STAFF PAPER

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Project	Leases		
Paper topic	Lessee accounting: short-term leases		
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Purpose

1. The purpose of this paper is to discuss the short-term lease recognition and measurement exemption for lessees that was proposed in the 2013 Exposure Draft ('2013 ED').

2. This paper should be read in conjunction with Agenda Paper 3F/FASB Memo No. 273, which discusses small-ticket leases. This is because the staff think that the boards should consider the short-term lease recognition and measurement exemption as one way of providing relief for small-ticket leases. This paper should also be read in conjunction with Agenda Paper 3G/FASB Memo No. 274, which discusses lease term, as the boards' decisions on lease term might be relevant when making decisions on short-term leases.

3. This paper is similar to the discussion of the short-term lease recognition and measurement exemption that was in Agenda Paper 3C/FASB Memo No. 264, discussed in the January 2014 joint board meeting. The most substantive differences between the short-term lease discussion in that paper and this one are as follows:

(a) Additional analysis has been added to the discussion of the short-term lease recognition and measurement exemption in response to comments from board members at the January 2014 board meeting.

(b) A discussion has been added regarding disclosure requirements for short-term leases.

4. This agenda paper does not discuss the short-term lease recognition and measurement exemption proposed in the 2013 ED for lessors. This is because the short-term lease recognition and measurement exemption may not be applicable to lessors, depending on which lessor model the boards decide upon.

5. This paper is structured as follows:

(a) Summary of staff recommendations

(b) Background

(c) Feedback received on the 2013 ED

(d) Staff analysis

(i) Confirmation of short-term exemption

(ii) Expanding the short-term exemption

(iii) Disclosure requirements

(e) Staff recommendations

Summary of staff recommendations

6. The staff recommend that the boards should:

(a) Confirm a recognition and measurement exemption for a lessee's short-term leases;

(b) Confirm that the short-term lease threshold is 12 months or less;

(c) Change the definition of 'short-term lease' so that it is assessed consistently with the definition of 'lease term'; and

(d) Require disclosure of the amount of expense recognised in the current period relating to short-term leases, as well as including short-term leases in whatever qualitative disclosures the boards decide upon for leases generally.

Background

7. The 2013 ED proposed a recognition and measurement exemption for short-term leases for lessees, proposing that:

> A lessee may elect, as an accounting policy, not to apply the requirements in paragraphs 25-35 and 37-57 to short-term leases. Instead, a lessee may recognise the lease payments in profit or loss on a straight-line basis over the lease term.

8. The 2013 ED proposed that the accounting policy election should be made by class of underlying asset to which the right of use relates.

9. The 2013 ED defined a short-term lease as a lease that, at the commencement date, has a maximum possible term, including any options to extend, of 12 months or less.

10. The 2013 ED did not explicitly exempt short-term leases from the disclosure requirements. However, short-term leases were, in effect, exempted from the quantitative disclosure requirements in the 2013 ED if a lessee elected not to recognise right-of-use (ROU) assets or lease liabilities for those leases. The 2013 ED also did not require any separate disclosure requirements for short-term leases.

11. IAS 17 *Leases* and Topic 840 *Leases* do not have specific recognition or measurement guidance for short-term leases. There are disclosure requirements for all operating leases which include:

    (a) A maturity analysis,

    (b) Disclosure of expense attributable to minimum lease payments, contingent rents and sublease payments; and

    (c) A general description of the lessee's significant leasing arrangements, including information about contingent rents and variable lease payments.

12. Under Topic 840, lessees do not have to include leases with terms of a month or less that have not been renewed in the disclosure of expenses attributable to minimum lease payments, contingent rents and sublease payments. Additionally under Topic 840, only leases with initial or remaining noncancellable lease terms in excess of one year are included in the maturity analysis. IAS 17 does not have any specific exclusions for short-term leases in terms of disclosure requirements.

Feedback received on the 2013 ED

13. Many constituents supported the recognition and measurement exemption for short-term leases. These constituents think that the exemption is a practical way to help reduce costs and exclude many small-ticket leases from the scope of the leases guidance while still providing relevant information to users.

14. A representative quote from the comment letters is as follows:

> We welcome the fact that the [boards have] accepted the recommendation from [the entity] and other constituents to include an exemption for short-term leases for lessees. The costs of recognising these leases would outweigh the benefits. We do not envisage any significant structuring opportunities from providing this exemption, as it is likely they would be too costly to implement. (CL 38)

15. However, many other constituents do not think the short-term lease exemption provides enough relief for preparers, especially with respect to small-ticket leases. These constituents note that a lease rarely has a maximum possible term of 12 months or less, and offered examples of different small-ticket leases with longer maximum possible terms.

16. A representative quote from the comment letters is as follows:

> If the proposals proceed [the representative body] considers that the relief in relation to short term leases is of little benefit to preparers and users and is unlikely to provide significant relief in practice.

> We believe the maximum possible term of twelve months is too short to include anything but incidental leases in respect of office equipment, telecommunications, cars, hotel rooms, etc. It would appear that the major concerns about existing lessee accounting relate to the lack of recognition of significant operating assets. As such, we believe that short-term leases be defined as having a maximum possible term of three years with related extension options only being included in that threshold if there is an economic incentive to exercise those options. (CL 564)

17. Some of these constituents suggested extending the recognition and measurement exemption for short-term leases beyond one year. These constituents offered various suggestions as to what the threshold for the exemption should be, ranging from eighteen months to five years.

18. Other constituents suggested that the definition of 'short-term' should be based on an assessment of the lease term as defined in the 2013 ED (that is, the noncancellable term of the lease plus any optional periods for which the lessee has a significant economic incentive to exercise). They said that, for example, a one-year lease with a one-year extension option that a lessee does not have a significant economic incentive to exercise should still qualify as a short-term lease. These constituents think that it is beneficial to use the same definition when determining the lease term of all leases, including short-term leases.

19. Other constituents suggested changing the definition of 'short-term' to depend on the life of the underlying asset (for example, a short-term lease would be one for which the lease term is less than 5 per cent of the life of the underlying asset) or the operating cycle of the lessee (for example, a short-term lease would be one in which the lease term is less than one operating cycle of the lessee).

20. Many of those constituents who suggested expanding the definition of short-term also suggested increased disclosure requirements about short-term leases to compensate for the loss of information resulting from the short-term recognition and measurement exemption.

21. Finally, some constituents do not agree with creating any short-term lease exemption. These constituents said that the costs of providing the short-term lease information do not outweigh the benefits to users. Some also think that the use of a bright line (12 months) in the proposal creates potential structuring opportunities that could result in an understatement of a lessee's assets and liabilities.

22. Regarding disclosures for short-term leases, relatively limited feedback was received. Some constituents agreed with the proposals in the 2013 ED. Other constituents disagreed with the proposal to include short-term leases in the general qualitative disclosure requirements. Some of these constituents think that such a requirement negates the cost relief provided by the recognition and measurement exemption. Others suggested that separate disclosures about short-term leases, particularly the amount of expense recognised related to short-term leases, would provide more useful information. Finally, some constituents requested that the boards clarify which disclosure requirements relate to short-term leases and which do not.

23. Limited user feedback was received on the issue of the short-term lease recognition and measurement exemption. Users generally support the short-term lease recognition and measurement exemption, although a few were concerned about structuring opportunities.

Staff analysis

Confirmation of short-term exemption

24. As discussed above, the boards have received requests to expand the short-term recognition and measurement exemption for lessees. However, before the boards discuss expanding the short-term exemption, the staff think the boards first need to confirm that they would like to retain a recognition and measurement exemption for a lessee's short-term leases in the final leases guidance.

25. The boards received broad support for the recognition and measurement exemption for short-term leases proposed in the 2013 ED. The staff think that the feedback

confirmed the boards' expectation that the short-term lease exemption provides relief for preparers without a large reduction in the usefulness of lease information for users.

26. Consequently, the staff recommend that a lessee should be permitted, as an accounting policy election by class of underlying asset, to not apply the recognition and measurement requirements to short-term leases and instead recognise lease payments in profit or loss, typically on a straight-line basis.

Expanding the short-term exemption

27. The staff think there are two ways in which the boards could consider amending the short-term recognition and measurement exemption to provide further relief for small-ticket leases:

    (a) Increase the short-term threshold beyond one year; or

    (b) Change the definition of a short-term lease to be consistent with the definition of the lease term.

Increase the short-term threshold

28. The staff think that there is a range of upper limits that the boards could consider for increasing the short-term threshold. Constituents suggested that the threshold should be increased to be anywhere from eighteen months to five years.

29. An increase in the short-term threshold would exclude more small-ticket leases from the scope of the leases guidance and, thus, reduce the costs associated with applying the leases guidance to small-ticket leases. The staff understand that the majority of small-ticket leases have lease terms of three to five years. This understanding has been verified by information obtained from European and U.S. leasing associations as well as from comment letters and from fieldwork participants. Consequently, the staff think that the boards would have to increase the threshold to at least three years to exclude a significantly larger amount of small-ticket leases when compared to the proposed one-year short-term exemption.

30. Such an increase could potentially exclude from the scope of the leases guidance not only small-ticket leases, but also many 'non-small-ticket' leases. For example, the

staff are aware that there are many leases of property, construction equipment, manufacturing equipment, and mining equipment, among other types of non-small-ticket leases, with lease terms that are between three and five years.

31. Moreover, the staff think that extending the short-term lease exemption beyond one or two years could give rise to a significant incentive to change leasing behaviour to achieve short-term lease classification. The staff think that this incentive is relatively limited if the short-term threshold remains at one year. This is because there is a significant economic difference between entering into a one-year lease versus a five-year lease. However, the staff think there is much less of an economic difference in entering into a three-year lease versus a five-year lease.

32. For these reasons, the staff do not think that the boards should extend the short-term lease exemption to be longer than 12 months.

Change the definition of 'short-term'

33. Another way to expand the short-term lease recognition and measurement exemption would be to change the definition of a short-term lease to include leases with extension options, which would be assessed in the same way as lease term would normally be determined (that is, using the significant economic incentive assessment test if the boards agree with the staff recommendation in Agenda Paper 3G/FASB Memo No. 274).

34. The main benefit of doing so would be to address the concerns raised about daily rentals and month-to-month or evergreen leases, which may not meet the definition of a short-term lease proposed in the 2013 ED. For these leases, it can be difficult to determine a maximum possible term because there is no explicitly set end date for the lease. The staff think it is appropriate that these types of leases with a non-cancellable period of less than 12 months would meet the definition of short-term. Additionally, aligning the definition of short-term with the definition of lease term would increase consistency within the leases guidance. This is because entities would have to perform only one assessment of the options in a lease for the purposes of determining the lease term and for determining whether the lease is a short-term lease.

35. The staff also note that there is little incremental information lost from expanding the definition of short-term to be consistent with the definition of lease term, as compared to the proposals in the 2013 ED. This is because the proposals in the 2103 ED would result in the lease term reflecting only the noncancellable period, assuming the lessee does not have a significant economic incentive to extend the lease for any optional periods. For example, under the 2013 ED, for a five-year lease with a six month notice period and no significant economic incentive for the lessee to continue to lease the asset beyond the notice period, only the six month notice period would be recognised as an asset and a liability on the lessee's balance sheet. If the boards change the definition of short-term to align with the definition of lease term, the only incremental change in information would be that the six months of lease payments would no longer be recognised on the lessee's balance sheet.

36. The disadvantages of changing the definition of short-term to be consistent with the definition of lease term are similar to the disadvantages of extending the short-term threshold, expressed earlier in this paper. Changing the definition of short-term to include options would potentially exclude more non-small-ticket leases from the scope of the leases guidance, in particular those generally short-term leases that do not include an explicit maximum possible lease term. Changing the definition of short-term to include options would also, in theory, make it easier for entities to change their behaviour to achieve an accounting outcome (for example, a lessee might decide to change a ten-year lease to a one-year lease with nine one-year extension options, with no significant economic incentive for a lessee to exercise those options, in order to have that lease qualify as a short-term lease). However, the staff note that, as discussed in Agenda Paper 3G/FASB Memo No. 274, there would often be an economic disincentive for lessors to grant shorter-term leases. This is because shortening the lease term would increase a lessor's risk with respect to the residual asset. The staff think that a lessor would often either demand increased lease payments from the lessee to compensate for this change in risk or refuse to shorten the noncancellable period at all. Therefore, the staff think that structuring opportunities from this proposal would be minimal.

37. On balance, the staff recommend that the boards change the definition of a short-term lease so that it is assessed consistently with the assessment of lease term. Accordingly, the staff's view is that a one-year lease with an extension option, in which the lessee does not have a significant economic incentive to exercise that option, should qualify as a short-term lease. The staff think there are significant benefits to this change, as described above. The staff also note that there is little incremental information lost by this change compared to the proposals in the 2013 ED, and the boards *could* rectify any concerns about information loss by requiring disclosures about short-term leases. Although the staff acknowledge that there are disadvantages to changing the definition, we think these are relatively limited. The staff do not think that this change would introduce a significantly larger motivation to structure leases to obtain a short-term lease classification than the 2013 ED.

Disclosure requirements

38. Given the feedback received on the 2013 ED and the staff recommendation above to expand the definition of short-term to be consistent with the definition of lease term, the staff think the boards should also consider the disclosure requirements for short-term leases.

39. The staff have provided analysis and recommendations for disclosure requirements for short-term leases in this paper assuming the board would like to vote on disclosures at the same time as they vote on the short-term lease recognition and measurement exemption. The boards may, however, prefer to wait and discuss disclosures more holistically as a package.

40. The staff think it would be best to make it clear in the final standard which, if any, disclosure requirements for leases generally would apply to short-term leases for which the lessee has chosen the short-term lease recognition and measurement exemption. The staff do not think that all disclosure requirements about leases should apply to short-term leases.

41. If the boards would like to require specific disclosures about leases captured by a short-term lease exclusion, the staff think the boards could consider the following disclosures:

   (a) Qualitative disclosures, included as part of the qualitative disclosures required more generally for leases.

   (b) The amount of expense recognised in the current period related to short-term leases.

   (c) A maturity analysis of future lease payments for short-term leases.

42. The staff recommend that the boards include short-term leases in whatever qualitative disclosures they decide upon for leases generally. The staff think it would be useful to provide information about short-term leases' terms and conditions, particularly if the boards decide to change the definition of short-term to be consistent with the definition of lease term. Moreover, the staff note that there would not be incremental costs to provide this disclosure as qualitative disclosures need to be given about short-term leases under IAS 17 and Topic 840.

43. The staff also recommend that the boards require the separate disclosure of expense relating to short-term leases. The staff think this disclosure would give users helpful information about the significance of short-term leases to an entity, particularly if users wish to estimate the assets and liabilities, or perform trend analysis, on short-term leases. The staff note that entities would have to provide this disclosure about short-term leases today under IAS 17, and for all short-term leases with terms of more than one month under Topic 840, so there would be minimal incremental costs of providing this disclosure.

44. The staff do not recommend that the boards require a maturity analysis of future lease payments for short-term leases. The staff think that the cost of providing such a disclosure would outweigh the benefit because, by definition, short-term leases would have a maturity of one year or less. The cost would be exacerbated for U.S. GAAP preparers because lessees are currently not required to include short-term leases in the operating lease maturity analysis.

45. In summary, the staff recommend that a lessee disclose the amount of expense relating to short-term leases recognised in the reporting period, as well as any qualitative information the boards decide upon for leases generally. The staff think that these disclosures will give users helpful information about the extent and terms of short-term leases without involving additional costs for preparers from existing IFRS and U.S. GAAP disclosure requirements for these leases.

Staff recommendations

46. The staff recommends that the boards should:

(a) Confirm a recognition and measurement exemption for a lessee's short-term leases;

(b) Confirm that the short-term lease threshold is 12 months or less;

(c) Change the definition of 'short-term lease' so that it is assessed consistently with the definition of 'lease term'; and

(d) Require disclosure of the amount of expense relating to short-term leases recognised in a reporting period, as well as including short-term leases in whatever qualitative disclosures they decide upon for leases generally.

Questions: Lessee short-term leases
Do the boards agree with the staff recommendations regarding relief for short-term leases? If not, what do the boards prefer?