Tech Q&A

The Institute has recently issued an invitation to comment on the IASB exposure draft *Leases*. How would the proposals change the requirements for lease accounting?

The existing accounting models contained in HKAS/IAS 17 *Leases* require lessees and lessors to classify their leases as either finance leases or operating leases and account for those leases differently. When a lease is determined to be economically similar to purchasing the underlying asset, the lease is classified as a finance lease and reported on the lessee's statement of financial position. All other leases are classified as operating leases and are not reported on the lessee's statement of financial position. Nevertheless, lessee commitments arise from both operating leases and finance leases.

Consequently, the existing model has been criticized for failing to meet the needs of users of financial statements because they do not always provide a faithful representation of leasing transactions. In particular, they do not require lessees to recognize assets and liabilities arising from operating leases. As a result, there has been a longstanding request from many users of financial statements and others to change the accounting requirements so that lessees would be required to recognize those assets and liabilities.

In view of these criticisms, the International Accounting Standards Board and the United States Financial Accounting Standards Board initiated a joint project to develop a new approach to lease accounting that would require assets and liabilities arising from leases to be recognized in the statement of financial position.

Accordingly, the boards developed a revised exposure draft issued in May 2013 (having considered responses received from their initial exposure draft issued in 2010). The core principle of the proposed requirements is that a lessee should recognize assets and liabilities arising from a lease.

Lessee accounting

In accordance with that principle, a lessee would recognize assets and liabilities for leases with a maximum possible term of more than 12 months. A lessee would recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the leased asset (the underlying asset) for the lease term.

The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee would depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

For most leases of assets other than property (for example, equipment, aircraft, cars and trucks), a lessee would classify the lease as a Type A lease and would do the following:

a. Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments; and
b. Recognize the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset.

For most leases of property (i.e. land and/or a building or part of a building), a lessee would classify the lease as a Type B lease and would do the following:

a. Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments; and
b. Recognize a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.

Lessor accounting

Similarly, the accounting applied by a lessor would depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. For practical purposes, this assessment would often depend on the nature of the underlying asset.

For most leases of assets other than property (i.e. land and/or a building or part of a building), a lessor would classify the lease as a Type A lease and would do the following:

a. Derecognize the underlying asset and recognize a right to receive lease payments (the lease receivable) and a residual asset (representing the rights the lessor retains relating to the underlying asset);
b. Recognize the unwinding of the discount on both the lease receivable and the residual asset as interest income over the lease term; and
c. Recognize any profit relating to the lease at the commencement date.

For most property leases, a lessor would classify the lease as a Type B lease and would apply an approach similar to existing operating lease accounting in which the lessor would do the following:

a. Continue to recognize the underlying asset; and
b. Recognize lease income over the lease term, typically on a straight-line basis.

Lease payments

When measuring assets and liabilities arising from a lease, a lessee and a lessor would exclude most variable lease payments. In

addition, a lessee and a lessor would include payments to be made in optional periods only if the lessee has a significant economic incentive to exercise an option to extend the lease, or not to exercise an option to terminate the lease.

Short-term leases

Entities would have the option of excluding leases that are classified as short-term leases (i.e. a lease that has a maximum possible term under the contract, including any options to extend, of 12 months or less). In this connection, a lessee may elect to adopt an accounting policy to not apply the requirements to recognize a right-of-use asset or lease liability for the short-term lease. Instead, the lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term. A lessor electing to apply this accounting policy choice would instead recognize the lease payments in profit or loss over the lease term on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which income is earned from the underlying asset.

This accounting policy election for short-term leases would be made by class of underlying asset to which the right of use relates, and this election would not be available for leases that contain a purchase option.

On transition, a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach.

The Institute's financial reporting standards committee is deliberating on the proposals and will be preparing a submission to the IASB. In this connection, the Institute welcomes comments on all matters addressed in the exposure draft. Please provide your comments to Simon Riley, director of standard setting, by 15 August.

Send your questions and comments to *commentletters@hkicpa.org.hk*. The standard setting team will answer these questions in accordance with its policy, posted on the Institute's website.