



cutting through complexity

“After eight years of working jointly, it now appears likely that a key outcome of the Boards’ leases project will be to make it harder to compare the financial statements of lessees reporting under IFRS versus US GAAP.”

Kimber Bascom,
KPMG’s global IFRS
leasing standards leader



DIVERGENT PATHS

This edition of *IFRS Newsletter: Leases* provides an overview of the IASB and FASB discussions of the leases project in March 2014.

The IASB and the FASB (the Boards) discussed fundamental aspects of their lease accounting proposals published in 2013, covering both lessee and lessor accounting, and potential simplifications to the accounting models. Although both Boards remain committed to on-balance sheet recognition of leases by lessees, the Boards could not agree on key aspects of the proposals.

Highlights

Lessee accounting

- The IASB decided that lessees would apply a *single* lease accounting model – under which all leases within scope would be treated as the purchase of an asset on a financed basis.
- The FASB, however, decided that lessees would apply a *dual* lease accounting model – under which all leases would be on-balance sheet but many would qualify for straight-line recognition of total lease expense without separate presentation of finance expense.

Lessor accounting

- The Boards decided to eliminate many aspects of the lessor accounting proposals included in the 2013 exposure draft, and to replace them with requirements based on IAS 17 *Leases*.

Simplifying the proposals

- The Boards decided to expand the scope of the short-term lease exemption, and to introduce other targeted simplifications.
- The IASB decided to exempt small-ticket leases from the lessee proposals – even if the effect is material in aggregate. The FASB rejected this exemption.

CURRENT STATUS OF THE PROPOSALS

The story so far ...

The Boards have been working towards a converged standard that would bring most leases on-balance sheet for lessees. This joint project was intended to replace the current lease accounting requirements under IFRS and US GAAP. In addition, there would be significant consequential amendments to IAS 40 *Investment Property*. In May 2013, the Boards published a revised exposure draft (the 2013 ED), which updated the proposals published in the 2010 exposure draft. The 2013 ED contains the following key proposals.

Lease identification

A 'lease' would be a contract that conveys the right to use an identifiable asset for a period of time in exchange for consideration. The identification criteria would be based on rights to control the use of specified assets. A contract would convey these rights if the customer could both direct the use of the asset and derive benefits from its use. If a single contract contains multiple lease and/or non-lease components, then the entity would generally be required to account separately for each component.

Lease classification

The proposals would introduce new lease classification tests, resulting in a 'dual model' for both lessees and lessors. For Type A leases – most leases in which the underlying asset is not property (i.e. not land and/or a building) – interest income/expense would be recognised, similar to finance leases today. Straight-line income/expense recognition would be preserved for Type B leases – most property leases – similar to operating leases today.

Lessee accounting

A lessee would recognise a right-of-use (ROU) asset (representing the right to use the underlying asset) and a lease liability (representing the obligation to make lease payments). The lease liability would be amortised using the effective interest rate method under both models. For Type A leases, the ROU asset would generally be amortised on a straight-line basis. However, for Type B leases the lessee would subsequently measure the ROU asset as a balancing figure to achieve a straight-line profile of total lease expense (excluding any contingent rentals) consisting of both amortisation and interest expense.

Lessor accounting

For Type A leases, the lessor would apply a new, complex model in which it would derecognise the underlying asset and recognise a lease receivable and residual asset. For Type B leases, the lessor would continue to recognise the underlying asset and recognise lease payments as income.

Short-term leases

Leases with a maximum contractual term, including renewal options, of 12 months or less would be exempt.

What happened in March 2014?

The Boards' March meeting was their first decision-making meeting on the leases project since the comment period on the 2013 ED closed in September 2013. The Boards received over 600 comment letters on the 2013 ED, and subsequently held outreach meetings to assess the many diverse views and concerns of the large constituent base of investors, analysts, regulators, preparers and others.

The Boards held preliminary discussions on key issues in January 2014, with differences emerging between Board members on key aspects of the proposals. However, no votes were taken.

The March discussions were wide-ranging, covering key aspects of lessee and lessor accounting. The Boards also considered a range of potential simplifications to the proposals, intended to reduce the cost and complexity of implementation.

Some aspects of the proposals were not challenged in any way – e.g. both Boards took as a given that lessees should recognise major lease commitments on-balance sheet. However, the Boards were unable to reach agreement on exactly how lessee accounting should work.

Given the extent and complexity of the discussions, it remains possible that the Boards will return to some topics. Some decisions could be reversed before the final standard is published. However, at the time of writing, Board members appear entrenched in their opposing views and a fully converged standard seems unlikely.

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MARCH DECISIONS AT A GLANCE

The Boards have taken divergent paths on key aspects of lease accounting.

Topic	IASB decisions	FASB decisions
Lessee accounting model	<ul style="list-style-type: none"> Single lease accounting model No lease classification test All leases on-balance sheet <ul style="list-style-type: none"> Treated as purchase of asset on a financed basis 	<ul style="list-style-type: none"> Dual lease accounting model Lease classification test based on IAS 17 classification criteria All leases on-balance sheet <ul style="list-style-type: none"> Type A leases treated as purchase of asset on a financed basis Type B leases qualify for straight-line recognition of total lease expense
Lessor lease classification	<ul style="list-style-type: none"> Dual lease accounting model for lessors Lease classification test based on IAS 17 classification criteria 	
Lessor accounting model	<ul style="list-style-type: none"> Type A accounting model (receivable and residual model) replaced with model based on IAS 17 finance lease accounting¹ 	
	<ul style="list-style-type: none"> No restriction on recognising selling profit on commencement of Type A lease 	<ul style="list-style-type: none"> Selling profit not recognised on commencement of Type A lease if lease does not qualify for Type A classification without involvement by third parties other than the lessee
Lease term and purchase options	<ul style="list-style-type: none"> Threshold to determine whether to include renewal and purchase options in lease accounting to be consistent with high threshold in current GAAP Lessees to reassess renewal and purchase options if there is a significant event or change in circumstances that is within the control of the lessee – e.g. construction of significant leasehold improvements No reassessment of renewal and purchase options by lessors 	
Short-term leases	<ul style="list-style-type: none"> Lessee exemption for short-term leases expanded to cover leases for which the lease term – as determined under the revised proposals for the lease term – is 12 months or less 	
Small-ticket leases	<ul style="list-style-type: none"> Lessee exemption for small-ticket leases, even if material in aggregate 	<ul style="list-style-type: none"> No exemption for small-ticket leases
	<ul style="list-style-type: none"> Portfolio-level accounting permitted in some cases 	

¹ The Type B accounting model in the 2013 ED is based on IAS 17 operating lease accounting.

LESSEE ACCOUNTING MODEL

The IASB decided that lessees would apply a single lease accounting model, whereas the FASB decided on a dual model.

What's the issue?

Should there be a dual model for lessee accounting and, if so, how should a lessee classify leases?

The 2013 ED proposed a dual model approach for lessee accounting, under which a lessee would classify each lease as either Type A or Type B. The proposed lease classification test was based on the nature of the underlying asset and the extent to which it is consumed during the lease term. Broadly, most leases in which the underlying asset is not property – i.e. not land and/or a building – would be classified as Type A; most property leases would be classified as Type B.

For all leases other than short-term leases, a lessee would recognise a right-of-use (ROU) asset for its right to use the underlying asset during the lease term, and a lease liability for its obligation to make lease payments. Subsequently, the lessee would measure the lease liability at amortised cost. However, subsequent accounting for the ROU asset and presentation of lease expense would depend on whether the lease was classified as Type A or Type B, as follows.

- For Type A leases (typically leases in which the underlying asset is not property), the lessee would measure the ROU asset at amortised cost, and would typically amortise the ROU asset on a straight-line basis. The lessee would recognise amortisation of the ROU asset and interest expense on the lease liability separately in profit or loss. Overall, the lessee would typically recognise a front-loaded pattern of total lease expense.
- For Type B leases (typically property leases), the lessee would recognise total non-contingent lease expense on a straight-line basis over the lease term, and would present this as a single expense in profit or loss. To achieve this accounting outcome, the lessee would measure the ROU asset as a balancing figure.

There was no consensus amongst constituents on the proposed dual model for lessees. Many welcomed the introduction of the Type B lease accounting model, as they believed that the straight-line profile of lease expense better reflected the economics of some leases – especially property leases. Some supporters of the Type B model wished to apply it to a wider range of leases. Other constituents questioned whether there was any conceptual basis for the Type B model. Many also raised concerns about the costs and complexity of the new proposed classification tests, noting that new accounting systems would be required and that applying the tests would require increased management judgement.

What's new in March?

The Boards decided on different models for lessee accounting, as follows.

- The IASB decided that a lessee would apply a *single* lease accounting model – i.e. Type A – to all leases.
- The FASB decided to retain a *dual* model – but to use a classification test based on the IAS 17 criteria to assess whether a lease should be accounted for as a Type A lease or a Type B lease. Lessees would apply the same lease classification criteria as lessors (see *Lessor lease classification*).

What are the implications?

The Boards' divergence on the lessee accounting model after nearly eight years of joint work on the leases project will surprise many. Given that the Boards have not identified any jurisdictional differences in the economics of leasing transactions, they will struggle to convince constituents of the merits of pursuing different paths at this point. Unfortunately, it now appears that a key outcome of this project will be to make it harder for users to compare the financial statements of lessees that apply IFRS versus US GAAP.

Under both GAAPs, the core results of the lessee ROU model – i.e. recognising all leases on-balance sheet – would still introduce a significant change from today's lease accounting. However, there would be significant differences under IFRS and US GAAP in the measurement and presentation of lease expense, with consequential impacts on the balance sheet.

The IASB's single model approach would be easier to apply, have a clearer conceptual grounding and provide greater consistency – but it would not allow for the straight-line recognition of total lease expense that many constituents believe better reflects the economics of certain leases, notably many property leases.

The FASB's dual model approach would not only preserve the straight-line recognition of total lease expense for Type B leases, but would also expand it to a wider population of leases because the classification test would not be based on the nature of the underlying asset as proposed in the 2013 ED.

LESSOR LEASE CLASSIFICATION

Lessors would apply a version of the IAS 17 'risks and rewards' lease classification test.

What's the issue?

How should lessors determine whether a lease is Type A or Type B?

The 2013 ED proposed that lessors apply the same classification test as lessees, based on the nature of the underlying asset and the extent to which the asset is consumed over the lease term. For Type A leases, the lessor would apply a new, complex model under which it would derecognise the underlying asset, and recognise a lease receivable and a residual asset. For Type B leases, the lessor would account for the lease in a similar way to current operating lease accounting under IAS 17.

Responding to the proposed lessor accounting models, most constituents did not consider symmetry between lessee and lessor accounting to be a high priority. Some felt that lessors should classify more leases as Type B – e.g. leases of ships and heavy equipment that would be classified as Type A under the proposals. In general, most users did not support the proposals, because they believed that lessor accounting works well in practice and because they do not adjust their financial statement figures for current lessor accounting requirements.

What's new in March?

Both Boards decided to retain a dual model approach that would determine lessor lease classification based on whether the lease is effectively a financing or sale (Type A) rather than an operating lease (Type B). However, the Boards decided that lessors would make this assessment based on a classification test similar to that in IAS 17. In making this assessment, a lessor would assess whether the lease transfers substantially all of the risks and rewards incidental to ownership of the underlying asset. Specifically, leases would be classified as Type B unless any of the following conditions are met:

- the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- the lessee has a purchase option that is reasonably certain to be exercised based on consideration of economic factors; or
- the lease otherwise transfers substantially all of the risks and rewards incidental to ownership of the underlying asset to the lessee (and other third parties, if any, involved in the transaction). Indicators include:
 - a lease term that is for a major part of the remaining economic life of the underlying asset;
 - lease payments and third party residual value guarantees (if any) with a present value that is substantially all of the fair value of the underlying asset; and
 - an underlying asset of such a specialised nature that it is expected to have no alternative use to the lessor at the end of the lease term.

What are the implications?

The decision to base the lessor lease classification test on IAS 17 reflects the feedback received from financial statement users that current lessor accounting works well in practice. It would also significantly reduce the cost and complexity of applying the proposals for lessors, because system and process changes would not be required in order to assess lease classification. In many cases, a lease that is currently classified as a finance lease would be classified as a Type A lease, and a lease that is currently classified as an operating lease would be a Type B lease. However, it will be important to review the final version of the lease classification test to assess whether this would always be the case.

LESSOR ACCOUNTING MODEL

Lessors would apply a version of IAS 17 finance lease accounting to Type A leases.

What's the issue?

How should lessors account for Type A leases?

The 2013 ED proposed that lessors apply a new, complex model to Type A leases – i.e. most leases of assets other than property. Under this model, a lessor would derecognise the underlying asset and recognise:

- a lease receivable – representing its right to receive lease payments from the lessee; and
- a residual asset – representing its interest in the underlying asset at the end of the lease term.

Many constituents questioned whether a new lessor accounting model was necessary. Some expressed specific concerns about the cost and complexity of applying the proposed Type A model, including:

- the judgement required to estimate the value of the residual asset and the sensitivity of income recognition to this estimate;
 - the complexity involved in accounting for variable lease payments; and
 - the different impairment tests for the lease receivable and the residual asset.
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What's new in March?

The Boards decided to eliminate the proposed lessor accounting model for Type A leases – i.e. the receivable and residual model. Instead, lessors would account for Type A leases using an approach similar to current finance lease accounting under IAS 17.

However, the FASB decided that selling profit would not be recognised on commencement of a Type A lease if the lease does not qualify for Type A classification without involvement by third parties other than the lessee – e.g. a third party residual value guarantee.

What are the implications?

Elimination of the lessor accounting model for Type A leases is consistent with the Boards' overall decision not to make significant changes to lessor accounting. Taken together with the Boards' decision that lessors should apply a lease classification test based on IAS 17, and the similarity of the lessor accounting model for Type B leases to current operating lease accounting, the changes to lessor accounting would be modest. This reflects user feedback that lessor accounting under current GAAP works well in practice.

However, it would be inaccurate to characterise the project as a 'lessee-only' project. There are still various proposals that will affect lessor accounting, including:

- the identification of a lease;
- sale-and-leaseback accounting; and
- the disclosure requirements.

There will be additional changes to lessor accounting under US GAAP, including the decision that selling profit would not be recognised on commencement of a Type A lease in cases when the lease does not qualify for Type A classification without involvement by third parties other than the lessee. This may be the case, for example, when a third party provides a residual value guarantee or commits to purchase the underlying asset at the end of the lease term. The FASB introduced this restriction to align with the Boards' forthcoming revenue standard.

LEASE TERM AND PURCHASE OPTIONS

The Boards reverted to the 'reasonably certain' criterion, and reduced their reassessment requirements.

What's the issue?

What threshold should apply for including options in lease accounting?

The 2013 ED proposed that the lease term be defined as the non-cancellable period of the lease, together with:

- the periods covered by an option to *extend* the lease, if the lessee has a significant economic incentive to exercise that option; and
- the periods covered by an option to *terminate* the lease, if the lessee has a significant economic incentive not to exercise that option.

The 2013 ED proposed that, in assessing whether a lessee has a significant economic incentive to exercise a renewal option, an entity would consider contract-based, asset-based, entity-based and market-based factors. The exercise price of a purchase option would also be included in the lease payments at initial measurement of the lease liability if the lessee has a significant economic incentive to exercise that option. The 2013 ED proposed that renewal and purchase options be reassessed in certain circumstances.

Many constituents agreed that there was a need to consider optional periods when determining the lease term. However, there were concerns about the proposed 'significant economic incentive' threshold, including whether the new threshold was meant to be the same as or higher than existing guidance. Most constituents also expressed significant concerns about whether the benefits of continuous reassessments would exceed the cost.

What's new in March?

The Boards decided that, when determining the lease term, an entity would consider all relevant factors that create an economic incentive to exercise an option to extend, or not to terminate, a lease. An entity would include such an option in the lease term if it is *reasonably certain* that the lessee will exercise those options. The Boards reaffirmed that purchase options would be assessed in the same way. The Boards indicated that they do not intend to change the high threshold in current GAAP for the recognition of renewal and purchase options.

The Boards also decided that a lessee would reassess the lease term and the likelihood of the purchase option being exercised if there is a significant event or change in circumstances that is within the control of the lessee – e.g. construction of significant leasehold improvements, or significant modification to the leased asset.

Finally, the Boards decided that lessors would assess the lease term and the likelihood of the purchase option being exercised in the same way as lessees at lease commencement. However, the reassessment requirements would not apply to lessors.

What are the implications?

The cost and complexity of transition and implementation would be reduced by confirmation that the Boards do not intend to change the high threshold in current GAAP for the recognition of renewal and purchase options. This is also likely to result in more consistent application of the threshold.

The Boards' decision to limit reassessments to lessee-controlled events would reduce the potentially significant changes in reported profit or loss that could have arisen under the reassessment proposals made in the 2013 ED. The elimination of these requirements for lessors would further align the lessor proposals with current practice.

SHORT-TERM LEASES

The lessee exemption for short-term leases would be expanded to include leases with a lease term of 12 months or less.

What's the issue?

Should exemptions from applying the proposals be expanded?

The 2013 ED proposed that lessors and lessees could elect to apply a simplified approach to short-term leases – i.e. leases with a maximum contractual term, including renewal options, of 12 months or less. Any lease that contains a purchase option would not be a short-term lease. Under this simplified approach, the lessor/lessee would account for the lease in a similar way to current operating lease accounting – i.e. the lessor/lessee would recognise lease payments as income/expense in profit or loss over the lease term, generally on a straight-line basis.

Many constituents welcomed the proposed relief for short-term leases as a way to reduce the cost of applying the proposals for small-ticket or immaterial items. In addition, many constituents supported expanding the short-term exemption by revising the definition of a short-term lease, either by extending the 12-month threshold – e.g. to 36 months – or by changing the definition to be consistent with the assessment of the lease term.

What's new in March?

The Boards agreed to retain the exemption for short-term leases for lessees. Furthermore, they agreed to expand the exemption to cover leases for which the lease term – as determined in accordance with the revised proposals on the lease term – is 12 months or less.

The Boards also agreed that, in addition to making qualitative disclosures, a lessee that applies the exemption would make quantitative disclosures, including:

- the amount of short-term lease expense recognised in the current period; and
- the amount of the lessee's commitment to short-term leases if the short-term lease expense for the period does not reflect the lessee's commitment at the reporting date.

What are the implications?

The Boards' decision would expand the population of leases eligible for the short-term lease exemption. In particular, month-to-month, evergreen, and other leases for which it is not reasonably certain that the lessee will renew the lease beyond 12 months may now meet the short-term lease exemption.

Aligning the definition of a short-term lease with the guidance on lease term would not require management to make an additional judgement – but it would increase the sensitivity of the judgement that has to be made. Whereas the 2013 ED proposed a bright-line test of a maximum contractual lease term of 12 months, entities would now have to analyse all relevant factors – e.g. contract-based, market-based, asset-based and entity-based – to determine whether leases are eligible for the short-term exemption. As a result, the revised exemption may attract more structuring efforts.

The newly proposed disclosure requirements for short-term leases may reduce some of the benefits associated with the exemption, because an entity would still be required to track such leases to compile the disclosures. In addition, due to the level of judgement required in determining the lease term for such leases, they may become subject to the same process and control requirements as all other leases, which may further reduce the benefits of applying the exemption.

The Boards did not discuss the short-term lease exemption for lessors. However, many leases qualifying for the exemption would be classified as Type B leases by lessors, such that lessors would apply similar accounting whether or not they applied the exemption.

SMALL-TICKET LEASES

The IASB decided to exempt small-ticket leases from the lessee proposals – but the FASB rejected this exemption.

What's the issue?

Should exemptions for 'small-ticket' leases be permitted?

The 2013 ED did not include any guidance or exemptions for applying the proposals to 'small-ticket' leases – i.e. leases that are small in value and/or secondary to an entity's business operations, such as photocopiers and IT equipment. Many constituents believed that the proposed relief for short-term leases included in the 2013 ED should also be available to a wider range of leases, to reduce the costs of implementing the proposals.

Proposals for expanding the circumstances in which a lessee could apply the simplified approach, or otherwise reduce the costs of implementing the proposals, included:

- developing a recognition and measurement exemption for leases of small, non-specialised assets;
- permitting the proposals to be applied at a portfolio level instead of to individual lease contracts in some circumstances; and
- providing guidance on materiality, either by including an explicit materiality threshold or by clarifying how to apply existing materiality guidance to leases.

What's new in March?

The IASB decided to develop a recognition and measurement exemption for a lessee's small-ticket leases. A lessee applying this exemption would not be required to consider whether the population of small-ticket leases is material in aggregate. The FASB did not approve a specific scope exemption for small-ticket leases, but instructed the staff to perform outreach on the potential impact of such an exemption.

The Boards decided that lessees and lessors may apply the proposals at a portfolio level if the entity has a reasonable expectation that portfolio-level accounting would not differ materially to applying the requirements to individual lease contracts.

The Boards agreed not to provide specific guidance on materiality in the final leases standard.

What are the implications?

The IASB's exemption for small-ticket leases would reduce the costs of applying the standard. However, judgement would be required to determine whether an item is eligible for the exemption. It is currently unclear what factors an entity would consider in order to make this determination, other than an item being 'small' in nature – although the IASB has not proposed a specific quantitative threshold. There is a risk that the relief may not be applied consistently, and that arrangements may be structured in order to take advantage of the exemption.

Some constituents may be surprised that an entity would not be required to assess whether items eligible for the exemption are material in aggregate. This could have a significant effect on certain industries – e.g. a telemarketing firm that leases a large number of phones and low-value IT equipment. In turn, this may complicate the comparison of financial statements of entities in such industries reporting under IFRS versus US GAAP, given the FASB's rejection of the exemption. However, given the likelihood that such leases would be classified as Type B leases under the FASB approach – generally resulting in straight-line recognition of income and expense – the difference would probably be limited to the balance sheet.

The decision to permit a portfolio-level approach aligns with the Boards' forthcoming revenue standard and may also help to reduce costs. For example, an entity may be able to use the same judgement to determine the discount rate and lease term for all similar items leased under a master lease agreement. However, judgement would be needed to determine when a portfolio-level approach is required. One practical question may be what level of analysis a regulator would expect an entity to perform in demonstrating that it has a reasonable expectation that portfolio-level accounting would not differ materially from applying the requirements to individual lease contracts.

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Our [IFRS – financial instruments](#) hot topics page brings together our materials on the financial instruments project, including our *IFRS Newsletter: Financial Instruments*.

Acknowledgements

We would like to acknowledge the effort of the principal authors of this publication: Brandon Gardner, Steve Hills and Brian O'Donovan.

We would also like to thank the following reviewers for their input: Kimber Bascom, Kris Peach and Ramon Jubels.

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Publication name: *IFRS Newsletter: Leases*

Publication number: Issue 14

Publication date: March 2014

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