IFRS NEWSLETTER

LEASES

Issue 13, January 2014

KPMG
cutting through complexity

"This project has many moving parts, but one fixed point – a continuing desire to see lessees recognise significant lease obligations on their balance sheets."

Kimber Bascom,
KPMG's global IFRS leasing standards leader

MODEL ALTERNATIVES

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

The IASB and the FASB (the Boards) discussed fundamental aspects of their lease accounting proposals published in 2013, covering both lessee and lessor accounting, and potential simplifications for small-ticket leases. No decisions were made, but the range of alternatives on the table was striking. The Boards will return to these fundamental issues in March, with a view to deciding the way forward on this controversial project.

Highlights

Lessee accounting

- The discussions took as a given that leases should be on-balance sheet for lessees – the issues discussed included whether to retain a dual model for lessee accounting and, if so, the lease classification test.

Lessor accounting

- The Boards discussed lease classification and lease accounting by lessors, including whether to retain more aspects of current accounting practice in these areas.

Small-ticket leases

- The Boards discussed a variety of options to simplify the application of the proposals to small-ticket leases, ranging from revisions to the proposed exception for short-term leases, to new guidance on materiality and portfolios of leases.

CURRENT STATUS OF THE PROPOSALS

The story so far …

The Boards are working towards a converged standard that would bring most leases on-balance sheet for lessees. This joint project would 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.

Lease identification

A 'lease' would be a contract that conveys the right to use an identifiable asset for a period of time in exchange for consideration. The identification criteria would be based on rights to control the use of specified assets. A contract would convey these rights if the customer can both direct the use of the asset and derive 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 possible term, including renewal options, of 12 months or less would be exempt.

What happened in January 2014?

The Boards received over 600 comment letters on the 2013 ED, and have held subsequent outreach meetings to assess the many diverse views and concerns of the large constituent base of investors, analysts, regulators, preparers and others. Based on the feedback received, at their November 2013 meeting the Boards discussed plans for future redeliberations on the following significant issues:

- the lessee model, lessor model, lease classification and scope simplifications;
- measurement – specifically the lease term, reassessment of variable lease payments, in-substance fixed payments, residual value guarantees and discount rate;
- scope – specifically the definition of a lease, separating lease and non-lease components, and scope exclusions;
- sale and lease-back, including leveraged leases;
- presentation and disclosure; and
- transition.

At the January 2014 meeting, the Boards were presented with alternative ways forward for:

- lessee accounting;
- lessor accounting – including lease classification and the lessor accounting model; and
- small-ticket leases.

The Boards were not asked to reach decisions on any of these topics at the January 2014 meeting. This newsletter summarises the alternatives presented to the Boards for each of the topics listed above.

The Boards plan to take potentially significant decisions on each of the issues discussed in this newsletter in their March meeting.

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LESSEE ACCOUNTING

The discussions took as a given that leases should be on-balance sheet for lessees.

What's the issue?

Should there be a dual model for lessee accounting and, if so, how should a lessee classify leases?

The 2013 ED proposed a dual model approach for lessee accounting, under which a lessee would classify each lease as either Type A or Type B. The proposed lease classification test was based on the nature of the underlying asset and the extent to which it was consumed during the lease term. Broadly, most leases in which the underlying asset was not property – i.e. not land and/or a building – would be classified as Type A; most property leases would be classified as Type B.

For all leases, a lessee would recognise a right-of-use (ROU) asset for its right to use the underlying asset during the lease term, and a lease liability for its obligation to make lease payments. Subsequently, the lessee would measure the lease liability at amortised cost. However, subsequent accounting for the ROU asset and presentation of lease expense would depend on whether the lease was classified as Type A or Type B, as follows.

- For Type A leases (typically leases in which the underlying asset is not property), the lessee would measure the ROU asset at amortised cost, and would typically amortise the ROU asset on a straight-line basis. The lessee would recognise amortisation of the ROU asset and interest expense on the lease liability separately in profit or loss. Overall, the lessee would typically recognise a front-loaded pattern of total lease expense.
- For Type B leases (typically property leases), the lessee would recognise total non-contingent lease expense on a straight-line basis over the lease term, and present this as a single expense in profit or loss. To achieve this accounting outcome, the lessee would measure the ROU asset as a balancing figure.

There was no consensus amongst constituents on the proposed dual model for lessees. Many welcomed the introduction of the Type B lease accounting model, as they believed that the straight-line profile of lease expense better reflected the economics of some leases – especially property leases. Some supporters of the Type B model wished to apply it to a wider range of leases. Other constituents questioned whether there was any conceptual basis for the Type B model. Many also raised concerns about the costs and complexity of the new proposed classification tests, noting that new accounting systems would be required and that applying the tests would require increased management judgement.

What's new in January?

The Boards discussed three alternative approaches to lessee accounting.

Lease classification	Approach 1 – Single model	Approach 2 – Modified 2013 ED	Approach 3 – Transfer of control
Type A	• All leases	• All non-property leases • Property* leases when the lessee controls the underlying asset	• All leases in which the lessee controls the underlying asset
Type B	• Not applicable	• Property* leases when the lessee does *not* control the underlying asset	• All leases in which the lessee does *not* control the underlying asset

* The Boards discussed expanding the definition of property to include 'integral equipment' – i.e. equipment or a physical structure attached to land or a building that cannot be removed and used separately without incurring significant cost.

Under Approaches 2 and 3, the lessee would 'control' the underlying asset if:

- the lease transfers ownership at the end of the lease;
- the lessee has a significant economic incentive to exercise a purchase option; or
- the lessee can otherwise obtain substantially all of the asset's remaining benefits. Indicators that this is the case would be that:
  - the lease term is for a major part of the remaining economic life of the asset;
  - the sum of the present value of the lease payments and any residual value guaranteed by the lessee amounts to substantially all of the fair value of the underlying asset; or
  - the underlying asset is specialised.

The Boards also considered a variant of Approach 2, under which the lessee would have the option of either applying the Type A model to all leases or applying the Type B model to a subset of leases that met certain parameters.

The Boards took no decisions but asked the staff to further develop criteria for instances when the lessee can elect to apply Type B accounting under Approach 2.

What are the implications?

Regardless of whether a single model (Approach 1) or a dual model (Approaches 2 or 3) is ultimately applied, the core results of the lessee ROU model – i.e. recognising all leases on-balance sheet – will still introduce a significant change from today's lease accounting. The key distinction between the alternatives considered by the Boards is the measurement and presentation of lease expense in the statement of profit or loss and consequential impact on the balance sheet.

The single model (Approach 1) may be easier to apply, have a clearer conceptual grounding and provide the greatest consistency – but it would not allow for the straight-line recognition of total lease expense that many constituents believe better reflects the economics of certain leases. Approaches 2 and 3 both preserve straight-line recognition of total lease expense, with the key distinction being whether this accounting should be available only for certain leases of property (Approach 2), or for a wider range of leases (Approach 3). Expanding the definition of property to include 'integral equipment' would reduce the differences between Approaches 2 and 3 in some cases.

The variant of Approach 2 – in which a lessee would have the option of classifying certain leases of property as either Type A or Type B – is particularly intriguing. This represents the first suggestion in this long-running project that lease classification should be an option. In effect, this option would retain the dual model approach, but would allow lessees to elect to apply a single lease accounting model (Type A) to present all leases on a consistent basis and avoid the costs of the dual model.

LESSOR LEASE CLASSIFICATION

New lease classification tests for lessors are up for discussion.

What's the issue?

Should lessors apply the same lease classification test as lessees?

The 2013 ED proposed that lessors apply the same classification test as lessees, based on the nature of the underlying asset and the extent to which the asset is consumed over the lease term. For Type A leases, the lessor would apply a new, complex model under which it would derecognise the underlying asset and recognise a lease receivable and a residual asset. For Type B leases, the lessor would account for the lease similar to current operating lease accounting under IAS 17 *Leases*.

In reacting to the proposed lessor accounting models, most constituents indicated that they do not consider symmetry between lessee and lessor accounting to be a high priority. Some constituents felt that lessors should classify more leases as Type B – e.g. leases of ships and heavy equipment that would be classified as Type A under the proposals. In general, most users did not support the proposals, as they believed that lessor accounting works well in practice and do not adjust financial statement figures for current lessor accounting requirements.

What's new in January?

The Boards discussed three main approaches to lease classification by lessors.

- *IAS 17 approach*: Determine lease classification by evaluating whether the lease is effectively a sale or financing transaction. This assessment is based on whether the lease transfers the risks and rewards incidental to ownership of the underlying asset to the lessee.
- *Modified IAS 17 approach*: If a lease gives rise to a selling profit (or loss), then determine lease classification by evaluating whether the lease transfers control of the underlying asset to the lessee, and therefore qualifies as a sale under the forthcoming revenue recognition standard. Apply the IAS 17 approach to other leases.
- *Business model approach*: Determine lease classification by evaluating whether a lessor's business model is designed to obtain a return based on:
  - the estimated value of the asset at the beginning and end of the lease period (financing transaction); or
  - the investment in the underlying asset over the period for which the lessor intends to hold the asset, which may cover several lease terms (non-financing transaction).

The Boards took no decisions, but asked the staff to consider further:

- the types of lease that do and do not give rise to a selling profit; and
- the relationship between the lessor proposals and the requirements in the forthcoming revenue recognition standard.

What are the implications?

Each of these alternatives would represent a significant change to the proposals in the 2013 ED. Retaining the current classification requirements under IAS 17, or applying a modified IAS 17 approach, would reduce the number of leases to which the Type A (financing) accounting model would apply compared to the 2013 ED.

A classification approach linked to an entity's business model could reflect the purposes for which the lessor enters into the leasing arrangement. However, applying this subjective approach would increase the amount of management judgement and may also allow for two identical transactions to be accounted for differently, based simply on the nature of the lessor's business. This approach may also give rise to additional application issues – e.g. single asset leasing vehicles, and leases acquired in a business combination.

LESSOR ACCOUNTING MODEL

The Boards will consider further whether the lessor proposals represent a sufficient improvement over current lessor accounting.

What's the issue?

How should lessors account for Type A leases?

The 2013 ED proposed that lessors apply a complex new model to Type A leases – i.e. most leases of assets other than property. Under this model, a lessor would derecognise the underlying asset and recognise:

- a lease receivable – representing its right to receive lease payments from the lessee; and
- a residual asset – representing its interest in the underlying asset at the end of the lease term.

Many constituents questioned whether a new lessor accounting model was necessary. Some expressed specific concerns about the cost and complexity of applying the proposed Type A model, including:

- the judgement required to estimate the value of the residual asset and the sensitivity of income recognition to this estimate;
- the complexity involved in accounting for variable lease payments; and
- the different impairment tests for the lease receivable and the residual asset.

What's new in January?

The Boards discussed two main alternatives for lessor accounting for Type A leases:

- retaining the Type A model proposed in the 2013 ED, subject to possible simplifications – e.g. simplifying the requirements for leases with variable payments and developing a single impairment approach for the lease receivable and residual asset; or
- replacing the Type A model with the IAS 17 finance lease accounting model, subject to minor modifications – one potential modification would be a requirement to present the lease receivable and residual asset separately.

The Boards took no decisions, but asked the staff to consider further potential simplifications to the Type A lessor model, and presentation alternatives.

What are the implications?

A decision to replace the Type A lessor accounting model with the IAS 17 finance lease accounting model would reduce cost and complexity. It would also significantly reduce the extent of change to lessor accounting generally, given that the 2013 ED proposed that lessors would apply a model similar to IAS 17 operating lease accounting to Type B leases.

It is likely that a final decision on the lessor accounting model will be taken in conjunction with a final decision on the lease classification test.

SMALL-TICKET LEASES

A variety of options for simplifying the accounting for small-ticket leases were considered.

What's the issue?

Should exemptions from applying the proposals be expanded?

The 2013 ED proposed that lessees and lessors could elect to apply a simplified approach to short-term leases – i.e. leases with a maximum contractual term, including renewal options, of 12 months or less. Any lease that contains a purchase option would not be a short-term lease. Under this simplified approach, the lessee/lessor would recognise lease payments as expense/income in profit or loss, similar to current operating lease accounting.

Many constituents welcomed the proposed relief but noted that substantial effort would be required to identify and analyse the key terms of leases to assess whether they qualified for the simplified approach. Many also felt that the simplified approach should be available to a wider range of leases, to reduce the costs of implementing the proposals. Constituents suggested a variety of ways to extend the simplified approach to more 'small-ticket' leases – i.e. leases that are small in value and/or are secondary to an entity's business operations.

What's new in January?

The Boards discussed alternative options for expanding the circumstances in which a lessee could apply the simplified approach to reduce the costs of implementing the proposals. Alternatives considered included:

- revising the definition of a short-term lease, either by extending the 12-month threshold or by basing the definition on the lease term rather than on the maximum contractual term;
- developing a definition of and scope exclusion for leases of 'non-core' assets;
- providing explicit guidance on materiality, either by including an explicit materiality threshold or by clarifying how to apply existing materiality guidance to leases; and/or
- permitting the proposals to be applied at a portfolio level instead of to individual lease contracts in some circumstances.

The Boards took no decisions, but requested the staff to further explore:

- practical application issues, including the risk of creating structuring opportunities; and
- how the alternative approaches would deal with lease modifications and other changes in circumstances.

What are the implications?

Extending the relief available for small-ticket leases may help alleviate constituent concerns about the costs of applying the proposals, while preserving the Boards' goal of bringing more significant leases on-balance sheet for lessees.

However, designing an enhanced form of relief involves balancing a range of factors. These include not only the relative costs and benefits of bringing small-ticket leases on-balance sheet, but also the consistency with which the relief will be applied and the possibility that arrangements will be structured in order to qualify for the relief. For example, any definition of 'non-core' assets would require an increase in management judgement.

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.

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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.