IFRS NEWSLETTER

LEASES

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KPMG
cutting through complexity

"The Boards are in the home stretch on the leases project – but on different tracks."

Kimber Bascom,
KPMG's global IFRS leasing standards leader

DEFINING THE PROBLEM

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

The IASB and the FASB (the Boards) continue to debate the remaining issues on their joint leases project, but have made no attempt to reconcile the key differences on lessee accounting that emerged earlier in the year. With each meeting, additional differences emerge between the Boards – e.g. on sale and leaseback accounting – which would further reduce the comparability of lessee accounting under IFRS and US GAAP. The Boards expect to conclude their redeliberations by the end of this year, and to issue their respective new standards in 2015.

Highlights

Definition of a lease

- The Boards agreed on further clarifications of the definition of a lease, but deferred a vote on aspects of the definition on which they appeared to have different initial views.

Sale and leaseback transactions

- The Boards reaffirmed the overall approach to sale and leaseback accounting, but differed on a number of important application issues.

Lessor disclosures

- The Boards decided to add new disclosure requirements for lessors.

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 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 identified assets. A contract would convey these rights if the customer could both direct the use of the asset and derive substantially all of the 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's happened since Q2 2014?

At their July and October joint meetings, the Boards continued joint redeliberations on the 2013 ED. The FASB also met separately in August to discuss sale and leaseback accounting and aspects of the proposals that are specific to US GAAP.

In these discussions, no attempt was made to reconcile the differences on lessee accounting that emerged earlier in the year. The IASB favours a single lease accounting model for lessees, whereas the FASB favours a dual model with a lease classification test.

Both Boards received feedback from important constituents on their alternative approaches. The FASB's Investor Advisory Committee expressed a preference for the IASB's single model approach. Respondents to a consultation by the European Financial Reporting Advisory Group (EFRAG) and European standard setters expressed mixed views about the project generally, but more respondents supported the IASB's single model approach than the FASB's dual model approach.

One of the Boards' goals remains to minimise further differences between the IFRS and US GAAP versions of the standard. However, additional differences between the Boards continue to emerge. The Boards were unable to agree on several detailed aspects of accounting for sale and leaseback transactions. The Boards also seemed to have different initial views on aspects of lease definition, although no votes were taken on the areas of contention.

In its August meeting, the FASB decided that the new leases standard would not include the special accounting requirements under current US GAAP for leveraged leases, a form of direct financing lease. However, the FASB decided to 'grandfather' the accounting treatment of existing leveraged leases on transition to the new standard. This would further reduce comparability for the remaining term of such leases.

The Boards plan to continue redeliberations before finalising their respective standards. 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 – and to conclude their discussions on the definition of a lease. In addition, the Boards also plan to redeliberate the following topics:

- lessee disclosure requirements;
- other sweep issues – e.g. consequential amendments;
- cost-benefit considerations; and
- transition and effective date.

Contents

Current proposals at a glance	3
Definition of a lease	4
Sale and leaseback transactions	6
Lessor disclosures	8
Summary of previous discussions	9
Find out more	10

CURRENT PROPOSALS AT A GLANCE

The Boards have diverged on key aspects of lease accounting.

<table>
<tr><th>Topic</th><th>IASB decisions</th><th>FASB decisions</th></tr>
<tr><td rowspan="1">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 solely 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 agreed on further clarifications to the definition of a lease, but deferred a vote on aspects of the definition on which they appeared to have different initial views.

What's the issue?

How is a lease distinguished from a service contract?

The 2013 ED stated that a lease would exist if both of the following conditions are met:

- fulfilment of the contract depends on the use of an identified asset that is either explicitly or implicitly specified; and
- the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration, and therefore the customer has the right to:
  - direct the use of an identified asset; and
  - obtain substantially all of the economic benefits from directing the use of the identified asset.

Many constituents felt that the 2013 ED did not provide sufficient guidance to distinguish between leases and service contracts, and were concerned that the definition would not be applied consistently in practice.

The Boards agreed a number of clarifications to the definition in their May 2014 meeting and requested further analysis of how the definition would be applied in practice.

What's new since Q2?

The Boards decided to add guidance clarifying how to assess the customer's right to control the use of an identified asset, and to give examples illustrating the analysis needed to assess whether a contract contains a lease.

In summary, the Boards clarified the following points.

- A customer has the right to direct the use of an asset whenever it has the right to direct (including the right to *change*) how and for what purpose the asset is used throughout the period of use.
- If the use is predetermined in the contract, or otherwise mutually agreed between the customer and the supplier, then the customer still has the right to direct the use of the asset if it has the right to direct how the asset is operated, or designed the asset in a way that predetermined its use.
- A supplier's protective rights typically define the scope of the customer's use of the asset but would not, in isolation, prevent the customer from having the right to direct the use of the identified asset.

The Boards also discussed whether the customer needs to have the *ability* to derive the economic benefits from directing the use of the identified asset, on its own or together with resources that are readily available to the customer, for a lease to exist. They directed their staff to provide additional analysis on this issue for consideration at a future meeting.

What are the implications?

Assessing whether an arrangement is, or contains, a lease would be one of the key judgements when applying the final standard. For a customer-lessee, this assessment would determine whether an arrangement is on-balance sheet or off-balance sheet.

No fundamental change in approach to lease definition …

The further clarifications could increase the consistency with which the definition is applied in practice. However, they do not represent a significant change from the proposals in the 2013 ED. In effect, the Boards have rejected calls from constituents seeking a fundamentally different approach to lease definition. Those constituents who would like the definition to focus on whether the arrangement contains a financing component, or relates predominantly to a service, will be disappointed.

A number of arrangements that are currently accounted for as leases may fall outside of the new definition. For example, an arrangement may be a lease under current guidance because the customer obtains all of an asset's output but does not pay a fixed or market price for each unit of output. Under the new definition, such an arrangement would only be a lease if the customer controls the asset. This may mean that some power purchase agreements, and some assets used to fulfil outsourcing contracts, may fall outside of lease accounting.

… but discussions will continue

The Boards will return to the question of whether it is necessary for the customer to have the *ability* to derive economic benefits from the asset at a future meeting. The question here is whether a customer can have a lease if it depends on the supplier to operate the asset – i.e. whether the customer can have a lease of an asset that it could not operate itself, and for which an alternative operator is not readily available.

Although the Boards' discussions suggested that this was not a common scenario, most FASB members seemed inclined to include such guidance in the final standard because they viewed it as a relevant aspect of assessing whether a customer controls the use of an identified asset. Conversely, most IASB members were less supportive, and appeared concerned that a requirement designed to address a narrow population of contracts could create additional complexity and structuring opportunities.

The possibility of the Boards reaching different decisions on lease definition will be of great concern to many constituents. Failure to reach a converged solution on such a fundamental question would make it more difficult for users of financial statements to compare similar types of transactions under IFRS and US GAAP.

SALE AND LEASEBACK TRANSACTIONS

The Boards reaffirmed the overall approach to sale and leaseback accounting, but differed on a number of important application issues.

What's the issue?

How to account for sale and leaseback transactions?

The 2013 ED proposed that an entity would account for a transaction as a sale and leaseback transaction only if it qualified as a sale under the new revenue standard (IFRS 15 *Revenue from Contracts with Customers*). If the transaction did not qualify as a sale, the 2013 ED proposed that an entity would account for the entire transaction as a financing transaction.

Although the 2013 ED did not specifically solicit feedback on sale and leaseback transactions, a number of constituents supported the broad proposal to align the accounting for sale and leaseback transactions with the new revenue standard. However, constituents also raised a number of application issues on which they felt additional guidance was required to clarify how the proposals would work in practice.

What's new since Q2?

The Boards agreed on the basic requirements that:

- assessing whether a transaction qualifies for sale and leaseback accounting would depend on whether a sale has occurred; and
- when this is the case, the leaseback would be accounted for like any other lease.

The Boards' decisions on other implementation issues were as follows.

Sale and leaseback topic	IASB decisions	FASB decisions
Determining whether a sale has occurred	Apply the new revenue recognition standard	If the leaseback is a Type A lease, then no sale has occurred If the leaseback is a Type B lease, then apply the new revenue standard
Impact of repurchase options held by the seller-lessee on determining whether a sale has occurred	If there is a substantive repurchase option, then no sale has occurred	A repurchase option with an exercise price equal to the fair value of the underlying asset at the exercise date would not preclude a sale if the underlying asset was non-specialised and readily available in the marketplace
Recognition of gain on sale	Recognise only the portion of the gain that relates to the residual interest in the asset transferred to the buyer-lessor	Recognise full amount of gain
Recognition of loss on sale	Recognise full amount of loss immediately	

Sale and leaseback topic	IASB decisions	FASB decisions
Identification of off-market terms	Consider whether there is a difference between either one of the following, depending on which is the more readily determinable: • the sales price and the fair value of the underlying asset; or • the present value of the contractual lease payments and the present value of fair market value lease payments	
Accounting for off-market terms	If the difference identified above is an excess – e.g. if the sales price exceeds fair value – then recognise a financial liability for the additional financing If the difference identified above is a deficiency – e.g. if the sales price is less than fair value – then recognise prepaid rent and increase the ROU asset	
Accounting for a transaction that does not qualify as a sale and leaseback because no sale has occurred	Treat as a financing transaction	

What are the implications?

Accounting for sale and leaseback transactions is – and will remain – a complex area. However, one thing remains clear – the new standard would largely eliminate sale and leaseback transactions as a potential source of off-balance sheet finance. Under the new standard, a sale and leaseback would always be on-balance sheet for the seller-lessee, unless the leaseback was short or, potentially, involved a small-ticket item. Unfortunately, the Boards cannot agree on the details of the accounting.

Firstly, the Boards cannot agree on how to determine when to recognise a sale. This seems astonishing, given that the core proposal is to apply the Board's new revenue standard – a substantially converged standard that was issued less than six months ago. Secondly, the Boards cannot agree on how to calculate the gain when a sale is recognised. As a result, entities applying US GAAP would often recognise larger, and sometimes much larger, up-front gains on sale and leaseback transactions than entities applying IFRS.

These differences would make it more difficult for users of financial statements to compare identical transactions under IFRS and US GAAP.

The new guidance on off-market terms would help entities to identify when a transaction is deemed to be off-market, and would also clarify the appropriate accounting treatment when the terms are above-market (financing) or below-market (prepayment). An entity would have to maximise the use of observable prices and information to determine which measure is the most appropriate to use when assessing whether terms are off-market. This would require significant management judgement, especially when the underlying asset is specialised.

LESSOR DISCLOSURES

The Boards decided to add new disclosure requirements for lessors.

What's the issue?

Do current lessor disclosures provide sufficient information?

The 2013 ED proposed new disclosure requirements for lessors, including information about the nature of leases, and significant assumptions and judgements made when applying the lease requirements. Although the Boards did not specifically seek feedback on the lessor disclosure proposals, a number of constituents expressed support for the new requirements. In addition, financial statement users requested additional information about the residual values of leased assets and how lessors manage their residual value risk.

What's new since Q2?

The Boards decided to retain the current lessor disclosure requirements and add a number of new requirements, including:

- information about how a lessor manages residual value risk;
- a table of lease income recognised in the reporting period;
- for Type A leases, a maturity analysis of the undiscounted cash flows that comprise the lease receivables; and
- for Type B leases, a maturity analysis of the undiscounted lease payments to be received.

The Boards also decided that a lessor would treat an underlying asset subject to a Type B lease as property, plant and equipment – so that under IFRS a lessor would provide the disclosures required by IAS 16 *Property, Plant and Equipment*.

In addition, the IASB decided that for Type A leases, a lessor would also provide an explanation of the significant changes in the balance of its net investment in the lease, including both quantitative and qualitative information. The FASB deferred a vote on this proposal, pending further discussion as part of its ongoing project on the impairment of financial instruments.

What are the implications?

In previous meetings, the Boards decided to retain the current accounting models for lessors, reducing the impact of the project on lessors. However, the new disclosure requirements would increase the reporting burden for lessors and would require lessors to compile and disclose information about how they manage risks related to residual values. As such, the project should not be viewed as a 'lessee-only' project. Furthermore, in addition to the new disclosure requirements, the proposals on lease identification and sale and leaseback accounting may still have significant implications for lessors.

SUMMARY OF PREVIOUS DISCUSSIONS

<table>
<thead>
<tr><th>Meeting date</th><th>Topics discussed</th><th>IFRS Newsletter</th></tr>
</thead>
<tbody>
<tr><td>March 2014</td><td>Lessee accounting model
Lessor accounting model
Lease term and purchase options
Lessee short-term leases and small-ticket leases
Significantly, the Boards reached a non-converged solution to lessee accounting, and decided not to make significant changes to current lessor accounting under IAS 17.</td><td>Issue 14</td></tr>
<tr><td>April 2014</td><td>Lease modifications and contract combinations
Variable lease payments
In-substance fixed payments
Discount rate
Significantly, the Boards decided how to identify and account for contract modifications. In addition, the Boards reaffirmed that only variable payments that depend on an index or rate, or are in-substance fixed, should be included in the initial measurement of lease assets and liabilities; however, they reached different conclusions as to when lessees should reassess such payments.</td><td rowspan="3">Issue 15</td></tr>
<tr><td>May 2014</td><td>Definition of a lease
Separating lease and non-lease components
Initial direct costs
Significantly, the Boards decided to retain the general principles from the 2013 ED supporting the definition of a lease based on the right to control the use of an identified asset. The Boards instructed the staff to provide additional guidance to clarify which decisions most significantly affect the economic benefits to be derived from the asset.</td></tr>
<tr><td>June 2014</td><td>Sub-leases
Lessee balance sheet presentation
Cash flow presentation
Significantly, the Boards decided that an intermediate lessor would account for a head lease and a sub-lease as two separate contracts, unless those contracts met the contract combination guidance.</td></tr>
</tbody>
</table>

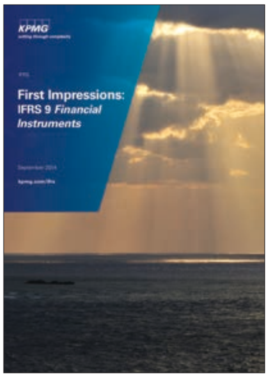
FIND OUT MORE

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.

Visit KPMG's *Global IFRS Institute* at kpmg.com/ifrs to access KPMG's most recent publications on the IASB's major projects and other activities.

Our IFRS – revenue hot topics page brings together our materials on the new revenue standard. Our *In the Headlines* summarises the key business impacts, while our *Issues In-Depth* provides more detailed analysis and observations.



Our IFRS – financial instruments hot topics page brings together our materials on the new financial instruments standard. Our *In the Headlines* summarises the key business impacts, while our *First Impressions* provides more detailed insights.

Our IFRS – insurance hot topics page brings together our materials on the insurance project, including our *IFRS Newsletter: Insurance* and our suite of publications on the IASB's re-exposure draft on insurance contracts published in June 2013.

Our IFRS Breaking News page brings you the latest need-to-know information on international standards in the accounting, audit and regulatory space.

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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.