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Exposure Draft ED/2010/9

Leases

Comments to be received by 15 December 2010

IFRS™

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This exposure draft *Leases* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as an International Financial Reporting Standard (IFRS). Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **15 December 2010.** Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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CONTENTS

INTRODUCTION AND INVITATION TO COMMENT

Why are the IASB and the FASB publishing this exposure draft?

Leasing is an important source of finance. Therefore, it is important that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities. The existing accounting models for leases require lessees to classify their leases as either finance leases or operating leases. However, those models have been criticised for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual framework. The models also lead to a lack of comparability and undue complexity because of the sharp 'bright-line' distinction between finance leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

Accordingly, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) initiated a joint project to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognised in the statement of financial position.

To meet that objective, the IASB and the FASB have jointly developed a draft standard on leases and, hence, are proposing an International Financial Reporting Standard (IFRS) and amendments to the *FASB Accounting Standards Codification™*. The boards developed the proposals after considering responses to their discussion paper *Leases: Preliminary Views*, published in March 2009.

Although many of the problems associated with existing lease standards relate to the treatment of operating leases in the financial statements of lessees, keeping the existing lease standards for lessors would be inconsistent with the proposed approach to lessee accounting. It would also be inconsistent with the boards' proposed approach to revenue recognition, described in their exposure draft *Revenue from Contracts with Customers*. Consequently, this exposure draft deals with both lessee accounting and lessor accounting.

Who would be affected by the proposed requirements?

If confirmed, the proposed requirements would affect any entity that enters into a lease, with some specified exemptions. The proposed requirements would supersede IAS 17 *Leases* in IFRSs and the guidance in Topic 840 on leases in US generally accepted accounting principles (GAAP).

What are the main proposals?

The exposure draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. For leases within the scope of the draft IFRS, this means that:

(a) a lessee would recognise an asset representing its right to use the leased ('underlying') asset for the lease term (the 'right-of-use' asset) and a liability to make lease payments.

(b) a lessor would recognise an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:

  (i) recognise a lease liability while continuing to recognise the underlying asset (a performance obligation approach); or

  (ii) derecognise the rights in the underlying asset that it transfers to the lessee and continue to recognise a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).

Assets and liabilities recognised by lessees and lessors would be measured on a basis that:

(a) assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.

(b) uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.

(c) is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

For contracts that combine service and lease components, the right to receive lease payments and the liability to make lease payments would exclude payments arising from distinct service components and non-distinct service components for lessors that apply the derecognition approach.

For leases of twelve months or less, lessees and lessors would be able to apply simplified requirements.

The exposure draft also proposes disclosures based on stated objectives, including disclosures about the amounts recognised in the financial statements arising from leases and the amount, timing and uncertainty of cash flows arising from those contracts.

How would the main proposals affect IFRSs and US GAAP?

The proposals in this exposure draft would, if confirmed, result in significant changes to the accounting requirements for both lessees and lessors.

Changes to lessee accounting

IFRSs and US GAAP classify leases into two categories: finance leases and operating leases. Lessees would be most affected if they have a significant portfolio of assets held under operating leases, especially those with leases of property. At present, IFRSs and US GAAP account for the lease payments arising from operating leases by recognising them in the period in which they occur. The proposals would require lessees to recognise the assets and liabilities arising from those leases.

Although the proposed changes may be less fundamental for leases currently classified as finance leases, they would result in significant changes in the measurement of the assets and liabilities arising from those leases because of the way the exposure draft proposes to account for options and contingent rentals. In addition, the pattern of income and expense recognition in profit or loss would change significantly.

Changes to lessor accounting

The proposed approach to lessor accounting would differ significantly from existing IFRSs and US GAAP. Depending on the extent to which a lessor retains exposure to risks or benefits associated with the underlying asset, a lessor would apply either a performance obligation approach or a derecognition approach.

If a lessor retains exposure to significant risks or benefits associated with the underlying asset, the lessor would continue to recognise the underlying asset and in addition recognise a right to receive lease payments and a lease liability. The lessor would be viewed as satisfying the lease liability continuously over the lease term, and therefore would recognise lease income continuously over the lease term.

If a lessor does not retain exposure to significant risks or benefits associated with the underlying asset, the lease would be accounted for in a way similar to the current accounting for finance leases. That pattern of income recognition is similar to the pattern of revenue recognition currently required for manufacturer/dealer lessors. However, there would be significant changes in the measurement of the right to receive lease payments, the recognition of lease income and the recognition and measurement of residual assets. For such leases, the lessor would satisfy the lease liability at the date of commencement of the lease by delivering the right-of-use asset to the lessee and thus would recognise lease income representing the sale of the right to use the underlying asset.

When would the proposals be effective?

The IASB and the FASB are working on various projects, including this project, as part of their commitment under their updated Memorandum of Understanding. Because the boards plan to complete those projects and issue IFRSs or Accounting Standards Codification amendments for many projects in 2011, they will invite additional comment through a separate consultation on how best to introduce those new requirements.

Questions for respondents

The boards invite individuals and organisations to comment on all matters in the exposure draft, particularly on the questions below. Comments are most helpful if they identify clearly the issue or question to which they relate. Those who disagree with the proposals are asked to describe their suggested alternatives, supported by specific reasoning.

Respondents should submit one comment letter to either the IASB or the FASB. The boards will share and jointly consider all comment letters received.

The accounting model

The exposure draft proposes a new accounting model for leases in which:

(a) a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

(b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

Question 1: Lessees

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Question 2: Lessors

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

Question 4

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Scope

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:

  (i) a lessee should apply the lease accounting requirements to the combined contract.

  (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

  (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in *Revenue from Contracts with Customers*.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

Measurement

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) assumes the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

(c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132–BC135).

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Sale and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Disclosure

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognised in the financial statements arising from leases; and

(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

Transition

Question 16

(a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Benefits and costs

Question 17

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Other comments

Question 18

Do you have any other comments on the proposals?

[Draft] International Financial Reporting Standard X *Leases* ([draft] IFRS X) is set out in paragraphs 1–97 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] IFRS. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[Draft] International Financial Reporting Standard X *Leases*

Overview and background

1 This [draft] IFRS establishes principles for the financial reporting of *leases* by *lessees* and *lessors*. Leases serve a vital role in many entities' operations and contain provisions that range from simple to complex.

2 This [draft] IFRS establishes principles for lessees and lessors for recognising, measuring and presenting assets and liabilities arising from leases and disclosing information about leasing arrangements and the assets and liabilities arising from them.

3 [This paragraph in the FASB exposure draft is not used in the IASB exposure draft.]

Objective

4 This [draft] IFRS establishes principles that lessees and lessors shall apply to report relevant and representationally faithful information to users of financial statements about the amounts, timing and uncertainty of the cash flows arising from leases.

Scope

5 An entity shall apply this [draft] IFRS to all leases, including leases of *right-of-use assets* in a *sublease*, except:

(a) leases of intangible assets (see IAS 38 *Intangible Assets*).

(b) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see IFRS 6 *Exploration for and Evaluation of Mineral Resources*).

(c) leases of biological assets (see IAS 41 *Agriculture*).

(d) leases between the *date of inception* and the *date of commencement* of a lease if they meet the definition of an onerous contract (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

6 An entity shall apply this [draft] IFRS to a contract that contains service components and lease components (see paragraphs B5–B8), except as follows:

(a) A lessee shall apply *Revenue from Contracts with Customers* to a service component of a contract that contains service components and lease components if the service component is distinct and the lessee is able to do so.

(b) A lessor shall apply *Revenue from Contracts with Customers* to a service component of a contract that contains service components and lease components if the service component is distinct and the lessor is able to do so.

(c) When a lessor applies the derecognition approach (see paragraphs 28 and 29), it shall apply *Revenue from Contracts with Customers* to a service component of a contract that contains service components and lease components, even if that service component is not distinct.

7 An entity shall apply this [draft] IFRS to *investment property* that it holds under a lease. However:

(a) after initial recognition, a lessee may measure a right-of-use asset in accordance with the fair value model in IAS 40 *Investment Property*. The lessee shall recognise in profit or loss changes in the liability to make lease payments arising after initial recognition in accordance with IAS 40.

(b) a lessor shall apply IAS 40 and not this [draft] IFRS to leases of investment properties that are measured at fair value in accordance with IAS 40.

8 An entity shall not apply this [draft] IFRS to the following contracts, which represent a purchase or sale of an *underlying asset*:

(a) a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity (see paragraphs B9 and B10); and

(b) a lease after the lessee has exercised a purchase option specified in the lease. A contract ceases to be a lease when such an option is exercised and becomes a purchase (by the lessee) or sale (by the lessor).

9 Except as specified in paragraphs 30 and 46, an underlying asset in a lease is not within the scope of this [draft] IFRS.

Lessee

Recognition

10 **At the date of commencement of a lease, a lessee shall recognise in the statement of financial position a right-of-use asset and a liability to make** *lease payments***.**

11 **A lessee shall recognise the following items in the statement of comprehensive income, except to the extent that another IFRS requires or permits its inclusion in the cost of an asset:**

(a) interest expense on the liability to make lease payments (see paragraph 16(a)).

(b) amortisation of the right-of-use asset (see paragraphs 16(b) and 20).

(c) revaluation gains and losses as required by IAS 38, when a right-of-use asset is revalued in accordance with paragraph 21 (see paragraphs 21–23).

(d) any changes in the liability to make lease payments resulting from reassessment of the expected amount of *contingent rentals* **or expected payments under term option penalties and** *residual value guarantees* **relating to current or prior periods (see paragraph 18(a)).**

(e) any impairment losses on a right-of-use asset (see paragraph 24).

Measurement

Initial measurement

12 **At the date of inception of the lease, a lessee shall measure:**

(a) the liability to make lease payments at the present value of the lease payments (see paragraphs 13–15), discounted using the *lessee's incremental borrowing rate* **or, if it can be readily determined, the** *rate the lessor charges the lessee* **(see paragraph B11).**

(b) the right-of-use asset at the amount of the liability to make lease payments, plus any *initial direct costs* **incurred by the lessee (see paragraphs B14 and B15).**

Present value of lease payments

13 A lessee shall determine the *lease term* by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease (see paragraphs B16–B20).

14 A lessee shall determine the present value of lease payments payable during the lease term determined in accordance with paragraph 13 on the basis of expected outcome, determined using all relevant information. The expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes (see paragraph B21). In determining the present value of lease payments payable, a lessee shall include:

(a) an estimate of contingent rentals payable. If the contingent rentals depend on an index or a rate, the lessee shall determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessee shall use the prevailing rates or indices.

(b) an estimate of amounts payable to the lessor under residual value guarantees. Residual value guarantees that are provided by an unrelated third party are not lease payments.

(c) an estimate of expected payments to the lessor under term option penalties.

15 The exercise price of a purchase option included in a lease is not a lease payment and the purchase option is not included in determining the present value of lease payments payable.

Subsequent measurement

16 After the date of commencement of the lease, a lessee shall measure:

(a) the liability to make lease payments at amortised cost using the *effective interest method*, subject to the requirements in paragraphs 17–19.

(b) the right-of-use asset at amortised cost unless paragraphs 21–24 apply.

Reassessment of the liability to make lease payments

17 **After the date of commencement of the lease, the lessee shall reassess the carrying amount of the liability to make lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period. When such indications exist, a lessee shall:**

(a) reassess the length of the lease term in accordance with paragraph 13 and adjust the right-of-use asset to reflect any resulting change to the liability to make lease payments arising from changes to the lease term.

(b) reassess the expected amount of any contingent rentals and expected payments under term option penalties and residual value guarantees in accordance with paragraph 14. A lessee shall recognise any resulting changes to the liability to make lease payments in accordance with paragraph 18.

18 A lessee shall distinguish changes in contingent rentals and expected payments under term option penalties and residual value guarantees that relate to current or prior periods from those that relate to future periods. A lessee shall recognise changes in the expected amount of such payments:

(a) in profit or loss, to the extent that those changes relate to current or prior periods.

(b) as an adjustment to the right-of-use asset to the extent that those changes relate to future periods.

For example, when lease payments depend on the amount of the lessee's sales, changes relating to sales in the current or prior periods are recognised in profit or loss, whereas changes relating to expectations of future sales are recognised as an adjustment to the right-of-use asset.

19 A lessee shall not change the rate used to discount the lease payments except to reflect changes in reference interest rates when contingent rentals are based on those reference interest rates. When contingent rentals are based on reference interest rates, a lessee shall recognise any changes to the liability to make lease payments arising from changes in the discount rate in profit or loss.

Amortisation of the right-of-use asset

20 If a lessee measures the right-of-use asset at amortised cost, it shall amortise the asset on a systematic basis from the date of commencement of the lease to the end of the lease term or over the useful life of the underlying asset if shorter. The lessee shall select the amortisation method and review the amortisation period and amortisation method in accordance with IAS 38.

Revaluation of the right-of-use asset

21 A lessee may measure a right-of-use asset at its fair value at the date of revaluation less any amortisation and impairment losses arising after the date of revaluation if it revalues all owned assets in that class of property, plant and equipment, in accordance with IAS 16 *Property, Plant and Equipment*. For the purposes of this revaluation, fair value need not be determined by reference to an active market. If a lessee measures a right-of-use asset at a revalued amount, it shall revalue all right-of-use assets relating to the class of property, plant and equipment to which the underlying asset belongs.

22 If the lessee revalues a right-of-use asset in accordance with paragraph 21, it shall perform revaluations with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value.

23 If the lessee revalues a right-of-use asset in accordance with paragraph 21, it shall recognise gains and losses on revaluation in the statement of comprehensive income in accordance with IAS 38.

Impairment of the right-of-use asset

24 A lessee shall apply IAS 36 *Impairment of Assets* at each reporting date to determine whether the right-of-use asset is impaired and shall recognise any impairment loss in accordance with IAS 36.

Presentation

25 A lessee shall present the following items in the statement of financial position:

(a) liabilities to make lease payments, separately from other financial liabilities.

(b) right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, separately from assets that the lessee does not lease.

26 A lessee shall present amortisation of the right-of-use asset and interest expense on the liability to make lease payments separately from other amortisation and interest expense, either in profit or loss or in the notes.

27 A lessee shall classify cash payments for leases as financing activities in the statement of cash flows and present them separately from other financing cash flows.

Lessor

When to apply the performance obligation or derecognition approach

28 At the date of inception of the lease, a lessor shall assess whether a lease is accounted for in accordance with the performance obligation approach or the derecognition approach on the basis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset either:

(a) during the expected term of the lease; or

(b) after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or selling the underlying asset

(see paragraphs B22–B27).

29 If a lessor retains exposure to significant risks or benefits associated with an underlying asset, the lessor shall apply the performance obligation approach to the lease. If a lessor does not retain exposure to significant risks or benefits associated with an underlying asset, the lessor shall apply the derecognition approach to the lease. A lessor shall not change the lessor accounting approach after the date of inception of the lease.

Recognition: performance obligation approach

30 At the date of commencement of a lease, a lessor shall recognise in the statement of financial position a right to receive lease payments and a *lease liability*. The lessor shall not derecognise the underlying asset.

31 A lessor shall recognise the following items in profit or loss:

(a) interest income on the right to receive lease payments (see paragraph 37(a)).

(b) lease income as the lease liability is satisfied (see paragraph 37(b)).

(c) any changes in the lease liability resulting from reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees when the lessor satisfies that liability (see paragraphs 39 and 40).

(d) any impairment losses on the right to receive lease payments (see paragraph 41).

32 A lessor shall classify lease income as revenue if it arises in the course of a lessor's ordinary activities.

Measurement: performance obligation approach

Initial measurement

33 At the date of inception of the lease, a lessor shall measure:

(a) the right to receive lease payments at the sum of the present value of the lease payments (see paragraphs 34–36), discounted using the rate the lessor charges the lessee (see paragraph B12), and any initial direct costs incurred by the lessor (see paragraphs B14 and B15).

(b) the lease liability at the amount of the right to receive lease payments.

Present value of lease payments

34 A lessor shall determine the lease term by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease (see paragraphs B16–B20).

35 A lessor shall determine the present value of the lease payments receivable during the lease term determined in accordance with paragraph 34 on the basis of expected outcome, determined using all relevant information. The expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes (see paragraph B21). In determining the present value of lease payments receivable, a lessor shall include:

(a) an estimate of contingent rentals receivable that the lessor can measure reliably. If the contingent rentals depend on an index or a rate, the lessor shall determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessor shall use the prevailing rates or indices.

(b) an estimate of amounts receivable from the lessee under residual value guarantees that the lessor can measure reliably. Residual value guarantees that are provided by an unrelated third party are not lease payments.

(c) an estimate of expected payments from the lessee under term option penalties.

36 The exercise price of a purchase option included in a lease is not a lease payment and the purchase option is not included in determining the present value of lease payments receivable.

Subsequent measurement

37 After the date of commencement of the lease, a lessor shall measure:

(a) the right to receive lease payments at amortised cost using the effective interest method, unless paragraph 39 or 41 applies.

(b) the remaining lease liability determined on the basis of the pattern of use of the underlying asset by the lessee. If the lessor cannot determine reliably the remaining lease liability in a systematic and rational manner on the basis of the pattern of use of the underlying asset by the lessee (see paragraph 38), it shall use the straight-line method.

38 Systematic and rational methods of determining the lessor's remaining liability, other than the straight-line method, include:

(a) output methods in which the pattern of use of the underlying asset is based on the number of units produced by the lessee (for example, units delivered, contract milestones, or estimates of goods or services transferred to date relative to the total goods or services to be transferred).

(b) input methods in which the pattern of use of the underlying asset is based on the efforts expended to date by the lessee (for example, machine hours used), relative to total efforts expected to be expended over the lease term.

Reassessment of the right to receive lease payments

39 After the date of commencement of the lease, the lessor shall reassess the carrying amount of the right to receive lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the right to receive lease payments since the previous reporting period. When such indications exist, a lessor shall:

(a) reassess the length of the lease term in accordance with paragraph 34 and adjust the lease liability to reflect any change to the right to receive lease payments arising from changes to the lease term (see paragraph B28).

(b) reassess the expected amount of any contingent rentals and any expected payments under residual value guarantees that the lessor can measure reliably and any expected payments under term option penalties in accordance with paragraph 35. A lessor shall recognise any resulting changes to the right to receive lease payments:

(i) in profit or loss to the extent that the lessor has satisfied the related lease liability.

(ii) as an adjustment to the lease liability to the extent that the lessor has not satisfied the related lease liability. However, the lessor shall recognise any changes that would reduce that liability below zero in profit or loss.

40 A lessor shall not change the rate used to discount the lease payments except to reflect changes in reference interest rates when contingent rentals are based on those reference interest rates. When contingent rentals are based on reference interest rates, a lessor shall recognise any changes to the right to receive lease payments arising from changes in the discount rate in profit or loss.

Impairment of the right to receive lease payments

41 A lessor shall apply IAS 39 at each reporting date to determine whether the right to receive lease payments is impaired and shall recognise any impairment loss in profit or loss.

Presentation: performance obligation approach

42 A lessor shall present the following items together in the statement of financial position:

(a) underlying assets.

(b) rights to receive lease payments.

(c) lease liabilities.

(d) the total of (a)–(c) as a net lease asset or a net lease liability.

43 An intermediate lessor shall present the liability to make lease payments under a head lease separately from other assets and liabilities arising from the sublease and shall present the following items together in the statement of financial position:

(a) right-of-use assets (which are the underlying assets in subleases).

(b) rights to receive lease payments under subleases.

(c) lease liabilities.

(d) the total of (a)–(c) as a net lease asset or a net lease liability

(see paragraph B29).

44 A lessor shall present in profit or loss interest income on a right to receive lease payments, lease income resulting from satisfaction of a lease liability and depreciation expense on an underlying asset separately from other interest income, income and depreciation expense.

45 A lessor shall classify the cash receipts from lease payments as operating activities in the statement of cash flows. If the lessor:

(a) applies the direct method, it shall present those cash receipts separately from other cash flows from operating activities.

(b) applies the indirect method, it shall present changes in the right to receive lease payments separately from the changes in other operating receivables.

Recognition: derecognition approach

46 At the date of commencement of a lease, a lessor shall:

(a) recognise a right to receive lease payments in the statement of financial position.

(b) derecognise from the statement of financial position the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease (see paragraph 50).

(c) reclassify as a *residual asset* the remaining portion of the carrying amount of the underlying asset that represents the rights in the underlying asset that the lessor retains (see paragraph 50).

47 **A lessor shall recognise the following items in profit or loss:**

(a) lease income representing the present value of the lease payments and lease expense representing the cost of the portion of the underlying asset that is derecognised at the date of commencement of the lease.

(b) interest income on the right to receive lease payments (see paragraph 54).

(c) lease income and lease expense upon any reassessment of the lease term required by paragraph 56(a).

(d) any changes in the right to receive lease payments resulting from reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees required by paragraph 56(b).

(e) any impairment losses on the right to receive lease payments or the residual asset (see paragraphs 58 and 59).

48 A lessor shall classify lease income as revenue and lease expense as cost of sales if that income and expense arise in the course of a lessor's ordinary activities.

Measurement: derecognition approach

Initial measurement

49 **At the date of inception of the lease, a lessor shall measure:**

(a) the right to receive lease payments at the sum of the present value of the lease payments (see paragraphs 51–53), discounted using the rate the lessor charges the lessee (see paragraph B12), and any initial direct costs incurred by the lessor (see paragraphs B14 and B15).

(b) the residual asset at an allocated amount of the carrying amount of the underlying asset (see paragraph 50).

50 A lessor shall determine the amount derecognised and the initial carrying amount of the residual asset by allocating the carrying amount of the underlying asset at the date of inception of the lease in proportion to the fair value of the rights that have been transferred and the fair value of the rights that have been retained by the lessor. Therefore, the amount derecognised by the lessor is the carrying amount of the underlying asset multiplied by the fair value of the right to receive lease payments divided by the fair value of the underlying asset (all determined at the date of inception of the lease).

Present value of lease payments

51 A lessor shall determine the lease term by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease (see paragraphs B16–B20).

52 A lessor shall determine the present value of lease payments receivable during the lease term determined in accordance with paragraph 51 on the basis of expected outcome, determined using all relevant information. The expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes (see paragraph B21). In determining the present value of lease payments receivable, a lessor shall include:

(a) an estimate of contingent rentals receivable that the lessor can measure reliably. If the contingent rentals depend on an index or a rate, the lessor shall determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessor shall use the prevailing rates or indices.

(b) an estimate of the amounts receivable from the lessee under residual value guarantees that the lessor can measure reliably. Residual value guarantees that are provided by an unrelated third party are not lease payments.

(c) an estimate of expected payments from the lessee under term option penalties.

53 The exercise price of a purchase option included in a lease is not a lease payment, and the purchase option is not included in determining the present value of lease payments receivable.

Subsequent measurement

54 After the date of commencement of the lease, a lessor shall measure the right to receive lease payments at amortised cost using the effective interest method, unless paragraph 56(a) or 58 applies.

55 A lessor shall not remeasure the residual asset unless paragraph 56(a) or 59 applies.

Reassessment of the right to receive lease payments

56 **After the date of commencement of the lease, the lessor shall reassess the carrying amount of the right to receive lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the right to receive lease payments since the previous reporting period. When such indications exist, a lessor shall:**

(a) reassess the length of the lease term in accordance with paragraph 51. When that reassessment results in a change to the residual asset, the lessor shall allocate those changes to the rights derecognised and the residual asset in accordance with paragraph 50 and adjust the carrying amount of the residual asset accordingly (see paragraph B30).

(b) reassess the expected amount of any contingent rentals and any expected payments under residual value guarantees that the lessor can measure reliably and any expected payments under term option penalties in accordance with paragraph 52. A lessor shall recognise any resulting changes in the expected amount of the right to receive lease payments in profit or loss.

57 A lessor shall not change the rate used to discount lease payments except to reflect changes in reference interest rates when contingent rentals depend on those reference interest rates. When contingent rentals are based on reference interest rates, a lessor shall recognise any changes to the right to receive lease payments arising from changes in the discount rate in profit or loss.

Impairment of the right to receive lease payments and the residual asset

58 **A lessor shall apply IAS 39 at each reporting date to determine whether the right to receive lease payments is impaired. A lessor shall recognise any impairment loss in profit or loss.**

59 **A lessor shall apply IAS 36 at each reporting date to determine whether the residual asset is impaired. A lessor shall recognise any impairment loss in profit or loss.**

Presentation: derecognition approach

60 A lessor shall present the following items in the statement of financial position:

(a) rights to receive lease payments, separately from other financial assets, distinguishing those that arise under a sublease.

(b) residual assets, separately within property, plant and equipment, distinguishing those that arise under a sublease.

61 A lessor shall present lease income and lease expense in profit or loss either in separate line items or net in a single line item so that the lessor provides information that reflects the lessor's business model. For example:

(a) if a lessor's business model uses leases as an alternative means of realising value from the goods it would otherwise sell, the lessor shall present lease income and lease expense in separate line items. Many manufacturers and dealers regard the lease of an asset as equivalent to selling the asset. Those lessors would present revenue and cost of sales so that income and expenses from sold and leased items are presented consistently.

(b) if a lessor's business model uses leases for the purposes of providing finance, the lessor would present lease income and lease expense net in a single line item.

62 A lessor shall present in profit or loss interest income from rights to receive lease payments separately from other interest income.

63 A lessor shall classify cash receipts from lease payments as operating activities in the statement of cash flows. If a lessor:

(a) applies the direct method, it shall present the cash receipts from lease payments separately from other cash flows from operating activities.

(b) applies the indirect method, it shall present the changes in the right to receive lease payments separately from changes in other operating receivables.

Short-term leases: lessees and lessors

64 At the date of inception of a lease, a lessee that has a *short-term lease* may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (a) the liability to make lease payments at the undiscounted amount of the lease payments and (b) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees shall recognise lease payments in profit or loss over the lease term.

65 At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets or liabilities arising from a short-term lease in the statement of financial position, nor

derecognise any portion of the underlying asset. Such lessors shall continue to recognise the underlying asset in accordance with other IFRSs and shall recognise lease payments in profit or loss over the lease term.

Sale and leaseback transactions

66 If a transferor transfers an asset to another party and leases that asset back from that other party, both the transferor and the transferee shall account for the transfer contract and the lease contract in accordance with paragraphs 67–69 if the contracts are:

(a) entered into at or near the same time;

(b) negotiated as a package with a single commercial objective; or

(c) performed either concurrently or consecutively.

67 The transferor shall account for transactions that meet the criteria in paragraph 66 as follows:

(a) If the transfer meets the conditions for a sale (see paragraphs B9, B10 and B31), the transferor shall account for the sale in accordance with applicable IFRSs and for the lease in accordance with paragraphs 10–27.

(b) If the transfer does not meet the conditions for a sale, the transferor shall account for the contract as a financing. The transferor shall not derecognise the transferred asset and shall recognise any amounts received as a financial liability.

68 The transferee shall account for transactions that meet the criteria in paragraph 66 as follows:

(a) If the transfer meets the conditions for a purchase (see paragraphs B9, B10 and B31), the transferee shall account for the purchase in accordance with applicable IFRSs and for the lease using the performance obligation approach (see paragraphs 30–45).

(b) If the transfer does not meet the conditions for a purchase, the transferee shall not recognise the transferred asset. The transferee shall recognise the amount paid as a receivable in accordance with applicable IFRSs.

69 If the consideration for a purchase or sale or the lease payments specified by the leaseback are not at fair value:

(a) a transferor shall adjust:

(i) the measurement of the right-of-use asset to reflect current market rates for lease payments for that asset.

(ii) the gain or loss on disposal of the underlying asset by any difference between the present value of lease payments based on the terms specified in the lease and the present value of the lease payments based on current market rates.

(b) a transferee shall adjust the carrying amount of the underlying asset and the lease liability it recognises under the performance obligation approach to reflect current market rates for the lease payments for that lease.

Disclosure

70 An entity shall disclose quantitative and qualitative financial information that:

(a) identifies and explains the amounts recognised in the financial statements arising from leases; and

(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows.

71 An entity shall consider the level of detail necessary to satisfy the disclosure requirements in paragraphs 73–86 and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

72 If the disclosures required by this and other IFRSs do not meet the objectives in paragraph 70, an entity shall disclose the additional information necessary to meet the objectives.

Information that identifies and explains the amounts in the financial statements

73 An entity shall disclose:

(a) the nature of its lease arrangements, including:

(i) a general description of those lease arrangements.

(ii) the basis and terms on which contingent rentals are determined.

(iii) the existence and terms of options, including for renewal and termination. A lessee shall provide narrative disclosure about the options that were recognised as part of the right-of-use asset and those that were not.

(iv) the existence and principal terms of any options for the lessee to purchase the underlying asset.

(v) information about assumptions and judgements relating to amortisation methods and changes to those assumptions and judgements.

(vi) the existence and terms of residual value guarantees.

(vii) initial direct costs incurred during the reporting period and included in the measurement of the right-of-use asset or right to receive lease payments.

(viii) the restrictions imposed by lease arrangements, such as those relating to dividends, additional debt and further leasing.

(b) information about the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations for the entity.

74 An entity shall identify the nature and amount of significant subleases included in the disclosures provided in accordance with paragraph 73.

75 An entity that accounts for short-term leases in accordance with paragraphs 64 and 65 shall disclose that fact and, for lessees, the amount recognised in the statement of financial position for such short-term leases.

76 A lessee that enters into a sale and leaseback transaction shall disclose that fact, disclose the terms and conditions for that transaction and identify any gains or losses arising from such transactions separately from gains or losses on other disposals of assets.

77 A lessee shall disclose a reconciliation of opening and closing balances of right-of-use assets and liabilities to make lease payments, disaggregated by class of underlying asset. The reconciliation shall show separately the total cash lease payments paid during the period.

78 A lessor shall disclose the information about its exposure to the risks or benefits associated with the underlying asset that it used in determining whether to apply the performance obligation approach or the derecognition approach.

79 A lessor shall disclose impairment losses arising from leases to which it applies the performance obligation approach separately from those to which it applies the derecognition approach.

80 A lessor shall disclose a reconciliation of the opening and closing balances for each of the following:

(a) rights to receive lease payments.

(b) lease liabilities arising from leases to which it applies the performance obligation approach.

(c) residual assets arising from leases to which it applies the derecognition approach.

81 A lessor shall disclose information about the nature and amount of each class of residual asset arising from leases to which it applies the derecognition approach.

82 A lessor shall disclose information about the nature of significant service obligations related to its leases.

Information about the amount, timing and uncertainty of cash flows arising from leases

83 An entity shall disclose information about significant assumptions and judgements and any changes in assumptions and judgements relating to renewal options, contingent rentals, term option penalties, residual value guarantees and the discount rate used when determining the present value of lease payments.

84 Except as described in paragraphs 85 and 86, an entity shall disclose information relating to risks arising from a lease required by paragraphs 31–42 of IFRS 7 *Financial Instruments: Disclosures*.

85 In place of the maturity analyses required by paragraph 39(a) and (b) of IFRS 7, a lessee shall disclose a maturity analysis of the liabilities to make lease payments showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years. The maturity analysis shall distinguish the minimum obligations specified in the lease (ie excluding contingent rentals and expected payments under term option penalties and residual value guarantees) and the amounts recognised in the statement of financial position.

86 In place of the maturity analyses required by paragraph 37(a) of IFRS 7, a lessor shall disclose a maturity analysis of the right to receive lease payments showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years. The maturity analysis shall distinguish the cash flows attributable to the minimum amounts receivable specified in the lease (ie excluding contingent rentals and expected payments from the lessee under term option penalties and residual value guarantees) and the amounts recognised in the statement of financial position.

Effective date and transition

Effective date

87 An entity shall apply this [draft] IFRS in its annual financial statements for periods beginning on or after [date to be inserted after exposure].

Transition

88 For the purposes of the transition provisions in paragraphs 88–96, the date of initial application is the beginning of the first comparative period presented in the first financial statements in which the entity applies this [draft] IFRS. An entity shall recognise and measure all outstanding contracts within the scope of the [draft] IFRS as of the date of initial application using a simplified retrospective approach as described in paragraphs 90–96.

89 An entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had been applied from the beginning of the earliest period presented.

Lessees

90 Unless paragraphs 91–93 apply, at the date of initial application, a lessee shall:

(a) recognise a liability to make lease payments for each outstanding lease, measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate on the date of initial application.

(b) recognise a right-of-use asset for each outstanding lease, measured at the amount of the related liability to make lease payments, subject to any adjustments required to reflect impairment.

91 When lease payments are uneven over the lease term, a lessee shall adjust the right-of-use asset recognised at the date of initial application by the amount of any recognised prepaid or accrued lease payments.

92 For leases that were classified in accordance with IAS 17 *Leases* as finance leases and do not have options, contingent rentals, term option penalties or residual value guarantees, the carrying amount at the date of initial application of the right-of-use asset and the liability to make lease payments shall be the carrying amount of the lease asset and liability under that standard.

93 For each short-term lease that the lessee accounts for in accordance with paragraph 64, at the date of initial application a lessee shall recognise a liability to make lease payments measured at the undiscounted amount of the remaining lease payments and a right-of-use asset at the amount of the liability recognised.

Lessors: performance obligation approach

94 At the date of initial application, a lessor shall:

(a) recognise a right to receive lease payments for each outstanding lease, measured at the present value of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease, subject to any adjustments required to reflect impairment.

(b) recognise a lease liability for each outstanding lease, measured at the amount of the related right to receive lease payments.

(c) reinstate previously derecognised underlying assets at depreciated cost, determined as if the asset had never been derecognised, subject to any adjustments required to reflect impairment and revaluation.

Lessors: derecognition approach

95 At the date of initial application, a lessor shall:

(a) recognise a right to receive lease payments for each outstanding lease, measured at the present value of the remaining lease payments, discounted using the rate charged in the lease determined at the date of inception of the lease, subject to any adjustments required to reflect impairment.

(b) recognise a residual asset at fair value determined at the date of initial application.

Disclosure

96 An entity shall provide the transition disclosures required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, without the disclosure of adjusted basic and diluted earnings per share.

Withdrawal of other IFRSs

97 This [draft] IFRS supersedes the following IFRSs:

(a) IAS 17

(b) IFRIC 4 *Determining whether an Arrangement contains a Lease*

(c) SIC-15 *Operating Leases—Incentives*

(d) SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

98 [This paragraph in the FASB exposure draft is not used in the IASB exposure draft.]

Appendix A
Defined terms

This appendix is an integral part of the [draft] IFRS.

contingent rentals	**Lease payments** that arise under the contractual terms of a **lease** because of changes in facts or circumstances occurring after the **date of inception of the lease**, other than the passage of time.
date of commencement of the lease	The date on which the **lessor** makes the **underlying asset** available for use by the **lessee**.
date of inception of the lease	The earlier of the date of the **lease** agreement and the date of commitment by the parties to the **lease** agreement.
initial direct costs	Recoverable costs that are directly attributable to negotiating and arranging a **lease** that would not have been incurred had the **lease** transaction not been made.
lease	A contract in which the right to use a specified asset (the **underlying asset**) is conveyed, for a period of time, in exchange for consideration.
lease liability	The **lessor**'s obligation to permit the **lessee** to use the **underlying asset** over the **lease term**.
lease payments	Payments arising under a **lease** including fixed rentals and rentals subject to uncertainty, including, but not limited to, **contingent rentals** and amounts payable by the **lessee** under **residual value guarantees** and term option penalties.
lease term	The longest possible term that is more likely than not to occur.
lessee	An entity that enters into a contract to provide another entity with consideration in return for the right to use an asset for a period of time.
lessor	An entity that enters into a contract to provide another entity with the right to use an asset for a period of time in return for consideration.

lessee's incremental borrowing rate	The rate of interest that, at the **date of inception of the lease,** the **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar **underlying asset**.
rate the lessor charges the lessee	A discount rate that takes into account the nature of the transaction as well as the specific terms of the **lease** such as **lease payments**, **lease term** and **contingent rentals**.
residual asset	An asset representing the rights to the **underlying asset** retained by the **lessor** under the derecognition approach for lessor accounting.
residual value guarantee	A guarantee made by the **lessee** that the fair value of the **underlying asset** that the **lessee** will return to the **lessor** will be at least a specified amount. If the fair value is less than that amount, the **lessee** is obliged to pay the difference to the **lessor**.
right-of-use asset	An asset that represents the **lessee**'s right to use, or control the use of, a specified asset for the **lease term**.
short-term lease	A **lease** that, at the **date of commencement of the lease**, has a maximum possible **lease term** including options to renew or extend, of twelve months or less.
sublease	A transaction in which an **underlying asset** is re-leased by the original **lessee** (or 'intermediate **lessor**') to a third party, and the lease agreement (or 'head lease') between the original **lessor** and **lessee** remains in effect.
underlying asset	The asset for which a right of use is conveyed in a **lease**.

The term 'investment property' is defined in IAS 40 *Investment Property* and is used in the [draft] IFRS with the meaning specified in IAS 40.

The term 'effective interest method' is defined in IAS 39 *Financial Instruments: Recognition and Measurement* and is used in the [draft] IFRS with the meaning specified in IAS 39.

The term 'performance obligation' is used in the [draft] IFRS with the meaning proposed in the exposure draft *Revenue from Contracts with Customers.*

CONTENTS

Appendix B
Application guidance

This appendix is an integral part of [draft] IFRS X.

Definition of a lease (Appendix A)

B1 At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether:

(a) the fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset') (paragraphs B2 and B3); and

(b) the contract conveys the right to control the use of a specified asset for an agreed period of time (paragraph B4).

Fulfilment of the contract depends on providing a specified asset

B2 In assessing whether fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset') to the lessee, it may be necessary to consider whether the asset or assets are implicitly or explicitly identified. An asset is implicitly 'specified' if it is (a) infeasible or impractical for a lessor to provide alternative assets in place of the underlying asset during the lease term or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice. For example, in a lease of an aircraft, it may not be practical to substitute another aircraft if the lessee has made extensive changes to the underlying asset (the aircraft) to suit the lessee's image, brand and requirements.

B3 A contract that permits an entity to substitute a similar asset for the specified asset after the date of commencement of the lease does not contain a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset. For example, if a supplier of a specified quantity of goods or services has the right and current ability to provide those goods or services using assets not specified in the arrangement, the underlying assets are not specified and the contract does not contain a lease. However, a contract that permits or requires the supplier to substitute other assets only when the specified asset is not operating properly may be a lease. In addition, a contractual provision (contingent or otherwise) that permits or requires a supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

Contract conveys the right to control the use of a specified asset

B4 A contract conveys the right to use an asset if it conveys to an entity the right to control the use of the underlying asset during the lease term. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

(a) The entity has the ability or right to operate the asset or direct others to operate the asset in a manner that it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The entity has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) The entity will obtain all but an insignificant amount of the output or other utility of the asset during the term of the lease, and the price that the entity will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. If the price that the entity will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of the output, then the entity is paying for a product or service rather than paying for the right to use the underlying asset.

Scope

Contracts that contain both service components and lease components (paragraph 6)

B5 An entity shall apply the proposals in the boards' exposure draft *Revenue from Contracts with Customers* to identify separate performance obligations within a contract that contains both service components and lease components. An entity shall account for each component as follows:

(a) If the service component is distinct (see paragraphs B6 and B7), the entity allocates the payments required by the contract between the service components and lease components using the principles proposed in paragraphs 50–52 of *Revenue from Contracts with Customers*. However, if a lessee or a lessor that applies the performance obligation approach is unable to allocate the payments, the lessee or lessor applies this [draft] IFRS to the whole contract.

(b) If the service component is not distinct, a lessee and a lessor that applies the performance obligation approach shall account for the whole contract as a lease.

(c) If a service component is not distinct and a lessor applies the derecognition approach, the lessor shall allocate the payments between service components and lease components on a reasonable basis, eg based on the stand-alone selling price of the service. The lessor recognises a receivable for the lease component only and recognises the service component in accordance with the principles proposed in paragraphs 50–52 of *Revenue from Contracts with Customers*.

B6 An entity shall determine whether a service component is distinct at the date of inception of the lease considering all concurrently negotiated contracts with another party.

B7 A service component is distinct if either:

(a) the entity, or another entity, sells an identical or similar service separately; or

(b) the entity could sell the service separately because the service meets both of the following conditions:

(i) It has a distinct function—a service has a distinct function if it has a utility either (1) on its own or (2) together with other non-leasing goods and services that the lessee has acquired from the lessor or is provided separately by the lessor or by another entity.

(ii) It has a distinct profit margin—a service has a distinct profit margin if it is subject to distinct risks and the lessor can separately identify the resources needed to provide the service.

B8 If the payments required by a contract that contains both lease and service components change after the commencement of the lease, an entity shall determine the change attributable to the lease and service components. If the amount of the change attributable to each component cannot be determined, the entity shall allocate the change to the service components and lease components in the same proportion as determined at the date of commencement of the contract.

Distinguishing between a lease and a purchase or sale (paragraph 8)

B9 An entity shall not apply this [draft] IFRS to contracts that meet the criteria for classification as a purchase or sale of an underlying asset. A contract represents a purchase or sale of an underlying asset if, at the end of the contract, an entity transfers to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset. That determination is made at inception and is not subsequently reassessed.

B10 An entity shall consider all relevant facts and circumstances when determining whether control of the underlying asset is transferred at the end of the contract. A contract normally transfers control of an underlying asset when the contract:

(a) automatically transfers title to the underlying asset to the transferee at the end of the contract term; or

(b) includes a bargain purchase option. A bargain purchase option is an option to purchase the asset at a price that is expected to be significantly lower than the fair value of the asset at the date that the option becomes exercisable. If the exercise price is significantly lower than fair value, it would be reasonably certain at the inception of the lease that such options will be exercised. An entity that has a bargain purchase option is in an economically similar position to an entity that will automatically obtain title to the underlying asset at the end of the lease term. By exercising its bargain purchase option, the transferee would be able to direct the use of, and receive the benefits from, the whole of the underlying asset for the whole of its life.

Lessee and lessor: initial measurement

Discount rate (paragraphs 12(a), 33(a) and 49(a))

B11 The discount rate used to determine the present value of lease payments for lessees is the lessee's incremental borrowing rate or the rate the lessor charges the lessee if that rate can be reliably determined. The lessee's incremental borrowing rate may be the same as the rate the lessor charges the lessee.

B12 The discount rate used to determine the present value of lease payments for lessors is the rate that the lessor charges the lessee. The rate the lessor charges the lessee could be, for example the lessee's incremental borrowing rate, the rate implicit in the lease (ie the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset) or, for property leases, the yield on the property.

B13 Both the lessee's incremental borrowing rate and the rate the lessor charges the lessee would reflect the nature of the transaction and the specific terms of the lease, such as lease payments, lease term, expected contingent rentals, expected payments under term option penalties and residual value guarantees, the expected value of the underlying asset at the end of the lease term and security attached to the underlying asset during and at the end of the lease term.

Initial direct costs (paragraphs 12(b), 33(b) and 49(a))

B14 Initial direct costs result directly from, and are essential to, acquiring or originating a lease and would not have been incurred had the lease transaction not been made. They may include:

(a) commissions

(b) legal fees

(c) evaluation of the prospective lessee's financial condition

(d) evaluating and recording guarantees, collateral and other security arrangements

(e) negotiating lease terms

(f) preparing and processing lease documents

(g) closing the transaction

(h) other costs that are incremental and directly attributable to negotiating and arranging the lease.

B15 The following items are not initial direct costs:

(a) general overheads, such as rent, depreciation, occupancy and equipment costs, unsuccessful origination efforts and idle time

(b) costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities.

Present value of the lease payments

Determining the lease term (paragraphs 13, 34 and 51)

B16 The lease term is defined as the longest possible term that is more likely than not to occur. An entity determines the lease term considering all explicit and implicit options included in the contract and given effect by the operation of statutory law.

B17 The following illustrates how an entity applies paragraphs 13, 34 and 51 to determine the lease term. An entity may have a lease that has a non-cancellable 10-year term, an option to renew for 5 years at the end of 10 years, and an option to renew for an additional 5 years at the end of 15 years. Assume that the entity determines the probability for each term as follows:

(a) 40 per cent probability of 10-year term

(b) 30 per cent probability of 15-year term

(c) 30 per cent probability of 20-year term.

The term will be at least 10 years, there is a 60 per cent chance that the term will be 15 years or longer, but only a 30 per cent chance that the term will be 20 years. Therefore there is a 60 per cent chance that the term will be 15 years, which is the longest possible term more likely than not to occur. Therefore the lease term is 15 years.

B18 An entity considers the following factors in assessing the probability of each possible term:

(a) contractual factors, which are the explicit contractual terms that could affect whether the lessee extends or terminates the lease. Examples of contractual factors are the level of lease payments in any secondary period (bargain, discounted, market or fixed rate), the existence and amount of any contingent rentals or other contingent payments such as payments under term option penalties and residual value guarantees, the existence and terms of any renewal options and costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.

(b) non-contractual factors, such as statutory law or the financial consequences of a decision to extend or terminate the lease that the contract does not state explicitly. Examples of non-contractual features are local regulations that affect the lease term, the existence of significant leasehold improvements that would be forgone if the lease were terminated or not extended, non-contractual relocation costs, costs of lost production, tax consequences and costs associated with sourcing an alternative item.

(c) business factors, such as whether the underlying asset is crucial to the lessee's operations, or whether the underlying asset is a specialised asset or the location of the asset.

(d) other lessee-specific factors, such as lessee's intentions and past practice.

B19 Leases sometimes include options and residual value guarantees. For example, a lease may have a term of 10 years. At the end of the 10-year period, the contract permits the lessee to return the underlying asset to the lessor or to extend the lease for an additional 5 years. If the lessee returns the leased asset to the lessor, the contract may specify that the lessee will pay the lessor the difference between the expected residual value of the leased asset at the end of 10 years and the actual residual value at the end of 10 years (a residual value guarantee). At the date of inception of the lease, a lessee or lessor shall determine whether exercising the option to extend is more likely than not to occur. At the date of commencement of the lease, the lessee recognises a liability to make lease payments and the lessor recognises a right to receive lease payments that is consistent with that outcome. Thus:

(a) if the lessee or lessor determine that returning the asset at the end of the 10-year period is more likely than not to occur, the lease term for the lessee or lessor is 10 years. In that case:

    (i) the lessee would recognise a liability to make lease payments equal to the present value of 10 years of lease payments plus an estimate of the amount payable under the residual value guarantee.

    (ii) if the lessor retains exposure to significant risks or benefits associated with the underlying asset, the lessor would recognise a receivable and a liability equal to the present value of 10 years of lease payments plus an estimate of the amount receivable under the residual value guarantee. The lessor would continue to recognise the underlying asset.

    (iii) if the lessor does not retain exposure to significant risks or benefits associated with the underlying asset, the lessor would recognise a receivable equal to the present value of 10 years of lease payments plus an estimate of the amount receivable under the residual value guarantee and would derecognise a portion of the underlying asset.

(b) if the lessee or lessor determines that renewal is more likely than not to occur, the lease term for the lessee or lessor is 15 years. In that case:

(i) the lessee would recognise a liability to make lease payments equal to the present value of 15 years of lease payments.

(ii) if the lessor retains exposure to significant risks or benefits associated with the underlying asset, the lessor would recognise a receivable and a liability equal to the present value of 15 years of lease payments. The lessor would continue to recognise the underlying asset.

(iii) if the lessor does not retain exposure to significant risks or benefits associated with the underlying asset, the lessor would recognise a receivable equal to the present value of 15 years of lease payments and would derecognise a portion of the underlying asset.

B20 At each reporting date, the lessee or lessor reassesses which outcome it considers to be most likely to occur on the basis of any new facts or circumstances that indicate that there would be a significant change in the recognised right to receive lease payments or liability to make lease payments since the previous reporting period. The lessee and lessor may have different information regarding the likelihood of an option being exercised; therefore they may reach different decisions about what is the most likely outcome.

Determining the amount of lease payments (paragraphs 14, 35 and 52)

B21 Estimating expected outcome involves:

(a) identifying each reasonably possible outcome. An entity need not assess every possible outcome to identify the reasonably possible outcomes included in the expected present value of the cash flows.

(b) estimating the amount and timing of the cash flows for each reasonably possible outcome.

(c) determining the present value of those cash flows.

(d) estimating the probability of each outcome.

Lessor: when to apply the performance obligation or derecognition approach (paragraphs 28 and 29)

B22 A lessor shall consider the following factors in assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the current lease:

(a) significant contingent rentals during the lease term that are based on the use or performance of the underlying asset.

(b) options to extend or terminate the lease.

(c) material non-distinct services provided under the current lease.

B23 The existence of material non-distinct services may expose the lessor to a significant risk that the lessee will terminate the lease early because of the non-provision of those services. When the risk that the lessee will terminate the lease early is significant, the lessor is likely to be exposed to significant risks or benefits associated with the underlying asset during the term of the lease.

B24 A lessor shall consider the following factors when determining whether it retains exposure to significant risks or benefits associated with the underlying asset after the expected term of the current lease:

(a) whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset.

(b) whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making that assessment, the lessor shall consider:

(i) the present value of the underlying asset at the end of the lease term, and

(ii) the effect that any residual value guarantees (including those provided by an unrelated third party) may have on the lessor's exposure to risks or benefits.

B25 In general, a residual value guarantee will reduce a lessor's exposure to downside risk but may give the lessor the potential to benefit from increases in the expected value of the underlying asset at the end of the lease.

B26 The existence of one or more indicators is not conclusive in determining whether the lessor retains exposure to significant risks or benefits associated with the underlying asset.

B27 A lessor shall not consider the risks associated with the counterparty credit risk of the lessee when determining whether it retains exposure to significant risks or benefits associated with the underlying leased asset during the expected term of the current lease.

Lessor: performance obligation approach

Accounting for changes in lease term (paragraph 39(a))

B28 The following examples illustrate how a lessor might apply the performance obligation approach if the lease term increases or decreases after recognition and initial measurement.

Example 1 – When the assessed lease term decreases

Entity A enters into a five-year lease of a machine with an expected useful life of fifteen years. The lease includes an option to terminate after three years. Annual lease payments are CU1,000[(a)] in arrears. The rate the lessor charges in the lease is 8 per cent. The carrying amount of the machine at the commencement of the lease is CU15,000. The lessor initially estimates the lease term is five years. The lessor further determines that it retains exposure to significant risks or benefits associated with the underlying asset after the expected lease term and accounts for the lease using the performance obligation approach.

The present value of five years of lease payments is CU3,993.

The lessor amortises the lease liability on a straight-line basis.

At the end of year 1, the lessor reassesses the lease term and determines that the option will be exercised and the lease will terminate at the end of three years. The present value of the remaining two years of lease payments is CU1,783.

At the date of commencement of the lease, the lessor recognises a right to receive lease payments (lease receivable) and a lease liability:

Dr	lease receivable		CU3,993	
	Cr	lease liability		CU3,993

At the end of year 1, the lessor recognises (1) receipt of the lease payment, (2) interest on the lease receivable, (3) lease income from satisfaction of the lease liability and (4) depreciation expense on the underlying asset:

continued...

(a) In this [draft] IFRS monetary amounts are denominated in 'currency units (CU)'.

...continued

Example 1 – When the assessed lease term decreases

Dr	cash		CU1,000		
	Cr	lease receivable		CU1,000	
Dr	lease receivable		CU319		(CU3,993 × 8%)
	Cr	interest income		CU319	
Dr	lease liability		CU799		(CU3,993 ÷ 5 years)
	Cr	lease income		CU799	
Dr	depreciation expense		CU1,000		(CU15,000 ÷ 15 years)
	Cr	accumulated depreciation		CU1,000	

Following these events, the carrying amount of the lease receivable is CU3,312 (CU3,993 − CU1,000 + CU319), the carrying amount of the lease liability is CU3,194 (CU3,993 − CU799) and the net amount recognised in profit or loss is income of CU118 (lease income of CU799 plus interest income of CU319 less depreciation expense of CU1,000).

At the end of year 1, the lessor reassesses the lease term and decreases its lease receivable to reflect the new expected payments (two years remaining). The lessor makes a corresponding decrease in the lease liability to reflect the shorter term of the lease:

Dr	lease liability		CU1,529		
	Cr	lease receivable		CU1,529	(CU3,312 – CU1,783)

After making this adjustment the carrying amount of the lease receivable is CU1,783 representing the present value of the two remaining CU1,000 lease payments and the carrying amount of the lease liability is CU1,665 representing the lease liability of CU3,194 adjusted for the decrease in the lease receivable of CU1,529.

At the end of year 2, the lessor recognises (1) receipt of the lease payment, (2) interest on the lease receivable, (3) lease income from satisfaction of the lease liability and (4) depreciation expense on the underlying asset:

Dr	cash		CU1,000		
	Cr	lease receivable		CU1,000	
Dr	lease receivable		CU143		(CU1,783 × 8%)
	Cr	interest income		CU143	

continued...

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Example 1 – When the assessed lease term decreases

Dr	lease liability	CU832		(CU1,665 ÷ 2 years)
	Cr lease income		CU832	
Dr	depreciation expense	CU1,000		(CU15,000 ÷ 15 years)
	Cr accumulated depreciation		CU1,000	

Following these events, the carrying amount of the lease receivable is CU926 (CU1,783 − CU1,000 + CU143), the carrying amount of the lease liability is CU833 (CU1,665 − CU832) and the net amount recognised in profit or loss is a loss of CU25 (lease income of CU832 plus interest income of CU143 less depreciation expense of CU1,000).

Example 2 –When the assessed lease term increases

Example 2 uses the same facts as in example 1 except that the lessor initially estimates that the lease term is three years. The lessor further determines that it retains exposure to significant risks or benefits associated with the underlying asset after the expected lease term and accounts for the lease using the performance obligation approach.

The present value of three years of lease payments is CU2,577.

At the end of year 1, the lessor reassesses the lease term and determines that the lease term is five years. The present value of four years of lease payments is CU3,312.

At the date of commencement of the lease, the lessor recognises a right to receive lease payments (lease receivable) and a lease liability:

Dr	lease receivable	CU2,577		
	Cr lease liability		CU2,577	

At the end of year 1, the lessor recognises (1) receipt of the lease payment, (2) interest on the lease receivable, (3) lease income from satisfaction of the lease liability and (4) depreciation expense on the underlying asset:

Dr	cash	CU1,000		
	Cr lease receivable		CU1,000	
Dr	lease receivable	CU206		(CU2,577 × 8%)
	Cr interest income		CU206	
Dr	lease liability	CU859		(CU2,577 ÷ 3 years)
	Cr lease income		CU859	

continued...

Example 2 –When the assessed lease term increases

Dr	depreciation expense	CU1,000		(CU15,000 ÷ 15 years)
	Cr accumulated depreciation		CU1,000	

Following these events, the carrying amount of the lease receivable is CU1,783 (CU2,577 − CU1,000 + CU206), the carrying amount of the lease liability is CU1,718 (CU2,577 − CU859) and the net amount recognised in profit or loss is income of CU65 (lease income of CU859 plus interest income of CU206 less depreciation expense of CU1,000).

At the end of year 1, the lessor reassesses the lease term and increases its lease receivable to the newly expected payments (remaining four years) with a corresponding increase in the lease liability to reflect the longer term of the lease:

Dr	lease receivable	CU1,529		(CU3,312 – CU1,783)
	Cr lease liability		CU1,529	

After making this adjustment the carrying amount of the lease receivable is CU3,312 representing the present value of four CU1,000 lease payments and the carrying amount of the lease liability is CU3,247 representing the lease liability of CU1,718 adjusted for the increase in the lease receivable of CU1,529.

At the end of year 2, the lessor recognises (1) receipt of the lease payment, (2) interest on the lease receivable, (3) lease income from satisfaction of the lease liability and (4) depreciation expense on the underlying asset:

Dr	cash	CU1,000		
	Cr lease receivable		CU1,000	
Dr	lease receivable	CU265		(CU3,312 × 8%)
	Cr interest income		CU265	
Dr	lease liability	CU812		(CU3,247 ÷ 4 years)
	Cr lease income		CU812	
Dr	depreciation expense	CU1,000		(CU15,000 ÷ 15 years)
	Cr accumulated depreciation		CU1,000	

Following these events, the carrying amount of the lease receivable is CU2,577 (CU3,312 − CU1,000 + CU265), the carrying amount of the lease liability is CU2,435 (CU3,247 − CU812) and the net amount recognised in profit or loss is income of CU77 (lease income of CU812 plus interest income of CU265 less depreciation expense of CU1,000).

Presentation by intermediate lessor in a sublease (paragraph 43)

B29 The following example illustrates in italics how an intermediate lessor would present lease assets and liabilities arising from a sublease.

Example 3 – Presentation of information from a sublease

Property, plant and equipment		X
Cash		X
Right-of-use asset	*X*	
Lease receivables	*X*	
Lease liability	*(X)*	
Net sublease asset		*X*
Total assets		X
Trade and other payables		*X*
Liability to make lease payments		*X*
Total liabilities		(X)

Lessor: derecognition approach

Accounting for changes in lease term (paragraphs 56(a))

B30 The following examples illustrate how a lessor might apply the derecognition approach if the lease term increases or decreases after recognition and initial measurement.

Example 4 – When the assessed lease term decreases

Entity A enters into a ten-year lease of a machine. The lease includes an option to terminate after eight years. Annual lease payments are CU1,000 in arrears. The rate the lessor charges in the lease is 8 per cent. The fair value of the machine at the commencement of the lease is CU7,000 and its carrying amount is CU5,000. The useful life of the machine is ten years. The lessor initially estimates the lease term is ten years. The lessor further determines that it does not retain exposure to significant risks or benefits associated with the underlying asset either during or after the expected lease term and accounts for the lease using the derecognition approach.

The present value of ten years of lease payments is CU6,710.

At the end of year 1, the lessor reassesses the lease term and determines that the option will be exercised and the lease will terminate at the end of eight years. The fair value of the machine at the end of year 1 is CU6,250. The present value of seven years of lease payments is CU5,206.

At the date of commencement of the lease, the lessor derecognises the portion of the asset transferred to the lessee, recognises a lease receivable and recognises revenue and cost of sales:

Dr	lease receivable	CU6,710		
Dr	cost of sales	CU4,793		
Cr	underlying asset		CU4,793	(CU5,000 × CU6,710 ÷ CU7,000)
Cr	revenue		CU6,710	

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Example 4 – When the assessed lease term decreases

At the date of commencement of the lease, the lessor recognises a profit from the lease of CU1,917 (CU6,710 − CU4,793).

At the end of year 1, the lessor recognises receipt of a lease payment and interest on the lease receivable:

Dr	cash		CU1,000		
	Cr	lease receivable		CU1,000	
Dr	lease receivable		CU537		(CU6,710 × 8%)
	Cr	interest income		CU537	

Following these events, the carrying amount of the residual asset is CU207 (CU5,000 − CU4,793) and the carrying amount of the lease receivable is CU6,247 (CU6,710 − CU1,000 + CU537).

At the end of year 1, the lessor reassesses the lease term and reinstates a portion of the asset, recognises an adjustment to lease receivable, revenue and cost of sales:

Dr	revenue		CU1,041		
Dr	residual asset		CU34		(CU207 × CU1,041 ÷ CU6,250)
	Cr	cost of sales		CU34	
	Cr	lease receivable		CU1,041	(CU6,247 – CU5,206)

The net result of the reassessment of the lease term is a loss of CU1,007 (CU34 − CU1,041).

After making this adjustment the carrying amount of the lease receivable is CU5,206 representing the present value of the seven remaining CU1,000 lease payments and the carrying amount of the residual asset is CU241 (CU207 + CU34).

At the end of year 1, the net amount recognised in profit or loss is income of CU1,447 (initial lease income of CU1,917 plus interest income of CU537 less CU1,007 loss from reassessment).

Example 5 – When the assessed lease term increases

Example 5 uses the same facts as in example 4 except that the lessor initially estimates that the lease term is eight years. The lessor determines that it does not retain exposure to significant risks or benefits associated with the underlying asset either during or after the expected lease term and accounts for the lease using the derecognition approach.

The present value of eight years of lease payments is CU5,747.

At the end of year 1, the lessor reassesses the lease term and determines that the lease term is ten years. The present value of nine years of lease payments is CU6,247.

At the date of commencement of the lease, the lessor derecognises the portion of the asset transferred to the lessee, recognises a lease receivable and recognises revenue and cost of sales:

Dr	lease receivable	CU5,747		
Dr	cost of sales	CU4,105		
Cr	underlying asset		CU4,105	(CU5,000 × CU5,747 ÷ CU7,000)
Cr	revenue		CU5,747	

At the date of commencement of the lease, the lessor recognises profit from the lease of CU1,642 (CU5,747 – CU4,105).

At the end of year 1, the lessor recognises receipt of a rental payment and interest on the lease receivable:

Dr	cash	CU1,000		
Cr	lease receivable		CU1,000	
Dr	lease receivable	CU460		(CU5,747 × 8%)
Cr	interest income		CU460	

Following these events, the carrying amount of the residual asset is CU895 (CU5,000 – CU4,105) and the carrying amount of the lease receivable is CU5,207 (CU5,747 – CU1,000 + CU460).

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Example 5 – When the assessed lease term increases

Upon reassessing the lease term, the lessor derecognises an additional portion of the asset transferred to the lessee, recognises additional lease receivable and recognises revenue and cost of sales:

Dr	lease receivable		CU1,040		(CU6,247 – CU5,207)
Dr	cost of sales		CU149		
	Cr	residual asset		CU149	(CU895 × CU1,040 ÷ CU6,250)
	Cr	revenue		CU1,040	

In profit or loss, the net result of the reassessment of the lease term is income of CU891 (CU1,040 – CU149).

After making this adjustment the carrying amount of the lease receivable is CU6,247 representing the present value of the nine remaining CU1,000 lease payments, and the carrying amount of the residual asset is CU746 (CU895 – CU149).

At the end of year 1, the net amount recognised in profit or loss is income of CU2,993 (initial lease income of CU1,642 plus interest income of CU460 plus CU891 lease income from reassessment).

Sale and leaseback transactions

Determining whether the transferred asset has been purchased or sold (paragraphs 67(a) and 68(a))

B31 An entity considers the effect of the transfer contract and the lease contract together to assess whether the transferred asset has been purchased or sold in accordance with paragraphs B9 and B10. Additionally, such sale and leaseback contracts may have conditions that generally do not arise in other transactions and may result in the transfer not meeting the conditions for a purchase or sale. For example, the following conditions normally preclude the seller/lessee from transferring more than a trivial amount of the risks and benefits associated with the transferred asset at the end of the contract and do not result in a purchase or sale:

(a) The seller/lessee has an obligation or an option to repurchase the asset at an amount that is not fair value at the time of repurchase, or the buyer/lessor can compel the seller/lessee to repurchase the asset.

(b) The seller/lessee guarantees the buyer/lessor's investment or a return on that investment.

(c) The seller/lessee provides the buyer/lessor with a residual value guarantee.

(d) The seller/lessee provides non-recourse financing to the buyer/lessor.

(e) The seller/lessee retains an obligation to service any existing debt related to the asset.

(f) The seller/lessee provides collateral on behalf of the buyer/lessor (other than the transferred asset) or guarantees the buyer/lessor's debt.

(g) The seller/lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer/lessor.

(h) The seller/lessee enters into a sale and leaseback transaction involving asset enhancements without leasing the transferred asset from the buyer/lessor.

(i) The buyer/lessor is obliged to share a significant portion of the appreciation of the asset with the seller/lessee.

(j) Any other provisions or circumstances exist that allow the seller/lessee to participate in any future profits of the buyer/lessor or the appreciation of the transferred asset, eg a situation in which the seller/lessee owns or has an option to acquire a significant interest in the buyer/lessor.

Appendix C
Amendments to other IFRSs

This appendix describes the amendments to other IFRSs that the Board expects to make when it finalises the proposed IFRS X.

Standard	Description of amendment
General	Except where otherwise stated: • Replace references to 'IAS 17 *Leases*' with 'IFRS X *Leases*'. • Replace references to 'IAS 17' with 'IFRS X'. • Replace references to 'finance lease' or 'operating lease' with 'lease' to reflect that there is only one model for all leases. • Eliminate references to the classification of leases as finance leases or operating leases.
Framework for the Preparation and Presentation of Financial Statements	• Paragraph 51 is amended to explain why a right-of-use asset meets the definition of an asset. • Replace other references to 'finance lease' with 'lease'.
IFRS 1 *First-time Adoption of International Financial Reporting Standards*	• Paragraphs D9 and D9A are amended so that first-time adopters apply transitional provisions to all leases based on those in IFRS X. However, the transitional relief for simple finance leases is not applicable for first-time adopters.

IFRS 3 *Business Combinations*	• Amend paragraph 17(a) to refer to accounting for leases using either the performance obligation or derecognition approaches. • Delete section on operating leases in paragraphs B28–B30, and amend paragraphs B32 and B42 to eliminate references to operating leases. • Amend the model relating to leases acquired in a business combination as follows: • If the acquiree is a lessee, the acquirer shall recognise a liability to make lease payments and a right-of-use asset for all leases in accordance with IFRS X. The liability to make lease payments and the right-of-use asset shall be measured at the present value of remaining lease payments, discounted using the acquirer's discount rate. Where there is a difference between the rate charged in the lease and market rates, the acquirer shall adjust the right-of-use asset to reflect the off-market rate of the lease.

- If the acquiree is a lessor, the acquirer shall:
    - recognise a right to receive lease payments and a lease liability for all leases to which the acquirer applies the performance obligation approach. The acquirer measures the right to receive rentals and the lease liability at the present value of the remaining lease payments discounted using the acquirer's discount rate.
    - recognise a right to receive lease payments and derecognise the portion of the carrying amount of the underlying asset that represents the cost of the lessee's right to use the underlying asset during the term of the lease for all leases to which the acquirer applies the derecognition approach. The acquirer measures the right to receive rentals at the present value of the remaining lease payments discounted using the acquirer's discount rate and measures the residual asset at fair value.
- After initial measurement, the acquirer shall apply the requirements of IFRS X to the lease assets and lease liabilities.

IAS 1 *Presentation of Financial Statements*	• Delete in paragraph 123 reference to lease assets.
IAS 7 *Statement of Cash Flows*	• Amend to reflect the proposals for presentation of cash flows.
IAS 16 *Property, Plant and Equipment*	• Eliminate reference to lease model in IAS 17 from paragraph 4. • Delete paragraph 27, which treats assets held under a finance lease as equivalent to owned assets. • Remove reference to leased items in paragraph 44. • Eliminate from paragraph 69 reference to disposal of an asset through a finance lease.

IAS 23 *Borrowing Costs*	•	Delete paragraph 6(d), which refers to finance charges in respect of finance leases.
IAS 32 *Financial Instruments: Presentation*	•	Delete paragraph AG9, which deals with the distinction between operating and finance leases and replace with an explanation of why lease assets meet the definition of a financial instrument.
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	•	Amend paragraph 5(c) to include within the scope of IAS 37 leases between the date of inception and date of commencement that are onerous.
IAS 38 *Intangible Assets*	•	Eliminate from paragraph 114 reference to disposal of an intangible asset through a finance lease.
IAS 39 *Financial Instruments: Recognition and Measurement*	•	Replace the reference to 'finance lease payables' with 'Liability to make lease payments arising from leases' to reflect new terminology.

IAS 40 *Investment Property*

Amend the model in IAS 40 to replace the requirements relating to lease accounting as follows:

- After initial recognition, a lessor of investment property (whether freehold or leasehold) chooses to account for investment property using a cost or fair value model.
    - A lessor that uses the cost model recognises lease income arising on investment property in accordance with IFRS X.
    - A lessor that uses the fair value model recognises lease income arising on the investment property (other than fair value gains and losses) on a straight-line basis over the lease term.
- A right-of-use asset is within the scope of IAS 40 if it meets the definition of investment property.
- Any right-of-use asset is accounted for at initial recognition in accordance with IFRS X. After initial recognition, a lessee chooses to account for the right-of-use asset using a cost or fair value model.
    - A lessee that uses the cost model accounts for the right-of-use asset in accordance with IFRS X.
    - A lessee that uses the fair value model accounts for the right-of-use asset in accordance with IAS 40 and recognises any changes in the liability to make lease payments in profit or loss.

IAS 41 *Agriculture*

- Include in paragraph 2 reference to IFRS X when referring to land related to agricultural activity.

SIC-32 *Intangible Assets—Web Site Costs*

- Amend paragraph 6 to require that the Interpretation applies to both lessors and lessees when a web site is leased.

Approval of *Leases* by the Board

The exposure draft *Leases* was approved for publication by eleven of the fourteen members of the International Accounting Standards Board. Mr Cooper voted against its publication. His alternative views are set out after the Basis for Conclusions. Ms König and Mr Pacter abstained in view of their recent appointment to the Board.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Elke König	
Patricia McConnell	
Warren J McGregor	
Paul Pacter	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	