STAFF PAPER

October 2015

REG IASB Meeting

Project	**Leases**		
Paper topic	Sweep issues		
CONTACT(S)	Sarah Geisman	sgeisman@ifrs.org	+44 (0)20 7246 6464
	Patrina Buchanan	pbuchanan@ifrs.org	+44 (0)20 7246 6468

This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. In July 2015, the staff issued for review a draft of the new *Leases* Standard (the 'external review draft') to a number of external parties, including (among others) Leases Working Group members, accounting firms and regulators. This draft was also made available to members of the IFRS Interpretations Committee and the International Forum of Accounting Standards Setters.

2. This paper discusses four sweep issues that have arisen as a result of comments received on the external review draft. The sweep issues discussed in this paper are as follows:

   (a) Issue 1: Lease modifications treated as a separate new lease;

   (b) Issue 2: Reassessment of the discount rate for floating interest rate leases;

   (c) Issue 3: Costs associated with returning an underlying asset at the end of a lease; and

   (d) Issue 4: Short-term leases and leases of low-value assets in a business combination.

3. Issue 1 in this paper is a joint issue that the FASB has already discussed, while Issues 2-4 are IASB-only issues.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

Issue 1: Lease modifications treated as a separate new lease

4. The external review draft stated that a lease modification should be treated as a separate new lease if the modification increases the scope of the lease, and the consideration for the lease increases by an amount commensurate with the stand-alone price for that increase in scope.

5. External reviewers raised concerns that the requirements of the external review draft would lead to inconsistency between the treatment of:

   (a) lease modifications extending the use of an underlying asset (for example, a modification that increases the term of a five-year lease to eight years), and

   (b) extension options already written into the contract (for example, a three-year extension option that is written into a lease with a five-year non-cancellable period).

6. Under the requirements of the external review draft, if an optional period had not been included in the initial lease term but subsequently was included on reassessment, then this reassessment would be treated as a continuation of the existing lease. However, if a lease were modified to extend the period of use of the underlying asset, that extended period of use would be treated as a new lease (if priced commensurately with the extended term).

7. The difference between treating a modification that extends the use of an underlying asset as the continuation of an existing lease or as a new lease is one of timing in terms of the recognition of any increase in lease assets and lease liabilities:

   (a) If the modification were treated as the continuation of an existing lease, a lessee would recognise any increase in lease assets and lease liabilities at the date that the lessee and lessor agree to the modified terms and conditions of the lease.

   (b) If the modification were treated as a new lease, a lessee would recognise any increase in lease assets and liabilities only at the commencement of the extended period (which could be much later than the date that the modified terms and conditions are agreed).

8. The staff think that a modification that extends the use of an underlying asset changes the lessee's right to use the underlying asset and its obligation to make lease payments at the date that the modified terms and conditions are agreed. The lessee already controls the use of the underlying asset at the date of the modification, and the lessor has already performed by making the underlying asset available for the lessee's use at the commencement date of the original lease. The modification simply changes the characteristics of the right-of-use asset and lease liability already recognised by the lessee—it does not create a new and separate right-of-use. Accordingly, the staff think that the right-of-use asset and lease liability should be remeasured at the date that the modified terms and conditions are agreed.

9. The staff also note that accounting for a lease modification that extends the use of an underlying asset as the continuation of an existing lease would align the accounting for this type of modification with that for an extension option included in the lease term. The staff think that this is appropriate because the lessee is economically in a similar position in each of the two scenarios.

10. Consequently, the staff recommend amending the lease modification requirements to state that a lease modification should be treated as a separate new lease only if the modification increases the scope of the lease by *adding* the right to use one or more underlying assets and if the consideration increases commensurate with that increase in scope. If the modification adds the right to use one or more underlying assets (and is priced accordingly), the staff think that it is appropriate to account for such a modification as a new lease. This is because the lessee does not control the right to use a new underlying asset until the date that the new underlying asset is made available for its use.

11. The effect of this recommendation would be to treat lease modifications that extend the use of an underlying asset as the continuation of an existing lease. Consequently, for such a modification, a lessee would recognise any increase in leased assets and lease liabilities at the date that the modified terms and conditions are agreed.

12. It should be noted that, earlier in October, the FASB decided to change the lease modification requirements in its forthcoming *Leases* Standard in line with this staff recommendation.

13. The staff also recommend applying this recommendation to finance leases held by a lessor.

Question 1: Lease modifications treated as a separate new lease
Does the IASB agree that a lessee (and a lessor holding a finance lease) should treat a lease modification as a separate new lease only if the modification increases the scope of the lease by adding the right to use one or more underlying assets and if the consideration increases commensurate with that increase in scope?

Issue 2: Reassessment of the discount rate for floating interest rate leases

14. The external review draft stated that a lessee should remeasure lease assets and lease liabilities using revised lease payments when those payments are based on an index or a rate. A lessee would not update the discount rate applied to those revised lease payments.

15. External reviewers raised concerns that the requirements of the external review draft are inconsistent with the requirements for the subsequent measurement of floating rate financial liabilities measured at amortised cost in IFRS 9 *Financial Instruments*. Paragraph B5.4.5 of IFRS 9 states that the effective interest rate used to account for floating rate financial instruments should be remeasured when the future cash flows resulting from that instrument are re-estimated. Paragraph B5.4.5 explains that updating the effective interest rate at the same time as the future cash flows means that there is normally no significant effect on the carrying amount of the financial asset or liability.

16. External reviewers who raised this issue were concerned that the requirements in the external review draft:

    (a) would result in floating interest rate leases being accounted for differently from financing the same underlying asset with an equivalent loan;

    (b) would represent a change from the treatment of floating interest rate finance leases under IAS 17; and

    (c) would result in interest adjustments being reflected in the depreciation of the right-of-use asset (because they would change the carrying amount of

the right-of-use asset). This outcome would not be a faithful representation of the change in future lease payments because, when those payments change in a floating interest rate lease, there is typically no change to the cost of the right-of-use asset—the change relates only to the amount of interest to be paid in future periods.

17. The staff agree with these concerns and think that it is appropriate to update the discount rate whenever the lease payments associated with a floating interest rate lease (for example, payments based on LIBOR) are updated, as is required by IFRS 9 for floating rate financial liabilities measured at amortised cost. Consequently, the staff recommend that the new *Leases* Standard require a lessee to update the discount rate for a floating interest rate lease whenever the lease payments are updated because of a change in the interest rate used to determine the lease payments.

18. The staff note that this is an IASB-only issue because the FASB has decided not to remeasure lease liabilities when lease payments change because of changes in an index or a rate used to determine those payments.

Question 2: Reassessment of the discount rate for floating interest rate leases
Does the IASB agree that a lessee should update the discount rate for a floating interest rate lease whenever the lease payments are updated because of a change in the interest rate used to determine those payments?

Issue 3: Costs associated with returning an underlying asset at the end of a lease

19. The external review draft did not include any specific requirements relating to a lessee's obligation to return an asset to the lessor in a specified condition at the end of the lease, to dismantle or remove the underlying asset or to restore the site on which the underlying asset had been located ('restoration obligations').

20. External reviewers noted that the requirements in IAS 16 *Property, Plant and Equipment*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*

result in similar obligations relating to items of property, plant and equipment being accounted for as follows:

(a) the estimated costs to be incurred are treated as part of the cost of the item of property, plant and equipment;

(b) the obligation is recognised as a provision in accordance with IAS 37; and

(c) changes in the obligation are accounted for an adjustment to the cost of the related asset (subject to the carrying amount of the asset not being less than zero).

21. The external reviewers asked whether restoration obligations associated with a lease should be accounted for similarly to those associated with property, plant and equipment or as part of the lease liability (ie whether these obligations would be included in the definition of lease payments).

22. The staff think that it is appropriate to account for restoration obligations as provisions in accordance with IAS 37. The staff view restoration costs associated with a right-of-use asset as similar to such costs associated with an owned asset. Accordingly, the staff think that the accounting for such costs associated with a lease should align with the requirements for similar costs associated with owned assets in IAS 16, IAS 37 and IFRIC 1. The staff also think that it would be helpful to include requirements about these costs in the new *Leases* Standard.

23. Consequently, the staff recommend that the new *Leases* Standard state that if a lessee has restoration obligations, the lessee should account for those obligations in accordance with IAS 37, with the initial estimate of costs to be incurred included in the initial measurement of the right-of-use asset. These amounts are not considered to be lease payments. The staff also recommend that such liabilities should be included in the scope of IFRIC 1 and, therefore, that changes in the measurement of the liabilities be treated as adjustments to the right-of-use asset, subject to the carrying amount of the right-of-use asset not being less than zero.

Question 3: Costs associated with returning the underlying asset at the end of a lease
Does the IASB agree that, if a lessee has restoration obligations associated with a lease, the lessee should account for these obligations in accordance with IAS 37? A lessee would include an initial estimate of costs to be incurred in the initial measurement of the right-of-use asset, and any changes in the obligation would be accounted for as an adjustment to the carrying amount of the right-of-use asset in accordance with IFRIC 1.

Issue 4: Short-term leases and leases of low-value assets in a business combination

24. The external review draft retained the proposal in the 2013 ED that an acquirer is not required to recognise assets or liabilities for leases that, at the acquisition date, have a remaining term of 12 months or less. The external review draft did not include any specific requirements regarding the treatment in a business combination of leases of low-value assets for which the recognition exemption is elected.

25. Accordingly, if an acquirer entered into a business combination under which it acquired right-of-use assets and lease liabilities relating to short-term leases or leases of low-value assets, the acquirer would not be required to recognise assets or liabilities for those leases. This would represent a change to IFRS 3 *Business Combinations*, which currently requires an acquirer to recognise an intangible asset if the terms of an operating lease (in which the acquiree is the lessee) are favourable relative to market terms and a liability if the terms are unfavourable.

26. External reviewers questioned whether the requirements regarding operating leases in IFRS 3 should be retained for short-term leases and leases of low-value assets.

27. The IASB has decided that the costs of capitalising such leases outweigh the benefits for a lessee. The staff believes that the same rationale would also apply to the requirements of IFRS 3. Moreover, given that the staff expect short-term leases and leases of low-value assets to be immaterial for many lessees, the assets or liabilities associated with any favourable or unfavourable terms of these leases are even more likely to be immaterial.

28. The staff acknowledge that the effect of this is that goodwill on acquisition may be over- or understated for leases for which (a) the short-term lease or low-value asset

lease exemption is applied; and (b) the lease terms and conditions are favourable or unfavourable compared to market rates. Nonetheless, for the reason described above, the staff think that this difference is unlikely to result in any material difference in outcomes.

29. The staff also note that the FASB has decided to allow an acquirer not to recognise assets or liabilities for leases that, at the acquisition date, have a remaining term of 12 months or less. The forthcoming FASB *Leases* Standard will not include a recognition exemption for leases of low-value assets.

Question 4: Short-term leases and leases of low-value assets in a business combination

Does the IASB agree that the requirement in IFRS 3 for an acquirer to recognise assets and liabilities if the terms of an operating lease (in which the acquiree is the lessee) are favourable or unfavourable should not be retained for short-term leases and leases of low-value assets?