

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/21

LEASES



Background

The International Accounting Standards Board (IASB) has issued an Exposure Draft (the ED) for public comment which sets out proposed changes to the accounting for leases. The ED has been developed through a joint project with the US Financial Accounting Standards Board (FASB).

The existing accounting models under both IFRS and US GAAP require lessees to classify their lease contracts as either finance leases or operating leases. However, those models have been criticised for failing to meet the need of users of financial statements because they often omit information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual frameworks. The model also leads to a lack of comparability, and to complexity, because of the distinction between finance leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect assets and liabilities arising from operating leases.

In order to address these aspects, the IASB and the FASB initiated a joint project to develop a new approach to lease accounting that would result in all assets and liabilities arising under lease contracts being recognised in an entity's statement of financial position.

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed

ACCOUNTING IMPACT

Significant changes proposed to the accounting requirements for both lessees and lessors

Proposals

Scope

The ED proposes that lessees and lessors apply a right-of-use model in accounting for all leases (including subleases), other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties (see below). For leases that would be within the scope of the new IFRS, this means that:

- (a) a lessee would recognise an asset representing its right to use the leased (underlying) asset for the lease term (a 'right-to-use' asset) and a liability to make lease payments.
- (b) a lessor would recognise an asset representing its right to receive lease payments and deal with the underlying asset, as follows:
 - (i) if there was not a transfer of significant risks or benefits of the underlying asset, the lessor would recognise a lease liability while continuing to recognise the entire underlying asset (a performance obligation approach); or
 - (ii) if there was a transfer of significant risks or benefits of the underlying asset, the lessor would derecognise the underlying asset to the extent that it is transferred to the lessee, and continue to recognise a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).

The proposals would apply to the initial measurement of all investment property that is held under a lease. However, after initial recognition, if a lessee measured a right-of-use investment property asset in accordance with the fair value model, the lessee would apply the requirements of IAS 40 *Investment Property* when accounting for the investment property asset and subsequent changes in the lease liability to make lease payments would be recognised in profit or loss. If the lessee used the cost model, the right of use asset would be accounted for in accordance with the new IFRS. If, after initial recognition, a lessor of investment property (whether freehold or leasehold) chose to account for investment property using the fair value model then the lessor would apply the requirements of IAS 40, with changes in fair value being recognised in profit or loss. Lease income would be recognised on a straight line basis over the lease term. A lessor that used the cost model would recognise lease income arising on investment property in accordance with the new IFRS.

The following contracts, which represent a purchase or sale of an underlying asset, would not be within the scope of the new IFRS:

- (a) a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity; and
- (b) a lease after the lessee has exercised a purchase option specified in the lease. A contract ceases to be a lease when such an option is exercised as it becomes a purchase (by the lessee) and sale (by the lessor).

Lessee Accounting

Recognition

Under the proposals, at the date of commencement of a lease a lessee would recognise a right-of-use asset and a liability to make lease payments. The date of commencement of a lease is the date on which the lessor makes the underlying asset available for use by the lessee. This may be different from the date of inception of the lease, which is used for measurement purposes (see below).

Initial Measurement

At the date of inception of a lease (being the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement), a lessee would measure its obligation to make lease payments at the present value of the lease payments, discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee.

The lessee's incremental borrowing rate is the rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset.

The right-of-use asset is measured at the amount of the obligation to make lease payments, plus any initial direct costs incurred by the lessee. Initial direct costs are those costs that are directly attributable to negotiating and arranging a lease, that would not have been incurred had the lease transaction not been made.

The present value of lease payments payable during the lease term is calculated on the basis of expected outcome. The proposals note that this is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes, and clarify that it is not necessary to assess every possible outcome. Amounts that would be included in the assessment are an estimate of contingent rentals payable, an estimate of amounts payable by the lessee (and not unrelated third parties) to the lessor under residual value guarantees, and an estimate of expected payments to the lessor under term option penalties. Purchase options, and any amounts payable under a purchase option, are not included in determining the present value of amounts payable under the lease.

The lease term is the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease. This is determined by estimating the probability of occurrence for each possible outcome.

The application guidance contains an example to illustrate how the lease term would be determined where a lease contains extension options. The example considers a lease that has a non-cancellable 10-year term, an option to renew for 5 years at the end of 10 years, and an option to renew for an additional 5 years at the end of 15 years. The probabilities for each term as follows:

- (a) 40% probability of 10-year term
- (b) 30% probability of 15-year term
- (c) 30% probability of 20-year term.

The analysis notes that the lease term will be at least 10 years, with there being a 60% probability that it will be 15 years but only a 30% probability that it will be 20 years. Consequently the lease term is determined to be 15 years.

Subsequent Measurement

After the date of commencement of the lease (being the date on which the lessor makes the asset available for use by the lessee), a lessee would measure its obligation to make lease payments at amortised cost using the effective interest method and the right-of-use asset at amortised cost (subject to impairment), unless it is revalued.

The proposals would require a lessee to reassess the carrying amount of each of its lease obligations if facts or circumstances indicate that there has been a significant change in them since the previous reporting period. Changes in obligations could arise as a result of reassessments of the length of the lease term and/or contingent rentals and other amounts that may become payable. Where the reassessment resulted in a change in the amount payable, this change would be split between amounts relating to the current or prior periods (which would be charged or credited to profit or loss), and future periods (which would adjust the carrying amount of the right of use asset).

As noted above, a lessee is permitted to measure a right-of-use asset at its revalued amount, less any amortisation and impairment losses arising after that date. The requirements are consistent with those set out in IAS 16 *Property, Plant and Equipment*, in that all assets in that class of property, plant and equipment would be required to be revalued. However, in contrast to items of property, plant and equipment, the recognition of gains and losses on the revaluation of right of use assets would be in accordance with IAS 38 *Intangible Assets*, although for the purposes of the revaluation itself the IAS 38 requirement for an active market to exist for an asset would not apply.

IAS 36 *Impairment of Assets* would be applied at each reporting date to determine whether a right-of-use asset is impaired and for the purposes of the recognition of any impairment loss.

Presentation

The following items would be included in the statement of comprehensive income:

- interest expense on the liability to make lease payments;
- amortisation of the right-of-use asset;
- any changes in the liability to make lease payments resulting from reassessment of the expected amount of contingent rentals or expected payments under term option penalties and residual value guarantees relating to current or prior periods; and
- impairment losses on a right-of-use asset, except to the extent that another IFRS requires or permits its inclusion in the cost of an asset.

Lessor accounting

Under the proposals, a lessor would apply the performance obligation approach to leases where it retains exposure to significant risks and benefits associated with (all of) the underlying asset, and the derecognition approach to leases where it does not.

Lessor - performance obligation approach

Recognition

Under the performance obligation approach, a lessor would not derecognise any part of the underlying leased asset.

At the date of commencement of a lease (being the date on which the lessor makes the asset available for use by the lessee), a lessor would recognise an asset representing its right to receive lease payments and a lease liability (the performance obligation), representing the lessors obligation to permit the lessee to use the leased asset over the lease term. The term 'performance obligation' is used in the ED with the meaning proposed in the exposure draft *Revenue from Contracts with Customers*.

Initial Measurement

At the date of inception of the lease (being the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement), a lessor would measure its right to receive lease payments at the present value of the lease payments, discounted using the rate that the lessor charges the lessee, plus any initial direct costs incurred by the lessor. The discount rate could be the lessee's incremental borrowing rate, the rate implicit in the lease or (for property leases) the yield on the property. Initial direct costs are defined in a similar way to those for lessees, being costs that are directly related and essential to acquiring or originating the lease which would not have been incurred had the lease transaction not been made.

The lease liability would be measured at the calculated amount of the right to receive lease payments.

Subsequent Measurement

After the date of commencement of the lease (being the date on which the lessor makes the asset available for use by the lessee), a lessor would measure its right to receive lease payments at amortised cost using the effective interest method and the remaining lease liability determined on the basis of the pattern of use of the underlying asset by the lessee. If the lessor is not able reliably to determine the remaining lease liability on the basis of the pattern of use of the underlying asset by the lessee, it is required to use the straight-line method.

The proposals would require a lessor to reassess the carrying amount of its right to receive lease payments arising from each lease if facts or circumstances indicated that there had been a significant change in the right to receive lease payments since the previous reporting period. Changes could arise as a result of reassessments of the length of the lease term and/or contingent rentals and other amounts that may become receivable.

Where the reassessment resulted in changes to amounts receivable, this change would be split between amounts relating to the extent to which the lessor had satisfied the lease liability (which would be recorded in profit or loss) and amounts relating to the extent to which the lessor had not satisfied the lease liability (which would adjust that carrying amount of that liability). If an adjustment was made to the carrying amount of the lease liability, this would not be permitted to be reduced to an amount below zero; any excess would be recorded in profit or loss.

IAS 39 *Financial Instruments: Recognition and Measurement* would be applied at each reporting date to determine whether a right to receive lease payments was impaired, with any impairment loss being recognised in profit or loss.

Presentation

A lessor would present the following items together in the statement of financial position:

- (a) the underlying assets;
- (b) rights to receive lease payments;
- (c) lease liabilities; and
- (d) the total of (a) – (c) as a net lease asset or a net lease liability.

During the lease term, a lessor would recognise the following items in profit or loss:

- interest income on the right to receive lease payments;
- lease income as the lease liability is satisfied (and therefore released);
- any changes in the lease liability required to be recognised in profit or loss;
- any impairment losses on the right to receive lease payments; and
- depreciation expense on the underlying asset.

These amounts would be recognised separately from other interest income, income and depreciation expense.

In its statement of cash flows, a lessor would classify cash receipts from lease payments within operating activities.

In contrast to the IASB's proposals to recognise amounts in profit or loss on a gross basis, the FASB has proposed that interest income, lease income and depreciation expense should be presented as one net amount of lease income or lease expense. The FASB approach is based on the net presentation of income and expense being consistent with presentation of a net lease asset or net lease liability in the statement of financial position. However, the IASB regards these income and expense items as separate components of comprehensive income that entities should recognise on a basis consistent with other interest income, and income and depreciation arising from non-leased assets.

Lessor - derecognition approach

Recognition

In contrast to the performance obligation approach, under the derecognition approach a lessor would derecognise a portion of the carrying amount of the underlying asset.

At the date of commencement of a lease (being the date on which the lessor makes the asset available for use by the lessee), a lessor would recognise a right to receive lease payments and derecognise the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease. The residual asset, representing the rights in the underlying asset that the lessor retains, would be reclassified and disclosed separately within property, plant and equipment.

Initial Measurement

At the date of inception of the lease (being the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement), a lessor would measure the right to receive lease payments at the present value of the lease payments, discounted using the rate the lessor charges the lessee, and any initial direct costs incurred by the lessor. The discount rate could be the lessee's incremental borrowing rate, the rate implicit in the lease or (for property leases) the yield on the property. Initial direct costs are defined in a similar way to those for lessees, being costs that are directly related and essential to acquiring or originating the lease, which would not have been incurred had the lease transaction not been made.

The amount of the underlying asset which would be derecognised, and the amount of the residual asset, would be determined by allocating the carrying amount of the underlying asset at the date of inception of the lease in proportion to the fair value of the rights that had been transferred, and the fair value of the rights that had been retained, by the lessor. Therefore, the amount derecognised by the lessor would be calculated by taking the carrying amount of the underlying asset and multiplying this by the fair value of the right to receive lease payments divided by the fair value of the underlying asset. The fair values would be determined at the date of inception of the lease (being the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement).

Subsequent Measurement

A lessor would measure its right to receive lease payments at amortised cost using the effective interest method and would not remeasure the residual asset unless there was a subsequent reassessment of the lease term or the asset was impaired.

A lessor would reassess the carrying amount of its right to receive lease payments arising from each lease if facts or circumstances indicate that there would be a significant change in the right to receive lease payments since the previous reporting period. Changes could arise as a result of reassessments of the length of the lease term and/or contingent rentals and other amounts that may become receivable.

If the reassessment of the length of the lease term resulted in a change to the residual asset, the lessor would allocate the change to the portion of the asset that had been derecognised and the portion that had been retained as a residual asset. The amounts would be calculated by following the approach outlined above for initial measurement.

For other changes, being expected amounts of contingent rentals and/or residual value guarantees, and expected payments under term option penalties, any associated changes in the amount of the right to receive lease payments would be recognised immediately in profit or loss.

IAS 39 *Financial Instruments: Recognition and Measurement* would be applied at each reporting date to rights to receive lease payments and IAS 36 *Impairment of Assets* to the residual assets. Any resulting impairment losses would be recognised in profit or loss.

Presentation

A lessor would present the following items in the statement of financial position:

- rights to receive lease payments (separately from other financial assets); and
- residual assets (separately within property, plant and equipment).

In each case, a distinction would be made for those assets arising from subleases.

At the commencement of the lease, a lessor would recognise the following items in profit or loss:

- lease income representing the present value of the lease payments; and
- lease expense representing the cost of the portion of the underlying asset that is derecognised at the date of commencement of the lease.

Lease income and lease expense would be presented in profit or loss either as gross amounts in separate line items or net in a single line item, based on the lessor's business model. If a lessor presented lease income and lease expense gross, i.e. revenue and cost of sales, interest income on rights to receive lease payments would be presented separately from other interest income.

During the lease term, a lessor would recognise the following amounts in profit or loss:

- interest income on the right to receive lease payments;
- lease income or lease expense upon any reassessment of the lease term;
- any changes in the right to receive lease payments resulting from reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees; and
- impairment losses on the right to receive lease payments or the residual asset.

Short-term leases

A lease that has a maximum possible term of twelve months or less is considered to be a short-term lease.

At the date of inception of a lease (being the earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement), a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently:

- the liability to make lease payments at the undiscounted amount of the lease payments; and
- the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs.

Lease payments would then be recognised in profit or loss over the lease term.

At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets or liabilities arising from a short-term lease in the statement of financial position, nor to derecognise any portion of the underlying asset. In these cases, the underlying asset would continue to be recognised in accordance with other IFRSs and lease payments would be recognised in profit or loss over the lease term.

Sale and leaseback transactions

If an entity transfers an asset to another party and leases that asset back from that other party, it is proposed that the arrangement would fall within the scope of the new IFRS if the contracts are:

- entered into at or near the same time;
- negotiated as a package with a single commercial objective; or
- performed either concurrently or continuously.

If these criteria are met:

- Accounting by the transferor (seller/lessee) would depend on whether the transfer met the conditions for a sale. If so, the sale would be accounted for in accordance with applicable IFRSs and the lease would be accounted for in accordance with the proposed guidance for lessees. If not, the contract would be accounted for as a financing transaction, meaning that the transferor would not derecognise the transferred asset and would recognise any amounts received as a financial liability.
- Accounting by the transferee (buyer/lessor) would depend on whether the transfer met the conditions for a purchase. If so, the purchase would be accounted for in accordance with applicable IFRSs and the lease would be accounted for using the proposed performance obligation approach. If not, the transferee would not recognise the transferred asset and would instead recognise the amount paid as a receivable.

If the transaction met the conditions for a purchase or sale of an asset but the consideration, or the lease payments specified by the leaseback, were not at fair value then adjustments would be required:

- A transferor (seller/lessee) would adjust the right-of-use asset to reflect current market rates for lease payments for that asset, and the gain or loss on disposal of the underlying asset would be adjusted by any difference between the present value of lease payments based on the terms specified in the lease and the present value of the lease payments based on current market rates.
- A transferee (buyer/lessor) would adjust the carrying amount of the underlying asset and the lease liability recognised under the performance obligation approach to reflect current market rates for the lease payments for that lease.

Disclosure

Under the proposals, an entity would disclose quantitative and qualitative financial information that:

- (a) identifies and explains the amounts recognised in its financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows.

Disclosures to identify and explain amounts recognised in financial statements arising from leases would include information about:

- how contingent rentals are determined;
- the existence and terms of options, including whether these were recognised as part of a right of use asset and whether a lessee has an option to purchase an underlying asset;
- assumptions and judgements made in respect of amortisation methods;
- the existence and terms of residual value guarantees; and
- restrictions imposed by lease arrangements, such as those relating to dividends, additional debt and further leasing.

Disclosures would also be required in respect of significant subleases, and sale and leaseback transactions.

Lessors would be required to make additional disclosures, including:

- information about the lessor's exposure to the risks and benefits of underlying assets that were used to determine whether to apply the performance obligation or derecognition approach;
- impairment losses (with separate disclosure for those relating to arrangements accounted for using the performance obligation approach and the derecognition approach); and
- significant service obligations related to their leases.

Disclosures that describe how leases may affect the amount, timing and uncertainty of the entity's future cash flows would include:

- significant assumptions and judgements made, and any changes in them, in relation to renewal options, contingent rentals, term option penalties, residual value guarantees, and the discount rate used to determine the present value of lease payments;
- for lessees, a maturity analysis of undiscounted cash flow obligations to make lease payments, analysed on an annual basis for the first five years and a total of remaining amounts for future years. This analysis would require separate disclosure to make a distinction between minimum obligations specified in leases and amounts recognised in the statement of financial position;
- for lessors, a maturity analysis for rights to receive lease payments, analysed on an annual basis for the first five years and a total of remaining amounts for future years. This analysis would require separate disclosure to make a distinction between minimum obligations specified in leases and amounts recognised in the statement of financial position.

Transition

The date of initial application would be the beginning of the first comparative period presented in the first financial statements in which the entity applies the new IFRS.

An entity would recognise and measure all outstanding contracts within the scope of the new IFRS as of the date of initial application using a simplified retrospective approach.

Lessees

- Lessees would recognise a liability to make lease payments for each lease, with future payments being discounted to present value using the lessee's incremental borrowing rate at the date of initial application. If lease payments were uneven during the lease term, an adjustment would be made to the lease liability to reflect any prepaid or accrued lease rentals. The related right-of-use asset would be measured at the amount of the lease liability.
- If a lease had been classified as a finance lease under IAS 17 and did not contain options, contingent rentals, term option penalties or residual value guarantees, the carrying amount of the right-of-use asset and liability to make lease payments would be the same as those recorded under IAS 17.
- For short term leases accounted for using the simplified approach outlined above, the asset and liability would be recorded at the undiscounted amount of the remaining lease payments.

Lessors – performance obligation approach

- A right to receive lease payments would be recognised at the present value of remaining lease payments, discounted at the rate determined at inception for the lease (subject to any adjustment for impairment). A lease liability would be recognised for the same amount as the related asset.
- Any previously derecognised assets would be reinstated at depreciated cost as if they had never been derecognised, subject to impairment and revaluation adjustments.

Lessors – derecognition approach

- A right to receive lease payments would be recognised at the present value of remaining lease payments, discounted at the rate determined at inception for the lease (subject to any adjustment for impairment).
- Residual assets would be recognised at their fair value as at the date of initial application.

The transitional disclosures required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would also be required, excluding the disclosure of adjusted basic and diluted earnings per share.



Withdrawal of other pronouncements

The new IFRS would supersede IAS 17 *Leases*, IFRIC 4 *Determining whether an Arrangement contains a Lease*, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

Comment period

The IASB has requested the submission of comments on its proposals by 15 December 2010.

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