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IFRS NEWSLETTER: LEASES
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The future of lease accounting

Highlights

- Boards conclude redeliberations on leases
- On-balance sheet approach for lessees
- 'Dual' model for income/ expense recognition
- Increase in complexity for lessee and lessor accounting
- Revised exposure draft delayed until first quarter of 2013

The home straight?

In September 2012, after many months of joint discussion, the Boards concluded their redeliberations on the lease accounting proposals published in August 2010. We can now look forward to a revised exposure draft (ED) in the first quarter of 2013, most likely with a 120-day comment period.

After a long period of redeliberation, with many twists and turns, the proposals to be included in the new exposure draft are now clear, at least in outline. This special edition of our newsletter highlights the key impacts of those proposals on lessees and lessors.

Central to the proposals will be the right-of-use model, under which all but short-term leases would be on-balance sheet for lessees. The goal of eliminating lease accounting as a source of off-balance sheet finance has become the project's touchstone. In most instances, the proposals achieve that goal. However, the costs of achieving this goal include complexity and conceptual compromise.

The proposals will introduce new 'dual models' for income/ expense recognition. Lessees and lessors would apply a new lease classification test, on a lease-by-lease basis, to determine which model to apply. Lease classification would depend on the extent to which the underlying asset is consumed over the lease term, and the nature of the underlying asset (real estate vs other assets).

Many leases of real estate would qualify for straight-line income/expense recognition. Lessors would achieve this by applying an approach similar to current operating lease accounting. Lessees would apply a version of the on-balance sheet right-of-use (ROU) model in which the asset is measured as a balancing figure to achieve straight-line expense recognition.

Many leases of other assets would result in an accelerated profile of income/expense recognition. Lessors would apply the new receivable and residual (R&R) model, recognising a lease receivable and a residual asset representing their interest in the underlying asset at the end of the lease term; lessors might also recognise an upfront profit. Lessees would generally recognise total lease expense on an accelerated basis, being the sum of a straight-line amortisation charge and an accelerated interest charge.

Lessees and lessors would not need to apply the models to leases with a maximum contractual term of 12 months or less. In such cases, they would not recognise lease assets and liabilities, and would recognise straight-line income/expense.

The proposals are certain to prove controversial. Several Board members have indicated that they may dissent from the proposals, and initial reaction from some user groups has been cool. We will all have a chance to comment in 2013.

Key Impacts – Lessee

Headline	What we expect to see in the ED	What this means for lessees
All non-short-term leases reflected on-balance sheet	The lessee would recognise a ROU asset and a lease liability. The ROU asset would initially be measured as the sum of the present value of the estimated lease payments plus initial direct costs less lease incentives. The lease liability would initially be measured as the present value of estimated future lease payments, which takes into consideration estimates of: • lease term; • variable lease payments that depend on an index or rate; • purchase options; • residual value guarantees; and • termination penalties.	The increase in assets and liabilities would affect key ratios and may impact debt covenants. Increased judgement about future expectations would be required to estimate lease payments, both initially and throughout the lease term. There would be increased volatility in assets and liabilities, and complexity, arising from lease classification and reassessment requirements.
Different expense recognition depending on model	The accelerated ROU model features: • a front-loaded profile of total lease expense; and • separate presentation of amortisation of the ROU asset (opex) and interest expense. The straight-line ROU model (SLM) features: • straight-line recognition of total lease expense; and • presentation of total lease expense as an operating expense, with no interest charge presented.	The profile of profits and key income ratios would depend on the type of lease model applied. Process and system changes would be required for the additional calculations and disclosures.
New lease classification test	A new lease classification test would be applied to all leases (other than short-term leases) to determine whether to apply the accelerated model or the SLM. The test would depend on the nature of the asset (real estate vs other assets) and on whether an insignificant portion of the underlying asset is consumed over the lease term. In many cases: • leases of real estate (land and buildings) would be accounted for using the SLM; and • leases of other assets (e.g. equipment) would be accounted for using the accelerated ROU model. Lease classification would be assessed only at lease commencement and upon a lease modification.	A new lease classification test would be applied to all leases on transition, and subsequently on commencement of new leases. The classification test results in a dual lease model, which would increase complexity and the reporting burden. The impact is likely to be greatest for leases of assets other than real estate, because many leases of equipment currently classified as operating leases under IAS 17 *Leases* would be accounted for using the accelerated ROU model.

Key Impacts – Lessee (continued)

Headline	What we expect to see in the ED	What this means for lessees
New criteria to determine lease term	The lease term would be the contractual minimum lease term plus any optional periods for which there is a 'significant economic incentive' to exercise a renewal option. This assessment would be based primarily on economic factors. The lease term would be reassessed on a change in economic factors.	More emphasis would be placed on judgement about future events. Volatility in assets and liabilities would arise from the reassessment requirements.
New approach to variable lease payments	The lease liability would include variable lease payments (VLP) that are in-substance fixed or represent a minimum payment. VLPs that depend on an index or a rate would initially be measured using the index or rate that exists at the date of commencement of the lease, and subsequently remeasured. Lessees would reflect changes in the measurement of lease payments that depend on an index or a rate: • in net income, to the extent that the changes relate to the current reporting period; and • as an adjustment to the ROU asset, to the extent that the changes relate to future reporting periods.	The reporting burden would increase, because lease payments that depend on an index or a rate need to be reassessed using the index or rate that exists at the end of each reporting period. The discount rate would need to be revised upon a change in VLPs based on the index or rate. If the index or rate is expected to increase, then the initial lease liability would be higher than under the current with IAS 17 approach to VLPs.
Additional impairment testing guidance for ROU assets	The ROU asset would be assessed for impairment under IAS 36 *Impairment of Assets* under both models. For SLM leases: • the lease expense attributed to unwinding of the discount (interest expense) would always be recognised, even if the ROU asset is fully impaired; and • if the ROU asset is partially impaired, then the remaining ROU asset balance would be recognised on a straight-line basis over the remaining lease term, in a modified fashion whereby the periodic expense could never be less than the unwinding of the discount on the liability.	For items impaired under the SLM, additional analysis of the impact of straight-line total lease expense recognition would be required. The record-keeping burden and complexity of maintaining dual lessee accounting models would increase.
Exemption for short-term leases	An election would be permitted for non-recognition of lease assets and liabilities for leases with a maximum possible term of 12 months or less (including renewal options). Under this election, the lease expense would be recognised on a straight-line basis over the lease term.	There would be a lack of comparability between short- and longer-term leases, with a bright-line cut-off at 12 months. Additional tracking of short-term leases may be required.

Key Impacts – Lessor

Headline	What we expect to see in the ED	What this means for lessors
New R&R model for finance-type lease transactions	Under the R&R model, the lessor would: • derecognise the underlying asset; • recognise a lease receivable, initially measured at the present value of the estimated future lease payments; and • recognise a residual asset, representing its rights in the underlying asset at the end of the lease term.	Accounting for the residual asset would introduce new concepts and complexity to lessor accounting.
Revised version of operating lease model retained	Similar to current operating lease accounting, the lessor would continue to recognise the underlying asset and recognise lease income over the lease term. However, the judgements required to apply the model would be different.	The model is similar to current operating lease accounting.
Different income recognition depending on classification	Under the R&R model, the lessor would generally recognise income on an accelerated basis as it: • may recognise upfront profit on the transfer of the ROU asset at commencement; • recognises interest income on the lease receivable; and • recognises income on accretion of the residual asset over the term of the lease. Under operating lease accounting, the lessor would recognise lease income on a straight-line basis, and depreciate the underlying asset as it would other productive assets, similar to current operating lease accounting.	There could be upfront profit for leases previously classified as operating leases. Debt covenants could be impacted (e.g. interest coverage ratio). The timing of income recognition could change. The record-keeping burden and time spent preparing disclosures would increase under dual lease models.
New lease classification test	A new lease classification test would be applied to all leases (other than short-term leases) to determine whether to apply the R&R or operating lease model. The test would depend on the nature of the asset (real estate vs other assets), and on whether an insignificant portion of the underlying asset is consumed over the lease term. In many cases: • leases of real estate (land and buildings) would be accounted for using the operating lease model; and • leases of other assets (e.g. equipment) would be accounted for using the R&R model. Lease classification would be assessed only at lease commencement and upon a lease modification.	The new classification test would be applied to all leases on transition, and subsequently on commencement of new leases. The classification test would result in a dual lease model, which would increase complexity and the reporting burden. The impact is likely to be greatest for leases of assets other than real estate, because many leases of equipment currently classified as operating leases under IAS 17 would be accounted for using the R&R model.

Key Impacts – Lessor (continued)

Headline	What we expect to see in the ED	What this means for lessors
New criteria to determine lease term	The lease term would be the contractual minimum lease term plus any optional periods for which there is a 'significant economic incentive' to exercise a renewal option. This assessment would be based primarily on economic factors.	More emphasis would be placed on judgement about future events. The reassessment requirements could result in volatility in assets.
New approach to variable lease payments	The lease liability would include VLPs that are in-substance fixed or represent a minimum payment. VLPs that depend on an index or a rate would initially be measured using the index or rate that exists at the date of commencement of the lease, and would subsequently be remeasured. Lessors applying the R&R model would recognise changes in the right to receive lease payments due to reassessments of variable lease payments that depend on an index or a rate immediately in profit or loss.	The reporting burden would increase, because lease payments that depend on an index or a rate would need to be reassessed using the index or rate that exists at the end of each reporting period. The discount rate would need to be revised upon a change in variable lease payments based on an index or rate.
Additional impairment guidance on early termination	Under the R&R model, the lessor would measure impairment of the lease receivable in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. In the event of early termination, the lessor would reclassify the carrying amount of the lease receivable (after impairment) and the net residual asset as the underlying asset. On re-recognition of the underlying asset, it would have to be tested for impairment under IAS 36, because early termination of a lease would be considered a triggering event for impairment testing.	The lessor would not recognise a gain due to early termination, even if the fair value of the portion of the underlying asset were greater than the carrying amount of the lease receivable. The deferred profit on the residual would not be recognised due to early termination.
Exemption for short-term leases	An election would be permitted for non-recognition of lease assets and liabilities for leases with a maximum possible term of 12 months or less (including renewal options). Under this election, lease income would be recognised on a straight-line basis over the lease term.	There would be a lack of comparability between short- and longer-term leases, with a bright-line cut-off at 12 months.

How to apply the proposals

1. Identify the lease

The ED will include new guidance on how to determine whether a transaction is or contains a lease. Similar to current IFRS, a lease would exist when both of the following conditions are met:

- fulfilment of the contract depends on the use of an explicitly or implicitly specified asset or assets; and
- the contract conveys the right to control the use of the specific asset or assets for a period of time.

The ED will exclude from its scope:

- leases of intangibles (other than ROU assets);
- leases for the right to explore for or use minerals, oil, natural gas, and similar resources;
- service concession arrangements; and
- the right to use an asset that is inseparable from the provision of services.

Lessees and lessors need not apply the new lease accounting models to short-term leases – i.e. leases with a maximum contractual duration of 12 months or less.

2. Classify the lease

Lessees and lessors would apply the same lease classification test to determine which accounting model to apply.

Leases of real estate (land and buildings, part of a building or both) would be accounted for under the SLM by lessees and under the operating lease model by lessors, unless:

- the lease term is for the major part of the economic life of the underlying asset; or
- the present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

Leases of other assets would be accounted for under the accelerated ROU model by lessees and under the R&R model by lessors, unless:

- the lease term is for an insignificant portion of the economic life of the underlying asset; or
- the present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

To determine whether the lease term is for the major part of the economic life of the underlying asset, the lessee and lessor would:

- consider expectations about how the asset will be maintained during the lease term; and
- ignore future market expectations, such as inflation and changes in supply and demand.

At the end of the lease term, if the underlying asset's value is not expected to change significantly from its value at the beginning of the lease term, then the lease term would generally not represent the major part of the underlying asset's economic life.

3. Apply the new lease accounting models

The mechanics of the new lease accounting models are illustrated in the examples that follow. These examples have been simplified for the purposes of illustration – e.g. they assume that there are no prepaid rentals, initial direct costs, variable lease payments, renewal options or purchase options.

A simple real estate lease

Fact pattern

Consider a simple real estate lease under which:

- a lessee and lessor enter into a lease of retail premises for a 5-year lease period;
- the fair value of the premises is 10,000 at commencement of the lease;
- the remaining economic life of the premises is 40 years at commencement of the lease;
- the fair value of the retail premises is expected to be 10,000 in year 5, ignoring inflation and assuming that real estate market values remain stable;
- the lessee's base rental is 412 per year (paid in arrears); and
- the rate the lessor charges the lessee is 4.12% (if the rate the lessor charges is not known, the lessee would use its incremental borrowing rate).

Lease classification

Under the new lease classification test, this lease would be accounted for under the SLM by the lessee and under the operating lease model by the lessor.

This is because the asset is real estate, the lease term is for less than the major part of the economic life of the asset, and the present value of the fixed lease payments is less than substantially all of the fair value of the asset.

Lessee accounting – straight-line ROU model

The lessee would apply the SLM to the simple real estate lease, as follows.

The lessee would initially measure its lease liability at the present value of estimated future lease payments, and the ROU asset at the same amount. The lessee would subsequently measure the lease liability at amortised cost using the effective interest rate method and would recognise total lease expense on a straight-line basis in the income statement. The lessee would subsequently measure the ROU asset each period as the balancing figure, calculated by deducting the difference between the straight-line lease expense (which equals the payments in this example), less interest on the lease liability for each period, from the beginning ROU balance.

Lessee: Straight-line ROU				
Balance sheet			Profit or loss impacts	
Year	Lease liability	ROU asset	Lease expense	Total expense
0	1,828	1,828	-	-
1	1,491	1,491	412	412
2	1,141	1,141	412	412
3	776	776	412	412
4	396	396	412	412
5	0	0	412	412
		Total	2,060	2,060

Some points to note about this example.

- The ROU asset would be adjusted each period by the difference between the amount of straight-line lease expense less interest arising on the lease liability for the period. In this example for year 1, the calculation of the ROU adjustment would be 412 - 75 = 337. The ROU asset would then be adjusted by this amount to calculate the year 1 ROU asset closing balance (1,828 - 337 = 1,491).
- In this simple fact pattern, the ROU asset would equal the lease liability throughout the lease term, because the lease payments are level throughout the lease term. If a lease contains variable lease payments that are based on an index or rate, escalating rents, or a significant rent holiday, then the calculation of the adjustment of the ROU asset each period significantly increases in complexity.

Lessor accounting – operating lease model

The lessor would apply the operating lease model to the simple real estate lease. Under this model, the lessor would continue to recognise the underlying asset and would recognise the lease income on a straight-line basis. In this example, it is assumed that the lessor is using the IAS 40 *Investment Property* fair value model to account for the underlying asset. In addition, for simplicity, it is assumed that the value of the underlying asset remained consistent during the lease term. (In practice, changes in the fair value of investment property would be recognised in the statement of profit or loss in the period in which the change arises.)

Lessor: Operating lease model		
Balance sheet		Profit or loss impacts
Year	Underlying asset	Total income
0	10,000	-
1	10,000	412
2	10,000	412
3	10,000	412
4	10,000	412
5	10,000	412
	Total	2,060

A simple equipment lease

Fact pattern

Consider a simple equipment lease under which:

- a lessee and lessor enter into a transaction to lease an asset for a 3-year lease term;
- the asset has a useful life of 10 years;
- the lease stipulates that the lessee's base rental is 125 per year (paid in arrears);
- the underlying asset has a carrying amount of 950 in the lessor's financial statements before lease commencement;

- the fair value of the underlying asset at lease commencement is 975;
- the lessor estimates that the carrying amount of the underlying asset at the end of the lease term, if it were subject to depreciation during the lease term, would then be 665; and
- the rate the lessor charges the lessee is 2.5% (if the rate the lessor charges is not known, then the lessee would use its incremental borrowing rate).

Lease classification

Under the new lease classification test, the lessee would account for this lease under the accelerated ROU model, and the lessor would use the R&R model.

This is because the asset is not real estate, the lease term is for more than an insignificant part of the economic life of the asset, and the present value of the lease payments is not insignificant compared to the fair value of the asset.

Lessee accounting – accelerated model

The lessee would apply the accelerated ROU model to the simple equipment lease, as follows.

The lessee would recognise an ROU asset and a liability for its obligation to make estimated future lease payments. The lessee would measure the lease liability initially at the present value of 125 per year over 3 years discounted at 2.5%. Over the lease term, the lessee would recognise amortisation of the ROU asset on a straight-line basis, and finance expense arising on the liability, which would be measured on an amortised cost basis.

The following table summarises the amounts arising in the lessee's statement of financial position and income statement.

Lessee: Accelerated ROU model					
Balance sheet			Profit or loss impacts		
Year	Lease liability	ROU asset	Amortisation charge	Interest expense	Total expense
0	357	357	-	-	-
1	241	238	119	9	128
2	122	119	119	6	125
3	0	0	119	3	122
		Total	357	18	375

The accelerated model treats the lease as a financing transaction. This would result in a front-loaded pattern of total lease expense.

Lessor accounting – R&R model

The lessor would apply the R&R model to the simple equipment lease, as follows.

The lessor would recognise a receivable for its right to receive lease payments. The lease receivable would initially be measured at the present value of the estimated future lease payments, discounted at the rate that the lessor charges the lessee; it would subsequently be measured using the effective interest rate method.

On initial recognition, the lessor would measure the residual asset as an allocation of the carrying amount of the underlying asset. The initial measurement of the residual asset comprises two amounts:

(a) the gross residual asset, measured as the present value of the estimated residual value at the end of the lease term, discounted using the rate that the lessor charges the lessee; and

(b) the deferred profit, measured as the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset to the residual asset.

Subsequently, the lessor would measure the gross residual asset by accreting it to the estimated residual value at the end of the lease term, using the rate that the lessor charges the lessee. The lessor would not recognise any of the deferred profit in profit or loss until the residual asset is sold or released. The gross residual asset and the deferred profit would be shown together as a net residual asset.

The following table summarises the amounts arising in the lessor's statement of financial position and income statement under the R&R model.

Lessor: R&R model								
Balance sheet					Profit or loss impacts			
Year	Lease receivable	Gross residual asset	Deferred profit	Net residual asset	Interest income	Accretion	Upfront profit	Total
0	357	618	(16)	602	-	-	9	9
1	241	633	(16)	617	9	15	0	24
2	122	649	(16)	633	6	16	0	22
3	0	665	(16)	649	3	16	0	19
				Total	18	47	9	74

The figures in the above table are derived as follows.

- The lessor's gross residual asset is measured as the present value of the estimated residual value at the end of the lease term, discounted using the rate that the lessor charges the lessee. In this example, 665 is discounted at 2.5% to give a gross residual asset of 618. The lessor then accretes that amount at the rate that it charges the lessee, such that the gross residual asset increases to 665 by the end of the lease term.
- The lessor's net residual asset is an allocation of the carrying amount of the underlying asset. The lessor calculates the opening balance of the net residual asset as:
  - the previous carrying amount of the underlying asset (950); less
  - the amount derecognised for the right of use sold to the lessee (950 x 357 / 975 = 348), being the carrying amount of the asset x (lease receivable / fair value of the asset).

  This gives an opening balance of 602.
- The lessor determines the amount of profit to defer on the residual element, being the difference between the gross residual asset and the net residual asset – in this case, 618 - 602 = 16. As a result, the lessor would always recognise upfront profit and loss when the fair value of the underlying asset is different to its carrying amount. The upfront profit would be calculated as:
  - the present value of estimated lease payments; plus
  - the net residual asset; less
  - the carrying amount of the underlying asset.

  In this example, it is (357 + 602) - 950 = 9.
- The lessor would recognise deferred profit when the underlying asset is sold or released at the end of the lease term.

Next steps

The Boards previously concluded discussions over the models to be applied to both lessees and lessors at their June 2012 meeting. In addition, the Boards reached tentative decisions at their July and September 2012 meetings regarding:

- presentation and disclosures;
- measurement of the underlying asset when a lease terminates prematurely;
- transition accounting for lessees;
- impairment for lessees under SLM;
- determining whether a sale has occurred in a sale and leaseback transaction; and
- subleases.

The Boards expect to issue the revised exposure draft in the first quarter of 2013. The Boards tentatively decided that the comment period will be 120 days. While there are no additional meetings planned, it remains possible that the Boards may have another meeting to discuss various 'sweep issues' that may arise upon drafting of the exposure draft.

For more information

For more information on the project, including our publication on the 2010 ED, *New on the Horizon: Leases*, see our website. A full summary of the Boards' previous tentative decisions on the lessee right-of-use model and the lessor R&R model is included in the December 2011 edition of this newsletter.

The IASB's website and the FASB's website contain summaries of the Boards' meetings, meeting materials, project summaries and status updates.

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If you would like further information on any of the matters discussed in this *IFRS Newsletter: Leases*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.