IFRS NEWSLETTER

LEASES

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cutting through complexity

"After almost ten years of joint work the IASB and the FASB have decided to ballot different lease accounting proposals."

Kimber Bascom,
KPMG's global IFRS leasing standards leader

PERMISSION TO BALLOT

This edition of *IFRS Newsletter: Leases* provides an overview of the IASB and FASB discussions of the leases project between November 2014 and March 2015.

The IASB and the FASB (the Boards) have decided to prepare non-converged ballot drafts of their new standards on lease accounting. This is an important step in the process, and is further proof of the Boards' determination to proceed with different lease accounting models.

In their latest project meetings, the Boards also decided to retain the key elements of their proposed definition of a lease. This will disappoint constituents who were keen to explore alternative approaches. However, the Boards have agreed additional reliefs, including the details of an exemption for 'small-ticket' leases under IFRS and a new transition relief related to the definition of a lease.

The Boards expect to issue their respective new standards by the end of 2015 but have not yet discussed an effective date.

Highlights

- *Definition of a lease* – The Boards agreed on a fully converged definition of a lease.
- *Small-ticket leases* – The IASB confirmed that it will include a 'small-ticket' exemption in the new standard, an exemption that the FASB has rejected.
- *Transition: Definition of a lease* – The Boards will permit, but not require, 'grandfathering' of the definition of a lease on transition.
- *Lessee disclosure requirements* – The Boards agreed on the overall disclosure objective, but disagreed on the detailed qualitative and quantitative information that a lessee would be required to disclose.

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 and 2015.

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 company 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 new?

The Boards' project on lease accounting reached a significant new milestone in March 2015 – the IASB and the FASB each instructed its staff to prepare a draft version of the new standard, on which the Boards will vote later this year.

This marks the end of substantive redeliberations on the proposals included in the 2013 ED. Those redeliberations have seen significant changes to the 2013 proposals – in particular:

- a joint decision by the Boards to abandon the lessor accounting proposals – the ballot drafts of the new standards will retain many key aspects of the current lessor accounting model; and
- disagreement over the lessee accounting model – the IFRS ballot draft will feature a single lessee accounting model, while the US GAAP version will feature a dual model.

However, the headline message coming out of the project remains unchanged – leases are coming on-balance sheet for lessees.

In their most recent meetings, the Boards have discussed a range of detailed implementation issues. This newsletter highlights four of the most significant recent decisions, regarding:

- the definition of a lease;
- leases of small assets (the small-ticket exemption);
- transition relief on the definition of a lease; and
- lessee disclosure requirements.

The most significant outstanding decision remains the effective date, which the Boards have not yet discussed. The effective dates of the leases standards may be influenced by whether the Boards decide to defer the effective date of their new standard on revenue recognition, which the Boards plan to discuss in Q2 2015.

In addition, the Boards plan to discuss any sweep issues that arise during the drafting process.

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THE BALLOT 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>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">Payments for 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 – i.e. leases of assets with a value of $5,000 or less when new – even if material in aggregate</td><td>No exemption for small-ticket leases</td></tr>
</table>

DEFINITION OF A LEASE

The Boards agreed on a fully converged definition of a lease.

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 were 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 the 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. In their October 2014 meeting, the Boards agreed to clarify 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
  - it 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; however, they would not, in isolation, prevent the customer from having the right to direct the use of the identified asset.

However, at that meeting, the Boards were unable to agree on whether the definition of a lease should include a requirement that a customer must be able to derive the benefits from directing the use of an identified asset on its own or together with other resources that are sold separately. In other words, can a customer have a lease of an asset that it could not operate itself, and for which an alternative operator is not readily available.

What's new?

At their December meeting, the Boards concluded their discussions on the definition of a lease – and agreed on a fully converged definition.

In particular, the Boards decided *not* to include a requirement that the customer must be able to derive benefits from directing the use of an identified asset on its own, or together with other resources that are sold separately. This decision will address the concerns of some Board members about creating additional complexity and structuring opportunities when assessing whether an arrangement is, or contains, a lease.

What are the implications?

In effect, the Boards have rejected calls for a fundamentally different approach to defining a lease. Those constituents who would have liked the definition to focus on whether the arrangement contains a financing component or relates predominantly to a service will be disappointed. However, constituents will be relieved that the Boards have agreed on a fully converged definition of a lease.

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 generally determine whether an arrangement is on-balance sheet or off-balance sheet.

Related developments could ease the pressure on application of the lease definition in some cases – notably:

- the IASB's exemption for small-ticket leases (see page 6); and
- grandfathering the assessment of whether an arrangement contains a lease, which will reduce the work that is required on adoption of the new standard (see page 7).

However, applying the definition is likely to remain one of the biggest practice issues with the new standard.

SMALL-TICKET LEASES

The IASB confirmed that it will include a 'small-ticket' exemption in the new standard, an exemption that the FASB has rejected.

What's the issue?

Should the new standard include an exemption for leases of small items?

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

In March 2014, 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.

Since March 2014, the IASB has reached out to constituents on this issue to assess whether:

- the exemption could be operationalised;
- the meaning of 'small' should be quantified; and
- there may be unintended consequences.

What's new?

At its February meeting, the IASB confirmed that it will include a small-ticket exemption in the new standard. The exemption would apply to the recognition and measurement of leases of small assets – in effect, a lessee would not be required to capitalise such leases.

The IASB decided to include in the basis for conclusions a discussion of the quantitative threshold it had in mind when deliberating the exemption. The staff papers and outreach considered that the value of the underlying asset, when new, would have to be below $5,000.

In addition, the IASB decided that the exemption should apply only to leases of assets that are not dependent on, or highly interrelated with, other leased assets. This decision would avoid potential unintended consequences, such as excluding large assets from the balance sheet that are held under a number of individually small leases – e.g. IT storage systems.

The FASB version of the standard is not expected to include this exemption.

What are the implications?

The exemption would permit a lessee applying IFRS to account for qualifying leases in the same manner as existing operating leases. However, unlike current requirements for operating leases, the lessee would not provide detailed disclosures about these leases. Instead, it would disclose only the income statement expense relating to small asset leases, if it is material enough to warrant disclosure. The exemption would reduce the compliance costs for IFRS preparers.

The exemption is intended to capture leases that are high in volume but low in value – e.g. small IT equipment (laptops, mobile phones and printers etc) and leases of office furniture. It would be available irrespective of whether the effect of applying the exemption would be material to the financial statements. The IASB's outreach suggested that the impact of this exemption on a lessee's financial statements would vary.

US GAAP preparers would not benefit from 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 – this GAAP difference would typically be limited to the balance sheet.

TRANSITION: DEFINITION OF A LEASE

The Boards will permit, but not require, 'grandfathering' of the definition of a lease on transition.

What's the issue?

How would companies apply the definition of a lease on transition?

The 2013 ED did not propose any form of relief for identifying leases on transition to the new standard. In effect, companies would have been required to review all of their existing contracts with suppliers against the new definition of a lease to assess which contracts were, or contained, leases on transition to the new standard.

Constituents expressed concerns that it would be costly for companies to reassess all of their existing contracts using the new definition of a lease. All existing leases, and all contracts previously considered to be service contracts, would need to be reassessed – even if there was little overall change to the population of contracts found to be, or contain, leases.

What's new?

The Boards decided to introduce a new, optional transition relief. Under this relief, companies would 'grandfather' their assessment of which contracts in place at the date of initial application of the new standard are, or contain, leases.

If a company chooses to apply the grandfathering approach, then it would apply this approach to *all* contracts in place at the date of initial application, and would disclose the approach taken. In addition, companies applying US GAAP could only apply this relief together with other specified reliefs.

What are the implications?

The proposed transition relief would reduce costs on transition and is likely to prove popular with many companies. A company that chooses to take advantage of the relief would apply the new lease accounting requirements to the arrangements that it has previously concluded are, or contain, leases under IAS 17 and IFRIC 4 *Determining whether an Arrangement contains a Lease*. Crucially, a company would not be required to assess other contracts with suppliers at the date of initial application to assess whether they are, or contain, leases.

In agreeing this new relief, the IASB noted that it expects only very narrow differences in outcomes between the application of IFRIC 4 and the new definition of a lease. However, differences would arise when a lessee takes all or substantially all of the output of the underlying asset during the lease term – and the contract is priced in a particular way – but does not have any decision-making rights over the use of that asset. Such a contract would be a lease under IFRIC 4, but generally a service under the new standard. These cases could arise in the manufacturing industry – e.g. when a customer-lessee is purchasing all of the output of a factory – and for certain power purchase agreements.

Companies that are party to such agreements will want to evaluate carefully whether to apply the new transition relief, balancing:

- the cost savings that would arise if they take the transition relief; against
- the need to apply the new lease accounting model to arrangements that would fall outside lease accounting under the new definition.

LESSEE DISCLOSURE REQUIREMENTS

The Boards agreed on the overall disclosure objective, but disagreed on the detailed qualitative and quantitative information that a lessee would be required to disclose.

What's the issue?

What information must a lessee disclose about its leases?

The 2013 ED included an overall disclosure objective – which was to enable users of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. The 2013 ED also included a broad range of qualitative and quantitative disclosure requirements for lessees to support this objective.

Many constituents felt that the lessee disclosure requirements should be reconsidered, with a focus on achieving the overall disclosure objective without requiring preparers to incur undue costs. Constituents also wanted to avoid excessive disclosure, 'clutter' in financial statements, and the use of boilerplate statements.

What's new?

The Boards agreed to retain the overall disclosure objective from the 2013 ED. However, the Boards reached different decisions about the qualitative and quantitative information that lessees should disclose. Some of these differences reflect underlying differences in the current lessee accounting proposals.

Qualitative disclosures

The IASB decided that a lessee would be required to provide qualitative disclosures in addition to the quantitative disclosures only if they are necessary to satisfy the lessee disclosure objective. However, the FASB decided to include a list of required qualitative disclosures in the US GAAP version of the standard.

Quantitative disclosures

The Boards identified the following key quantitative disclosures for lessees.

Disclosure	IFRS	US GAAP
For Type A leases, amortisation of ROU assets	By class of underlying asset	✓
For Type A leases, interest on lease liabilities (including capitalised interest)	✓	✓
Additions to ROU assets	✓	
The carrying amount of ROU assets, by class of underlying asset	✓	
Type B lease expense (including capitalised costs)		✓
Short-term lease expense, when the lease term exceeds 30 days	✓	✓
Small-ticket lease expense	✓	
Variable lease expense	✓	✓
Sub-lease income	✓	✓
Gains and losses on sale and leaseback transactions	✓	✓

Disclosure	IFRS	US GAAP
A maturity analysis of lease liabilities for each of the first five years after the balance sheet date and in total thereafter, including a reconciliation of the undiscounted cash flows to lease liabilities on the balance sheet		✓
A maturity analysis of lease liabilities in accordance with IFRS 7 *Financial Instruments: Disclosures*, separate from the maturity analysis for other financial liabilities	✓	
Cash paid for amounts included in the measurement of lease liabilities, segregated between Type A and Type B leases and between operating and financing cash flows		✓
Total cash outflows for leases	✓	
Supplemental non-cash information on lease liabilities exchanged for ROU assets separately for Type A and Type B leases		✓
The weighted-average remaining lease term, separately for Type A and Type B leases		✓
The weighted-average discount rate for Type B leases as at the balance sheet date		✓

In addition, the Boards discussed presentation requirements for lessees. The IASB decided to:

- require lessees to present quantitative disclosures in a tabular format, unless another format is more appropriate; and
- present all lessee disclosures in a single note or separate section in the financial statements.

The FASB did not agree to the same presentation requirements, but agreed to include an example illustrating quantitative disclosure requirements in a tabular format in its final standard.

As part of other decisions reached at this meeting, the IASB decided not to require a lessee to disclose a reconciliation of the opening and closing balances of ROU assets. Meanwhile, the FASB decided not to require a lessee to disclose a reconciliation of the opening and closing balances of lease liabilities.

What are the implications?

The Boards' decisions would tend to increase the lessee disclosures compared to those required under current standards. To many constituents, this will seem inconsistent with the objective of the new lessee accounting model, and with the Boards' current initiatives to improve disclosure effectiveness.

SUMMARY OF PREVIOUS DISCUSSIONS

<table>
<tr><th>Meeting date</th><th>Topics discussed</th><th>IFRS Newsletter</th></tr>
<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 meet the contract combination guidance.</td></tr>
<tr><td>July 2014</td><td>• Sale and leaseback transactions
• Lessor disclosure requirements
Significantly, the Boards reaffirmed the overall approach to sale and leaseback accounting, but differed on a number of important application issues. In addition, they decided to add new disclosure requirements for lessors.</td><td rowspan="2">Issue 16</td></tr>
<tr><td>October 2014</td><td>• Definition of a lease
Significantly, 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.</td></tr>
</table>

YOU MAY ALSO BE INTERESTED TO READ …

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.

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Our IFRS – revenue hot topics page brings together our materials on the new revenue standard. Our *Issues In-Depth* provides more detailed analysis and observations while our *IFRS Newsletter: Revenue* examines the latest developments on the standard.

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Our IFRS – financial instruments hot topics page brings together our materials on the complete version of IFRS 9 published in July 2014.

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***IFRS Newsletter: Leases* is KPMG's update on the joint IASB/FASB leases project.**

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.