IFRS NEWSLETTER

LEASES

Issue 15, June 2014

cutting through complexity

> Despite the significant divergence on key aspects of their lease proposals earlier this year, the Boards appear determined to finalise this long-running project – even if it results in non-converged standards.

Kimber Bascom,
KPMG's global IFRS leasing standards leader

CONTINUING FORWARD

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

Despite reaching divergent views on fundamental aspects of their lease accounting proposals in March 2014, the IASB and the FASB (the Boards) continued their redeliberations on the leases project during the second quarter of 2014. They discussed various aspects of the project, including the key question of how to define a lease. Although the Boards agreed on most issues, they differed on some points – e.g. the reassessment of variable lease payments by lessees. This will further reduce the comparability of lessee accounting under IFRS and US GAAP.

Highlights

Definition of a lease

- To help distinguish leases from service contracts, the Boards sought to clarify the definition of a lease and decided to develop further guidance on how the definition would be applied in practice.

Separating lease and non-lease components

- The Boards decided to retain guidance on the separation of lease and non-lease components for lessors, and to introduce a new practical expedient for lessees.

Variable lease payments

- The Boards reached different conclusions on when a lessee would reassess variable lease payments – meaning that subsequent measurement of a lessee's lease liability could be different under IFRS and US GAAP.

Lease modifications

- The Boards defined a lease modification and introduced new criteria for accounting for different types of modifications – agreeing to introduce significant new guidance to address a common practice issue.

CURRENT STATUS OF THE PROPOSALS

The 2013 proposals …

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, all of which have been redeliberated by the Boards in the first half of 2014.

Lease identification

A 'lease' would be a contract that conveys the right to use an identified 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 the second quarter of 2014?

Although the Boards' March 2014 meeting indicated that fully converged standards are unlikely, the Boards continued joint redeliberations through the second quarter of 2014. One of the Boards' goals was to minimise further differences between the IFRS and US GAAP version of the standard. However, additional small differences between the Boards emerged during their April, May and June meetings.

This newsletter discusses the significant decisions reached in the second quarter of 2014 and provides an overview of the other issues discussed.

The Boards plan to continue redeliberations in the second half of 2014. Notably, the Boards intend to consider further the implications and practicability of allowing an exemption for small-ticket leases – an exemption that the FASB appeared to reject in March. In addition, the Boards also plan to redeliberate the following topics:

- sale and leaseback transactions;
- disclosures;
- transition;
- FASB-only issues – e.g. leveraged leases;
- other sweep issues – e.g. related party leases and consequential amendments;
- cost-benefit considerations; and
- effective date.

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CURRENT PROPOSALS AT A GLANCE

The Boards have diverged on key aspects of lease accounting.

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<tr><td>Lessee accounting model</td><td>• Single lease accounting model
• No lease classification test
• All leases on-balance sheet:
– lessee would recognise a right-of-use (ROU) asset and lease liability
– treated as the purchase of an asset on a financed basis</td><td>• Dual lease accounting model
• Lease classification test based on IAS 17 Leases classification criteria
• All leases on-balance sheet:
– lessee would recognise a ROU asset and lease liability
– Type A leases treated as the purchase of an asset on a financed basis
– Type B leases would generally have straight-line recognition of total lease expense</td></tr>
<tr><td rowspan="2">Lessor accounting model</td><td colspan="2">• Dual lease accounting model for lessors
• Lease classification test based on IAS 17 classification criteria
• Type B accounting model based on IAS 17 operating lease accounting
• Type A accounting model based on IAS 17 finance lease accounting with recognition of net investment in lease comprising lease receivable and residual asset</td></tr>
<tr><td>• No restriction on recognising selling profit on commencement of Type A leases</td><td>• Selling profit not recognised on commencement of leases that qualify for Type A classification only due to the involvement of third parties other than the lessee</td></tr>
<tr><td>Lease term and purchase options</td><td colspan="2">• Optional – e.g. renewal – periods and purchase options included in lease accounting if it is reasonably certain that the lessee will exercise those options, consistent with the 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</td></tr>
<tr><td rowspan="2">Practical expedients and targeted reliefs</td><td colspan="2">• Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under the revised proposals is 12 months or less
• Portfolio-level accounting permitted if it does not differ materially from applying the requirements to individual leases</td></tr>
<tr><td>• Optional lessee exemption for small-ticket leases – e.g. leases of IT equipment and office furniture – even if material in aggregate</td><td>• No exemption for small-ticket leases</td></tr>
</table>

DEFINITION OF A LEASE

The Boards sought to clarify the definition of a lease to help distinguish leases from service contracts.

What's the issue?

How is a lease distinguished from a service contract?

The 2013 ED defined a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". A lease would exist if both of the following conditions are met:

- fulfilment of the contract depends on the use of an identified asset; and
- the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

Many constituents felt that the ED did not provide sufficient guidance to distinguish between leases and service contracts. This was considered to be a key issue because of the significantly different accounting outcomes for leases and executory contracts, as the latter would remain off-balance sheet. Most constituents were concerned that the ED's proposals would not support consistent application of the definition of a lease – in particular, when assessing whether a contract conveys the right to control the use of an identified asset for which there are substitution rights. Finally, constituents were concerned that the ED would enable structuring opportunities designed to exclude arrangements from the proposals.

What's new in Q2?

The IASB decided to retain the principles from the 2013 ED on the definition of a lease based on the right to control the use of an identified asset. The FASB expressed general support for the principles underlying the ED's proposed definition of a lease, but directed its staff to provide additional information about the way the principles would be articulated in the standard – along with examples of its application – before proceeding to a formal vote.

In addition, the Boards decided to add guidance clarifying that:

- fulfilment of the contract depends on the use of an identified asset when the supplier has no *practical ability* to substitute an alternative asset or the supplier would not benefit from substituting an alternative asset; and
- if it is impractical for the customer to determine whether the supplier has a *practical ability* to substitute, or would benefit from substituting, an alternative asset, then the customer would presume that the contract depends on the use of an identified asset.

Lastly, the Boards decided to clarify how the definition would be applied in practice, by:

- indicating that the assessment is based on which party has the ability to make decisions about the use of the identified asset that *most significantly* affect the economic benefits to be derived from its use;
- clarifying which decisions *most significantly* affect the economic benefits derived from use when both parties share decision-making rights; and
- removing the guidance included in the 2013 ED on assets that are incidental to the delivery of services.

What are the implications?

Assessing whether an arrangement is, or contains, a lease would be one of the key judgements when applying the proposals. In effect, it is the new '90 percent test' – the key dividing line between whether an arrangement is on-balance sheet or off-balance sheet for the customer. Realistically, this is likely to remain a key judgement, however hard the Boards work to clarify and supplement the definition.

The Boards' decision to reaffirm the principles from the 2013 ED supporting the definition of a lease would result in entities having to perform a different assessment to that required under IFRIC 4 *Determining whether an Arrangement contains a Lease*. As such, all entities will have to reassess current lease and service arrangements on adoption of the final leases standard. The implementation guidance and illustrative examples in the final standard will be critical in helping entities make this evaluation.

Although the introduction of a presumption for customers that fulfilment of the contract depends on the use of an identified asset in some cases is notably directional, customers would still have to go through the remaining control steps in determining whether the contract is, or contains, a lease.

SEPARATING LEASE AND NON-LEASE COMPONENTS

The Boards decided to retain guidance on the separation of lease and non-lease components for lessors, and to introduce a new practical expedient for lessees.

What's the issue?

How should an entity separate and allocate consideration to lease and non-lease components?

The 2013 ED proposed that a right to use an asset would be a separate lease component of a contract if:

- the lessee can benefit from the use of the leased asset either on its own or with readily available resources – i.e. goods or services that are sold or leased separately, or resources that the lessee has already obtained; and
- the leased asset is neither dependent on, nor highly inter-related with, other underlying assets in the contract.

Generally, an entity would account for each lease component as a separate lease, separately from non-lease components. An entity would allocate the total contractual payments to components based on their relative fair values – similar to the general approach in the Boards' new revenue standard. If the lessee was unable to obtain observable stand-alone selling prices for all of the components, then it would combine the components and account for them as a single lease component.

Some constituents were concerned that lessees would combine non-lease components with lease components when they are unable to obtain observable stand-alone selling prices for all components, thereby grossing up the balance sheet for the non-lease component. Furthermore, some lessors believed that they would be requested to communicate proprietary information about the way they price contracts so that lessees could apply the proposals.

What's new in Q2?

The Boards decided to retain the guidance from the 2013 ED on identifying separate lease components for lessors, and to modify the guidance for lessees by introducing a new practical expedient.

For lessors, the Boards reaffirmed the requirements on the separation of lease and non-lease components, and the allocation of consideration to those components. Additionally, the Boards decided to clarify that a lessor would reallocate the consideration in a contract if there is a contract modification that is not accounted for as a separate additional lease.

For lessees, the Boards decided that lease components would be separated from non-lease components (unless the accounting policy election discussed below is selected) and the consideration would be allocated on a relative stand-alone selling price basis using observable stand-alone selling prices, if available. Otherwise, estimation techniques – e.g. a residual approach – would be allowable. The Boards decided to clarify that a lessee would reallocate the consideration in a contract when there is either:

- a reassessment of the lease term or a purchase option; or
- a contract modification that is not accounted for as a separate additional lease.

Finally, the Boards decided, as a practical expedient, to allow lessees an accounting policy choice by class of underlying asset, to:

- not separate lease components from non-lease components; and instead
- account for the components together as a single lease component.

What are the implications?

In general, the approach to lease components is a less significant aspect of the proposals than it was in the 2013 ED, due to other decisions reached during the redeliberations. It was important under the 2013 ED to identify each lease component and assess the nature of the primary asset to determine classification as either a Type A or Type B lease. However, the Boards' decision on lessee classification in March 2014[1] reduced the relevance of separating different lease components.

Notably, the guidance on components has potentially acquired a new significance for the IASB's proposals. Identifying separate lease components as the unit of account would establish a 'floor' below which an entity will not be able to further disaggregate an asset when applying the final standard. This will be critical if the IASB proceeds with a small-ticket lease exemption for lessees, as it would limit the ability of lessees to break down a lease of a large asset into smaller leases of separate parts to qualify for the exemption.

The decision to allow lessees to use estimation techniques – e.g. a residual approach – in determining the stand-alone selling prices of components (if observable prices are not available) for the allocation of contract consideration will eliminate lessors' concerns arising from the 2013 ED about potentially having to provide proprietary pricing information to lessees. The use of estimation techniques will also help to reduce the costs and complexity of applying the proposals.

Finally, the decision to introduce a practical expedient allowing lessees not to separate lease components from non-lease components, and instead to account for the components together as a single lease component, may reduce costs and complexity for some lessees. However, the use of the expedient could be limited, as the accounting effects would include an increase in the lessee's lease liabilities.

1 The IASB opted for a single lessee accounting model with no lease classification test, while the FASB opted for a dual lessee accounting model with a lease classification test based on IAS 17 criteria and not the nature of the underlying asset.

VARIABLE LEASE PAYMENTS

The Boards reaffirmed the types of variable lease payments to be estimated up-front, but differed on reassessment.

What's the issue?

Which variable lease payments should be estimated up-front, and when are they reassessed?

The 2013 ED proposed that an entity would include only variable lease payments (VLPs) that depend on an index or rate – using the index or rate at lease commencement – or that are in-substance fixed payments in the lease payments when calculating the lease asset and liability on initial recognition. The 2013 ED also proposed that an entity reassess the lease payments for changes in the index or rate used to determine lease payments during the reporting period.

Most constituents agreed with the proposed definition of VLPs, as they believe that payments contingent on future events – e.g. based on performance or usage – do not represent a present obligation of the lessee, or a right of the lessor. Similarly, many constituents supported including in-substance fixed payments in the definition of lease payments because they are unavoidable, although many questioned how to determine whether a payment is in-substance fixed. Finally, almost all constituents expressed concerns about the reassessment requirements for VLPs, arguing that this would result in additional cost and complexity for limited benefit.

What's new in Q2?

The Boards reaffirmed that entities would initially measure lease assets and liabilities including VLPs that depend on an index or rate using the index or rate at lease commencement. However, the Boards differed on the reassessment of VLPs by lessees as follows.

- The IASB decided that a lessee would reassess VLPs that depend on an index or a rate:
  - when the lessee remeasures the lease liability for other reasons – e.g. reassessment of the lease term; and
  - when there is a change in the cash flows resulting from a change in the reference index or rate – i.e. at the time when an adjustment to the lease payments takes effect.
- The FASB decided that a lessee would only reassess VLPs that depend on an index or rate when the lessee remeasures the lease liability for other reasons – e.g. reassessment of the lease term.

Both Boards decided that lessors would not reassess VLPs that depend on an index or a rate.

Lastly, the Boards decided to retain the principle that variable payments that are in-substance fixed payments would be included in the definition of lease payments.

What are the implications?

The different reassessment requirements for lessees proposed by the IASB and the FASB would further reduce the comparability of lease accounting between entities reporting under IFRS and under US GAAP. Combined with the Boards' previous non-converged decision on the lessee accounting model, the different approaches to reassessment of VLPs would not only further distort the comparability of the lessee's ROU asset but would also result in different subsequent measurement of the lessee's lease liability. VLPs based on an index or rate are a common feature in lease agreements, especially leases of property, making this a widespread issue.

The decision that lessors would not reassess VLPs is a further nudge towards retention of a version of current IAS 17 accounting for lessors.

LEASE MODIFICATIONS

The Boards decided to add significant guidance on accounting for lease modifications.

What's the issue?

How is a lease modification identified and accounted for?

The 2013 ED proposed that if there was a substantive change to the terms and conditions of an existing lease agreement, then an entity would account for an additional lease from the date on which the new terms become effective. The entity would recognise any changes in the carrying amounts of assets and liabilities resulting from the modification in profit or loss.

Some constituents questioned whether there was sufficient guidance on lease modifications, given that lease modifications are common and give rise to practice issues.

What's new in Q2?

The Boards decided to define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease.

The Boards also decided that a lessee and a lessor would account for a separate lease when the modification grants an additional right-of-use not included in the original lease and the additional right-of-use is priced commensurate with its stand-alone selling price.

The Boards decided that other lease modifications would be accounted for as follows.

- Lessees would remeasure the lease liability using an updated discount rate at the effective date of the modification. The ROU asset would be adjusted as follows.
  - If the modification increases the scope of, or changes the consideration paid for, the lease, then the lessee would recognise a corresponding adjustment to the ROU asset.
  - If the modification decreases the scope of the lease, then the lessee would recognise a decrease to the carrying amount of the ROU asset to reflect the partial or full termination of the lease. Any difference between the decrease in the lease liability and the proportionate decrease in the ROU asset would be recognised in profit or loss.
- Lessor accounting for the modification would be as follows.
  - Modifications to a Type A lease would be accounted for in accordance with IFRS 9 *Financial Instruments* (or ASC Topic 310 *Receivables* under US GAAP).
  - Modifications to a Type B lease would effectively be accounted for as a new lease from the effective date of the modification, by recognising the modified payments prospectively over the remaining lease term.

What are the implications?

Clarifying the definition of a lease modification eliminates the judgement and subjectivity that could have arisen under the 2013 ED in determining whether a modification exists. It also helps to distinguish between scenarios resulting in a lease reassessment (e.g. a change in lease term resulting from the exercise of an option included in the original lease) and those that result in a lease modification (e.g. a change in lease term resulting from changes to the terms and conditions of the original lease). This is an important distinction, as the required accounting – notably whether any gain or loss is recognised in profit or loss – is different for reassessments and modifications.

The Boards' decisions on lessor modifications generally conform with the way lessors account for modifications under existing GAAP, consistent with the Boards' overall intention not to make significant changes to lessor accounting.

SUMMARY OF OTHER ISSUES DISCUSSED IN Q2

<table>
<tr><th>Topic</th><th>IASB decisions</th><th>FASB decisions</th></tr>
<tr><td>Contract combinations</td><td colspan="2">Two or more contracts would be accounted for on a combined basis as a single transaction if the criteria for contract combinations in the new revenue standard are met.</td></tr>
<tr><td>Discount rate</td><td colspan="2">The lessee's discount rate would be the rate implicit in the lease, if readily determinable; otherwise, the lessee would use its incremental borrowing rate. The value used to determine the lessee's incremental borrowing rate would be the cost of the ROU asset.
Lessees would reassess the discount rate when there is:
– a change to the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option; or
– a lease modification.
The lessor's discount rate would be the rate implicit in the lease – i.e. the implicit rate. Initial direct costs would be included in determining the implicit rate unless the lease is a Type A lease for which selling profit will be recognised at lease commencement.
Lessors would reassess the discount rate only when there is a lease modification.</td></tr>
<tr><td>Initial direct costs</td><td colspan="2">Initial direct costs (IDCs) would include only incremental costs that an entity would not have incurred if it had not obtained the lease.
Lessees would recognise IDCs in the initial measurement of the ROU asset and amortise the costs over the lease term.
Lessors would recognise IDCs for Type A leases:
– in the initial measurement of the lease receivable if no selling profit is recognised at lease commencement; or
– as an expense at lease commencement if selling profit is recognised at lease commencement.
Lessors would capitalise IDCs for Type B leases and amortise the costs over the lease term in the same pattern as lease income.</td></tr>
<tr><td rowspan="2">Sub-leases</td><td colspan="2">An intermediate lessor would account for a head lease and a sub-lease as two separate contracts, unless those contracts meet the contract combination guidance.
– The head lease would be accounted for in accordance with the lessee accounting proposals.
– The sub-lease would be accounted for in accordance with the lessor accounting proposals.
An intermediate lessor would not offset lease liabilities and lease assets arising from a head lease and sub-lease, unless they meet the financial instruments requirements for offsetting in IFRS or US GAAP, as applicable.
An intermediate lessor would not offset lease income from a sub-lease and lease expense from a head lease unless it meets the requirements for offsetting in other IFRS or US GAAP, as applicable – e.g. the new revenue standard.</td></tr>
<tr><td>An intermediate lessor would consider the ROU asset to be the leased asset in determining the classification of the sub-lease.</td><td>An intermediate lessor would consider the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sub-lease.</td></tr>
</table>

<table>
<tr><th>Topic</th><th>IASB decisions</th><th>FASB decisions</th></tr>
<tr><td rowspan="2">Lessee presentation – balance sheet</td><td colspan="2">• Lessees would either present Type A ROU assets and lease liabilities as separate line items on the balance sheet, or disclose them separately in the notes to the financial statements.
• If they are not separately presented on the balance sheet, lessees would:
– present Type A ROU assets on the balance sheet as if the underlying asset were owned; and
– disclose in the notes the line items on the balance sheet in which Type A ROU assets and lease liabilities are included and their amounts.</td></tr>
<tr><td>• N/A – as the IASB opted for a single lessee accounting model, with no Type B leases.</td><td>• Lessees would not include Type B ROU assets and lease liabilities in the same line items as Type A ROU assets and lease liabilities on the balance sheet.
• If they are not separately presented on the balance sheet, lessees would disclose in the notes the line items on the balance sheet in which Type B ROU assets and lease liabilities are included and their amounts.</td></tr>
<tr><td>Lessee presentation – statement of cash flows</td><td>• Lessees would present cash paid for:
– principal on lease liabilities as financing activities;
– interest on lease liabilities as either operating or financing activities, based on the lessee’s accounting policy choice under IAS 7 Statement of Cash Flows; and
– variable lease payments and leases that are not recognised on-balance sheet – e.g. some short-term leases – as operating activities.
• Lessees would disclose total lease payments in the notes to the financial statements.</td><td>• Lessees would present cash paid for:
– principal on Type A lease liabilities as financing activities;
– interest on Type A lease liabilities as operating activities; and
– Type B leases, VLPs and leases that are not recognised on-balance sheet – e.g. some short-term leases – as operating activities.</td></tr>
<tr><td>Lessor presentation</td><td colspan="2">• Lessors would present lease assets and liabilities, income and expense consistent with the current guidance in IAS 17.
• Lessors would classify all cash inflows from leases as operating activities in the statement of cash flows.</td></tr>
</table>

FIND OUT MORE

For more information on the leases project, please speak to your usual KPMG contact or visit the IFRS – leases hot topics page, which includes line of business insights.

You can also go to the Leases page on the IASB website.

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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.