How revised IASB draft *Leases* affects lessees and lessors

Candy Fong explains the 2013 revised draft on lease accounting

In May 2013, the International Accounting Standards Board published a revised exposure draft on lease accounting that covers both lessee and lessor accounting, with a comment period ending on 13 September. The revised exposure draft was jointly developed by the IASB and the United States Financial Accounting Standards Board. The Hong Kong Institute of CPAs has issued an invitation to comment on the revised draft, with the comment period ending on 15 August.

The first exposure draft was published in 2010 and the boards received an overwhelming response of approximately 800 comment letters. To try to address the various comments from constituents, significant changes have been made to the proposals.

Key differences between the 2010 exposure draft and the revised draft

Lessee accounting

Similar to the 2010 exposure draft, the revised one continues to propose a right-of-use method (i.e. no more operating lease or off-balance sheet treatment except for short-term leases). However, rather than proposing a single model, the revised draft introduces a dual model such that leases would be categorized into two types depending on the nature of the underlying leased asset (Type A and Type B), which would determine the amount of lease expense recognized for each period.

Lessor accounting

The 2010 exposure draft proposed that a lessor would apply either the derecognition approach or the performance obligation approach, depending on whether significant risks and benefits associated with the underlying asset are transferred to the lessee. The revised draft removes the performance obligation approach. Similar to the revised proposal for lessee accounting, lessors would be required to categorize leases into two types. Type A leases would be accounted for similar to the derecognition model proposed in the 2010 exposure draft. Type B leases would be accounted for similar to operating lease accounting under the existing IAS 17 *Leases*.

Measurement of lease assets and lease liabilities

In estimating lease payments for measuring lease assets and lease liabilities:

- Rather than requiring inclusion of an estimate of all variable lease payments (as proposed in the 2010 exposure draft), the revised draft proposes to include only variable lease payments that either depend on an index or a rate or are in-substance fixed payments; and
- Rather than requiring inclusion of extension options or termination options on the basis of what is the longest possible term that is more likely than not to occur, the revised draft proposes to include extension options or termination options only when there is significant economic incentive to exercise an option.

This article outlines the main proposals set out in the revised exposure draft and some of the key changes from the existing IAS 17.

What is the proposed scope under the revised draft?

The revised draft defines a lease as a contract that conveys the right to use an asset for a period of time in exchange for consideration. All leases would be within the scope of the proposed leasing standard except for a) leases of biological assets, b) leases to explore for or use minerals, oil, natural gas and similar non-generative resources, c) service concession arrangements, and d) leases of intangible assets for lessors (lessees are permitted to use the proposed lessee accounting).

Significantly more guidance has been included in the revised draft on whether or not a contract contains a lease (developed based on IFRIC 4 *Determining whether an Arrangement Contains a Lease* with additional guidance developed to add clarity). For example, contracts for "capacity" rather than the use of an identified asset and service contracts are not considered as leases. Also, a contract that merely gives the customer the right to specify the output (e.g. description and quantity of goods or services) is not a lease.

For a contract that contains a lease and non-lease (e.g. service) components, each "separate" lease component would be accounted for in accordance with the leasing standard and other non-lease components would be accounted for in accordance with other applicable standards. The revised draft includes specific requirements on how the consideration for the contract would be allocated to lease and non-lease components.

With the above proposed scope, examples of leases covered by the proposed lease standard would include leases of land and/or buildings, and leases of equipment, airplanes and vehicles.

What is the proposed lessee accounting under the revised draft?

The lessee accounting currently under IAS 17 depends on whether the lease is classified as an operating or a finance lease. The classification under IAS 17 depends on whether substantially all of the risks and rewards incidental to ownership of the leased asset have been transferred from the lessor to the lessee. Finance leases are recognized in the lessees' statement of financial position whereas operating leases are not recognized in the lessees' statement of financial position (i.e. off-balance sheet). Lease payments under operating leases are recognized over the lease term on a systematic basis, with disclosures of the future minimum lease commitments being made in the notes to the financial statements.

The revised draft proposes a "right-of-use" model for all types of leases, except for short-term leases. Short-term leases are leases with a maximum possible lease term (including renewal options) of 12 months or less. Lessees of short-term leases would be given an accounting policy choice: either the right-of-use model or the current operating lease model.

The right-of-use model requires a right-of-use asset and a lease liability to be recognized in the statement of financial position at the commencement date of the lease. This is on the basis that leases are a source of financing for a lessee.

On initial recognition, the lease liability is measured at the present value of the lease payments. A right-of-use asset is measured at the same amount as the lease liability plus costs that are directly attributable to negotiating and arranging a lease (e.g. legal fees and stamp duty).

At subsequent reporting dates, the carrying amount of the lease liability would be adjusted to reflect the unwinding of the discount on the lease liability and is measured using the effective interest method. The right-of-use asset would be amortized, but the manner of amortization, which would determine the amount of the amortization expense to be recognized in profit or loss for each period, would depend on the type of the underlying leased asset. Please see Table A for details.

The proposal in Table A is different from the proposal set out in the 2010 exposure draft. The 2010 exposure draft proposes a single model (similar to the proposed accounting for Type A leases). The proposed change is to address concerns expressed by many constituents that the 2010 draft's proposal would result in "expense frontloading" at the beginning of the lease term for all types of leases and hence does not reflect the economics for different types of leases. To try to address the concern, the revised draft proposes that the classification and subsequent accounting for leases should take into account the expected consumption by the lessee of the economic benefits embodied in the underlying leased asset during the lease term. With that in mind, two types of leases have been developed, with a presumption that lessees would generally consume more than an insignificant portion of the economic benefits embedded in the underlying asset for most equipment and vehicle leases.

Table A - Proposed lessee accounting

Nature of the underlying leased asset	
Type A leases Assets other than property (e.g. equipment and vehicles), unless the lease term is for an insignificant part of the total economic life of the underlying asset, or the present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date (in which case, the lease would be treated as a Type B lease)	**Type B leases** Leases of property (i.e. land or a building, or part of a building, or both), unless the lease term is for the major part of the remaining economic life of the underlying asset; or the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date (in which case, the lease would be treated as a Type A lease)
Impact on profit or loss	
· Recognize interest expense on the lease liability using an effective interest method (interest expense would generally decrease over time). · Recognize amortization expense for the right-of-use asset using a systematic method (e.g. straight-line basis or reducing balance method). · The total amount of interest expense and amortization expense recognized would decrease over time ("expense frontloading" at the beginning of the lease term). · Present interest expense on the lease liability and amortization expense for the right-of-use asset separately in the statement of comprehensive income and the statement of cash flows.	· Recognize interest expense on the lease liability (same as that for Type A leases). · Recognize amortization expense for the right-of-use asset so that the cost of the lease (including lease payments and initial direct costs) is allocated over the lease term on a straight-line basis. · The total amount of lease expense will be recognized on a straight-line basis. · Present interest expense on the lease liability and amortization for the right-of-use asset as one amount (lease expense) in the statement of comprehensive income. · Include cash paid for the lease payment in the operating activities in the statement of cash flows.

What is the proposed accounting for lessors under the revised draft?

The lessor accounting currently under IAS 17 depends on whether the lease is classified as an operating or a finance lease. Lessors under operating leases do not derecognize the leased assets; lease income from operating leases is recognized as income on a systematic basis. Lessors under finance leases recognize a receivable and recognize finance income on the receivable over the lease term.

Under the revised draft, similar to the proposed lessee accounting, the proposed lessor accounting would depend on the nature of the underlying leased asset (Type A or Type B leases), except for short-term leases. Please see Table B for details.

For short-term leases, lessors would be given an accounting policy choice: either the proposal set out in the revised draft or an approach similar to the current operating lease model (i.e. recognize the lease payments in profit or loss on a straight-line basis over the lease term).

Comments

The proposals shown in Table C may significantly affect the financial statement metrics of both lessees and lessors. For example, the recognition of the right-of-use assets and lease liabilities in the statement of financial position (for lessees) and the application of the receivable and residual approach (for lessors of Type A leases) may significantly affect gearing ratios, debt covenant ratios and other key performance ratios. Also, in applying the proposal, significant judgment and estimates would inevitably be required (e.g. whether leases should be categorized as Type A or Type B, whether options to renew or terminate should be included in determining the lease term and estimates of residual assets under the receivable and residual approach for lessors). If you have any comments on the revised exposure draft, please send your comments to the Institute or the IASB by mid September.

Table B - Proposed lessor accounting

Type A leases
Accounting treatment: At the commencement of the lease: · Derecognize the leased asset; · Recognize a lease receivable for the lease payments and measure it at the present value of the lease payments; and · Recognize a residual asset (that represents the lessor's claim to the residual value of the leased asset at the end of the lease term) and measure it using a specific formula, which is the sum of the present value of a) the amount expected to be received at the end of the lease term and b) expected variable lease payments, less any unearned profit. In subsequent periods: · Measure the lease receivable at amortized cost (with the effective interest income being recognized over the lease term) – the lease receivable would be adjusted to reflect the unwinding of discount; and · Measure the residual asset to reflect the unwinding of the discount, expected variable lease payments and impairment. In estimating the residual asset at initial recognition and subsequent reporting dates, lessors would be required to take into account the expected variable lease payments (i.e. lessors would inevitably need to estimate variable lease payments (although not required to do so in measuring the lease receivable)).
Type B leases
Accounting treatment: · Apply a model similar to the current operating lease (i.e. recognize lease payments as lease income in profit or loss over the lease on either a straight-line basis or another systematic basis). · Variable lease payments are recognized in profit or loss in the period in which the income is earned. · Do not derecognize the underlying leased asset – continue to measure the underlying leased asset under the applicable standards.

Table C - Other key proposals under the revised draft

Variable lease payments	Include only variable lease payments that either depend on an index or a rate or are in-substance fixed payments in the measurement of lease liability or lease receivable.
Options to extend or terminate a lease	Include extension options or termination options in determining the lease term only when there is significant economic incentive to exercise an option.
When the leased property meets the definition of an investment property	Require the right-of-use asset arising from the lease to be measured in accordance with IAS 40 Investment Property (lessees). This is a change from the current IAS 40 because the standard allows, but does not require, a property held under an operating lease to be classified as an investment property. The standard allows a property under an operating lease to be classified as an investment property provided that the property meets the definition of an investment property and the fair value model is adopted. Such a classification alternative under IAS 40 is available on a property-by-property basis.
Disclosures	Extensive disclosures would be required.
Transitional provisions	Require retrospective application with specific transitional reliefs on measurement (but not on classification).

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