected to meet the criteria to be classified as a Type B lease in most instances.

Lessee A incurs costs in determining the appropriate discount rate to apply to each portfolio of leases, in training its employees and updating its group accounting policies.

Lessee A also incurs costs in setting up systems to account for its leases according to the proposals. Lessee A requires systems that can apply the requirements for Type A leases (its vehicle leases) and for Type B leases (its property leases). Lessee A is able to modify its existing systems for vehicle leases to produce the information required to account for those leases in accordance with the proposals. Lessee A incurs costs in setting up a system to account for its property leases using spreadsheets—the spreadsheets developed are distributed to subsidiaries that hold property leases.

**Case study A**

***Ongoing***

Steps to be taken and costs on an ongoing basis

Lessee A remeasures the lease liability arising from property leases that include variable lease payments that depend on an index or a rate during the terms of those leases. There is a cost associated with implementing that remeasurement on an ongoing basis.

Lessee A is not expected to change the measurement of lease assets and lease liabilities to reflect changes in the lease term. This is because it is unlikely that Lessee A would conclude that it has a significant economic incentive to exercise the options within its vehicle lease contracts, or that there would be a change to that conclusion during the lease term, when those options are priced at market rates at the commencement date and lease terms are for less than five years.

Lessee A also incurs some costs in providing enhanced disclosures in its financial statements about leases (for example a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of right-of-use assets and lease liabilities).

Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessee A inputs any new leases into that system.

**Case study B**

*Lessee B is a retailer that operates in a number of countries. Apart from 10 stores that it owns in key locations, Lessee B leases all of the retail outlets from which it operates.*

*It has approximately 6,000 leases of retail outlets throughout the group, with non-cancellable lease terms of between three and 15 years, with most being for less than 10 years. Many of these contracts include (a) extension options priced at market rates, (b) variable lease payments that either depend on an index or a rate, or are linked to sales, and (c) maintenance services. Lessee B also renegotiates and modifies the terms and conditions of many property leases before the end of the non-cancellable period. Lessee B has sophisticated systems in place to manage its property leases, for example to determine (a) when and whether to extend or renegotiate a lease and (b) the amounts payable when those amounts are variable.*

*Lessee B classifies all of its property leases as operating leases in accordance with IAS 17. Lessee B does not have other leases that are material to the group.*

*1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessee B first applies [draft] IFRS X; the effective date is 1 January 20X2.*

**Implementing the proposals**

***At or before transition***

Steps to be taken at transition

Lessee B prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. Lessee B classifies all of its leases of property as Type B leases.

Lessee B obtains the following information for its property leases at 1 January 20X1:

(a) the remaining lease term;

(b) the remaining lease payments, including variable lease payments determined using the index or rate as at 1 January 20X1. Lessee B does not need to estimate amounts expected to be payable when those amounts are linked to sales; and

(c) the observable stand-alone prices for any maintenance services included in its lease contracts—those stand-alone prices are generally available in the contracts.

Lessee B also determines a discount rate for each portfolio of leases with similar characteristics.

Costs on transition

**Case study B**

Lessee B incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:

(a) Lessee B already prepares disclosures about operating leases required by IAS 17 (ie the disclosure of future minimum lease payments under non-cancellable operating leases). Lessee B, therefore, already has an inventory of all of its leases, including information about the remaining lease term and the remaining lease payments.

(b) Lessee B already has sophisticated systems in place to manage its property leases.

(c) Classifying the property leases is straightforward given Lessee B's lease portfolio. Even a 15-year lease of property would be expected to meet the criteria to be classified as a Type B lease in many instances, and relatively few of Lessee B's portfolio of leases are for longer than 10 years. In addition, if Lessee B concluded that its property leases were operating leases under IAS 17, those leases would be expected to meet the criteria to be classified as Type B leases under the proposals.

Lessee B incurs costs in determining the appropriate discount rate to apply to each portfolio of leases, training its employees and updating its group accounting policies.

Lessee B also incurs costs in setting up systems to account for its property leases according to the proposals. Lessee B is able to extend its existing property lease management systems to produce the information required to account for its leases in accordance with the proposals.

***Ongoing***

<u>Steps to be taken and costs on an ongoing basis</u>

Lessee B remeasures the lease liability arising from leases that include variable lease payments that depend on an index or a rate during the terms of those leases based on the relevant spot amount at future reporting dates. There is a cost associated with implementing that remeasurement on an ongoing basis. Because variable lease payments linked to sales are not included in the measurement of the right-of-use asset and lease liability, there are no additional costs associated with accounting for those variable lease payments—those payments are recognised as an expense as incurred, consistently with IAS 17.

Lessee B is not expected to change the measurement of lease assets and lease liabilities to reflect changes in the lease term. This is because changes to the lease term should be relatively rare because a significant economic incentive is a high threshold for including optional periods in the lease term and the options are priced at market rates at the commencement date. Lessee B accounts for other modifications to contracts as new leases.

Lessee B also incurs some costs in providing enhanced disclosures in its financial statements about leases (for example qualitative and quantitative information about the options and variable lease payments in its leases as well as information about contract renegotiations; a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of right-of-use assets and lease liabilities).

Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessee B inputs any new leases (and modified contracts accounted for as new leases) into that system.

**Case study C**

*Lessee C is an entity that uses large and smaller items of equipment in its operations. In general, it has a policy of using equipment that is less than 12 years old, ie if purchased, Lessee C will sell equipment that is 12 years old to a third party. In order to manage its exposure to residual asset risk and to provide financial flexibility, Lessee C has a policy of purchasing 60 per cent of the equipment used in its operations and leasing the remaining 40 per cent.*

*Lessee C has approximately 800 leases of equipment throughout the group, with non-cancellable lease terms of between six and eight years. For some of these contracts, Lessee C provides a residual value guarantee to the lessor.*

*Lessee C has a relatively small number of property leases (approximately 30) used for corporate purposes, with non-cancellable lease terms of between five and 10 years. Lessee C also has three property leases with non-cancellable lease terms of 30 years.*

*In addition, Lessee C has approximately 40 capacity contracts that are considered to be leases in accordance with IFRIC 4.*

**Case study C**

*Lessee C classifies its leases as follows in accordance with IAS 17:*

(a) *70 per cent (approximately 560) of its equipment leases are operating leases; the remaining 30 per cent (approximately 240) are finance leases.*

(b) *three of its property leases are finance leases; the remainder are operating leases.*

(c) *All of the capacity contracts are operating leases.*

*Lessee C has a sophisticated system in place to account for its finance leases but does not have such a system in place for its operating leases.*

*1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessee C first applies [draft] IFRS X; the effective date is 1 January 20X2.*

**Implementing the proposals**

***At or before transition***

Steps to be taken at transition

Lessee C prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. In doing so, Lessee C analyses its capacity contracts and determines that they do not contain leases.

Lessee C classifies all of its equipment leases as Type A leases and any operating leases of property as Type B leases. Lessee C is not required to reclassify leases previously classified as finance leases—they are treated as Type A leases for presentation and disclosure purposes.

Lessee C obtains the following information at 1 January 20X1:

(a) For equipment leases previously classified as operating leases, the remaining lease term, remaining lease payments and original lease term.

(b) For property leases previously classified as operating leases, the remaining lease term and remaining lease payments.

Lessee C determines a discount rate for each portfolio of those leases with similar characteristics.

Lessee C is not required to obtain new information for leases previously classified as finance leases—it continues to account for those leases consistently with how they were accounted for in accordance with IAS 17.

Costs on transition

Lessee C incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:

(a) Lessee C already prepares disclosures about operating leases required by IAS 17 (ie the disclosure of future minimum lease payments under non-cancellable operating leases). Lessee C, therefore, already has an inventory of all of its leases, including information about the remaining lease term and the remaining lease payments.

(b) Lessee C does not incur any costs relating to accounting for leases previously classified as finance leases because of the transition relief for such leases.

(c) Lessee C has a system in place to account for its finance leases. This system is able to be used to account for Lessee C's equipment leases, with some modifications, because the accounting for Type A leases is largely consistent with existing finance lease accounting.

(d) Lessee C also has relatively few property leases that are classified as Type B leases. Although Lessee C is required to set up a system to account for those leases as Type B leases, Lessee C is able to do so using spreadsheets already available within the group.

(e) Classifying the equipment and property leases is straight-forward given Lessee C's lease portfolio. A lease of any item of equipment (including longer-lived equipment) that is between six and eight years is more than an insignificant part of the economic life of that equipment. If Lessee C concluded that a property lease was an operating lease under IAS 17, that lease would be expected to meet the criteria to be classified as a Type B lease under the proposals.

Lessee C incurs costs in determining the appropriate discount rate to apply to each portfolio of operating leases, training its employees and updating its group accounting policies. Lessee C also incurs costs in assessing that the capacity contracts do not contain a lease.

**Case study C**

***Ongoing***

Steps to be taken and costs on an ongoing basis

Lessee C remeasures the lease liability arising from equipment leases that have residual value guarantees during the terms of those leases. There is a cost associated with implementing that remeasurement on an ongoing basis.

Lessee C also incurs costs in providing enhanced disclosures in its financial statements about leases (for example a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of right-of-use assets and lease liabilities for both Type A leases and Type B leases). However, Lessee C excludes its capacity contracts from its lease disclosures.

Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessee C inputs any new leases into that system.

**Case study D**

*Lessor D is an entity that leases vehicles to numerous third parties. Lessor D has approximately 300,000 vehicle leases throughout the group, with non-cancellable lease terms of between two and eight years, depending on the nature of the vehicle. Some of these contracts include:*

(a) *purchase or extension options priced at market rates;*

(b) *restrictions on mileage. The lessee is required to pay additional amounts at the end of the lease if it exceeds specified mileage limits; or*

(c) *maintenance services.*

*Lessor D prices its leases by estimating the residual value of the vehicle at the end of the lease term (assuming the mileage limits are not exceeded) and determining a required return on its investment in the vehicle (taking into account, among other factors, the credit rating of the lessee), subject to market constraints.*

*Lessor D classifies approximately 55 per cent of its leases as operating leases and the remaining 45 per cent as finance leases in accordance with IAS 17. In applying IFRS, Lessor D already separates the maintenance services from the lease components of a contract.*

*Lessor D has sophisticated systems in place to manage its vehicle leasing operations. That system has all of the following information—an inventory of all leases and, for each lease, the rate implicit in the lease, the fair value and estimated residual value of the vehicle at the commencement date, the non-cancellable period, information about options, payments separated into lease and service components, and initial direct costs.*

*1 January 20X1 is the beginning of the earliest comparative period presented in the financial statements in which Lessor D first applies [draft] IFRS X; the effective date is 1 January 20X2.*

**Implementing the proposals**

***At or before transition***

Steps to be taken at transition

Lessor D prepares an inventory of leases with a remaining lease term beyond 1 January 20X1. Lessor D classifies all of its vehicle leases as Type A leases.

Lessor D chooses to apply the proposals retrospectively because it has already determined, for each lease, the rate implicit in the lease and estimated the residual value of the vehicle at the commencement date. The rate implicit in the lease does not include estimated variable payments that a lessee might make for exceeding mileage limits.

Costs on transition

Lessor D incurs costs in preparing to apply the proposals from 1 January 20X2. However, those costs are mitigated by the following:

(a) Lessor D has sophisticated systems in place to manage its vehicle leasing operations, which have all of the information that is required to apply the proposals.

(b) Classifying the vehicle leases is straight-forward given Lessor D's lease portfolio. Even a two-year lease of any vehicle is more than an insignificant part of the economic life of that vehicle.

**Case study D**

Lessor D incurs costs in adapting its accounting systems to apply the accounting proposed for Type A leases. Although the accounting proposed for Type A leases is similar to finance lease accounting in many respects, there are important differences that need to be built into the accounting systems (for example accounting for the residual asset separately from the lease receivable (including accounting for impairment of those separate assets), not recognising any unearned profit on the residual asset until the end of the lease term, calculating the rate implicit in the lease). As noted above, all of the information required to apply the proposals retrospectively is already available within Lessor D. However, that information resides within systems used to price and manage the leases, instead of within the accounting systems.

***Ongoing***

Steps to be taken and costs on an ongoing basis

Lessor D is not expected to change the measurement of lease assets and lease liabilities to reflect changes in the lease term. This is because it is unlikely that Lessor D would conclude that the lessee has a significant economic incentive to exercise the options within its leases, or that there would be a change to that conclusion during the lease term, when those options are priced at market rates at the commencement date.

Lessor D incurs costs in providing enhanced disclosures in its financial statements about leases (for example a maturity analysis for each of the first five years after the reporting date; a reconciliation of the opening and closing balances of lease receivables and residual assets; information about how Lessor D manages its exposure to residual asset risk).

Further ongoing costs are not incurred beyond those that had been incurred in complying with IAS 17. Having set up its systems to account for leases under the proposals, Lessor D inputs any new leases into that system.

# Appendix E
# Summary of changes from the 2010 Exposure Draft

The following table summarises the changes to the boards' August 2010 proposals in response to feedback received:

| Topic | Description of changes to the proposals |
|---|---|
| The lessee and lessor accounting models | Changed the proposals on the classification of leases as follows:<br>The 2010 Exposure Draft proposed that, when determining how to account for leases, a lessor would assess whether significant risks and benefits associated with the underlying asset are transferred to the lessee.<br>This Exposure Draft proposes that a lessee and lessor would classify leases 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. That principle would be applied by presuming that:<br>(a) a lease of property is a Type B lease unless specified criteria are met; and<br>(b) a lease of an asset that is not property is a Type A lease unless specified criteria are met. |
| | Changed the lessee accounting model as follows:<br>The accounting for Type A leases is consistent with the lessee accounting approach proposed in the 2010 Exposure Draft.<br>The accounting for Type B leases differs from the lessee accounting approach proposed in the 2010 Exposure Draft as follows:<br>(a) a lessee would amortise the right-of-use asset so that the remaining cost of the lease is allocated over the lease term on a straight-line basis;<br>(b) the lessee would present amortisation of the right-of-use asset and the unwinding of the discount on the lease liability together as a single lease cost; and<br>(c) the lessee would classify cash flows arising from Type B leases within operating activities. |
| | Changed the lessor accounting model as follows:<br>The 2010 Exposure Draft proposed that a lessor would apply either the derecognition approach or the performance obligation approach, depending on whether significant risks and benefits associated with the underlying asset are transferred to the lessee.<br>This Exposure Draft proposes that a lessor would apply:<br>(a) an approach similar to the derecognition approach in the 2010 Exposure Draft to Type A leases. The accounting for Type A leases differs from the derecognition approach as follows:<br>(i) the lessor would recognise the unwinding of the discount on the residual asset as interest income over the lease term; and<br>(ii) the lessor would present the carrying amount of the lease receivable and the residual asset together as lease assets, with the lease receivable and the residual asset presented or disclosed separately.<br>(b) an approach similar to operating lease accounting in IAS 17 to Type B leases, recognising lease income over the lease term on either a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset.<br>This Exposure Draft does not retain the performance obligation approach proposed in the 2010 Exposure Draft. |

| Topic | Description of changes to the proposals |
|---|---|
| **Other topics** | |
| Definition of a lease | Retained the definition of a *lease* but:<br>(a) clarified that the underlying asset can be a physically distinct portion of a larger asset, and cannot be a capacity portion of a larger asset that is not physically distinct.<br>(b) changed the guidance on the right to control the use of an asset to be more consistent with the concept of control applied in other requirements and projects (ie the revenue recognition proposals and consolidation requirements). |
| Accounting for changes to a lease | Clarified that contract modifications resulting in substantive changes to a lease would result in the modified contract being treated as a new contract. |
| Cancellable leases | Clarified that a lease creates *enforceable* rights and obligations.<br>Added requirements on cancellable leases, specifying that a lease is cancellable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party, with no more than an insignificant penalty. |
| Separating lease and non-lease components | Modified the proposals to require both a lessee and a lessor to identify and account for each lease component separately from non-lease components of a contract, subject to some specified requirements for lessees. |
| Measurement of lease assets and lease liabilities | <u>Variable lease payments</u><br>Changed the proposals to include in the measurement of lease assets and lease liabilities only variable lease payments that either depend on an index or a rate or are in-substance fixed payments, rather than requiring the inclusion of an estimate of all variable lease payments. Variable lease payments that depend on an index or a rate would be measured using the index or rate at the commencement date and would be reassessed as at the end of each reporting period. |
| | <u>Options to extend or terminate a lease or to purchase the underlying asset</u><br>Changed the proposals to include in the measurement of lease assets and lease liabilities lease payments to be made in optional periods, or the exercise price of a purchase option, only when a lessee has a significant economic incentive to exercise an option, rather than including lease payments on the basis of an estimate of the lease term as the longest possible term that is more likely than not to occur. |
| | <u>Reassess the discount rate</u><br>Changed the proposals to require an entity to reassess the discount rate when there is a change in either of the following, unless the change was reflected in determining the discount rate at the commencement date:<br>(a) relevant factors, other than market-based factors, that result in a lessee having, or no longer having, a significant economic incentive either to exercise an option to extend the lease or purchase the underlying asset, or not to exercise an option to terminate the lease.<br>(b) reference interest rates, if variable lease payments are determined using those reference rates. |

| **Topic** | **Description of changes to the proposals** |
|---|---|
| | Lessor—residual value guarantees<br>Changed the scope of application of the requirements on residual value guarantees for lessors so that they apply to all residual value guarantees rather than only residual value guarantees provided by a lessee.<br>Modified the proposals on the accounting for residual value guarantees to be consistent with the changes to the lessor accounting model to require a lessor to consider guarantees relating to Type A leases when determining whether the residual asset is impaired, but not include the expected amounts to be received under residual value guarantees in the measurement of the lease receivable.<br>Added requirements on lease payments structured as residual value guarantees. |
| Costs relating to the construction or design of an underlying asset | Added application guidance on costs incurred by a lessee relating to the construction or design of an underlying asset. |
| Disclosure | Modified to reflect changes to the lessee and lessor accounting models. |
| Sale and leaseback transactions | Retained the proposal to account for a sale and leaseback transaction as a sale and leaseback when the transferred asset has been sold. However, revised the proposals to require an entity to assess whether the transferred asset has been sold using the control principle in the 2011 Exposure Draft *Revenue Recognition* rather than on the basis of a list of conditions that would apply only when assessing sale and leaseback transactions. |
| Short-term leases | Revised the proposals to permit both a lessee and a lessor to apply an approach similar to operating lease accounting in IAS 17 as an accounting policy election. |
| Transition | Revised the transition proposals to permit an entity to apply the proposed requirements using a full retrospective approach or, alternatively, using a modified retrospective approach reflecting changes to the lessee and lessor accounting models.<br>According to the modified retrospective approach:<br>(a) for leases classified as finance leases in accordance with IAS 17, an entity would carry forward amounts previously recognised for lease assets and lease liabilities, subject to some reclassifications.<br>(b) for leases classified as operating leases in accordance with IAS 17, an entity would apply a retrospective approach but would use information available at the date of transition when measuring lease assets and lease liabilities.<br>(c) the Exposure Draft includes some specified reliefs for transitioning to the proposed requirements on a retrospective basis.<br>Added transition requirements relating to sale and leaseback transactions and amounts previously recognised in respect of business combinations. |
| Business combinations | Added requirements relating to the measurement of lease assets and lease liabilities acquired in a business combination. |
| FASB – Related-party leases | The FASB decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties on the basis of legally enforceable terms and conditions of the lease, acknowledging that some related-party transactions are not documented and/or the terms and conditions are not at arm's length. In addition, a lessee and a lessor would be required to apply the disclosure requirements for related-party transactions in Topic 850. Under existing US GAAP, entities are required to account for leases with related parties on the basis of their economic substance, which may be different from the legally enforceable terms and conditions of the arrangement. |

| Topic | Description of changes to the proposals |
|---|---|
| FASB – Application by nonpublic entities | Added FASB-only specific requirements for nonpublic entities as follows:<br><u>Discount Rate</u><br>Added a specified relief for nonpublic entity lessees permitting the use of a risk-free discount rate, determined using a period comparable to that of the lease term, as an accounting policy election for all leases.<br><u>Lessee Disclosures</u><br>Added an exemption for nonpublic entity lessees from the requirement to provide a reconciliation of the opening and closing balances of the lease liability. |