

Leases

EFRAG Outreach

The purpose of this note is to enable EFRAG's constituents to consider the IASB's re-deliberations in relation to the Exposure Draft *Leases* (the 'ED') before attending any of EFRAG's outreach events on the issue. At EFRAG's outreach events, constituents will be asked for their views on selected issues and any major concerns in relation to remaining issues.

On the following pages, the IASB's re-deliberations are summarised for each of these main steps. In addition, some main concerns raised in European constituents' comment letters to the IASB in response to the ED are summarised for each of the issues that have been re-deliberated. Firstly, however, some general comments from the European constituents' comment letters are summaries. The last pages of this note include some specific issues and some examples illustrating the effects of the re-deliberations.

This document does not address the following topics for which the IASB has not yet started redeliberations:

- Impact of reassessment of lease term and/or contingent rentals.
- Disclosure requirements;
- Transition provisions.

General comments

Comments

- A new Lease standard is not required. Preparers and users are familiar with the distinction between finance and operating leases, that reflect the different economics and business reasons to enter different lease arrangements.
- The proposals in terms of recognition and measurement are complex and costs to implement them exceed the benefits.
- The level of judgment (especially for options and contingent rentals) will reduce comparability.
- The definition of a lease is complex to apply and may capture arrangements that are in substance service arrangements. This is a lesser issue under IAS 17, because these arrangements are likely to be assessed operating leases; but when operating lease accounting is removed, the boundary between service and leases must be robust and operational.
- There is inconsistency between the proposed models for lessees and lessors.

Re-deliberations

The IASB has reaffirmed the overall objective that all leases should be recognised on the balance sheet. However, the tentative decisions in the redeliberation period have:

- Recognised that not all leases are financing transactions and that transactions with a different purpose should be treated differently;
- Attempted to make the boundary between leases and service arrangements more clear;
- Aimed at reducing complexity.

Definition of a lease

The ED

The ED carries forward from IAS 17 and IFRIC the definition of a lease and the criteria to identify a lease.

A lease is an arrangement that conveys the right of use a specified asset for a period of time, in exchange for consideration.

An arrangement contains a lease when the following criteria are both met:

- Fulfilment of the arrangement is dependent on providing a specified asset;
- The arrangement conveys the right to control the use of the specified asset.

Concerns

- The accounting treatment should reflect the business purpose of the client that enters into the transaction. When the use of an asset is incidental to the provision of a service, the arrangements are in substance services and should not be considered leases
- No useful information is conveyed by the recognition of leases of non-core assets or assets that are not linked to the revenue-generating activity of the entity.
- The criteria to identify a lease in IFRIC 4 have raised a number of application issues. These issues become more relevant now that the proposal eliminate operating lease accounting

Re-deliberations

The IASB now proposes that:

- An asset is specified only when the supplier does not have substantive rights to replace (to be further elaborated by the IASB).
- Non-physically distinct portions of assets (i.e. portions of capacity) are not specified asset.
- The right of control is transferred only when the client has the ability to direct the use and obtain substantially all the benefits from the use of the underlying.
- If the asset is not separable from the provision of the services specified in the contract, the arrangement does not contain a lease. An asset is separable when any one of the following is met: a) the customer can use the asset on its own or together with other resources readily available to the customer; b) the asset is sold or leased separately by the supplier; c) the right to use the asset and the services were negotiated separately between the supplier and customer

Scope of the Standard

The ED

The ED proposed excluding from the scope of the Standard:

- leases of intangible assets;
- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- leases of biological assets.

Lessors of investment property measured at fair value would apply IAS 40 to those leases. Lessees of investment property may measure the right-of-use asset in accordance with the fair value model in IAS 40.

Concerns

- No conceptual basis for the exclusion of intangible assets.
- Exclusion of leases of intangibles creates complexity when a contract is a lease of both tangible and intangible assets.
- Additional exemptions for leases of inventory and arrangements in the scope of IFRIC 12 are required.

Re-deliberations

The Board has tentatively re-affirmed that entities are not required to apply the Standard to leases of intangible assets.

The Board has added a scope exemption for arrangements in the scope of IFRIC 12 *Service Concession Arrangements*.

The accounting model - lessees

The ED

The ED required a lessee to recognise a right-of-use asset and a liability to make payments for all arrangements that include a lease.

The RoU asset and the liability would be initially measured at the present value of the future rental payments (see below for the treatment of options and contingent rentals).

At subsequent dates, the liability would be measured at amortised cost; the RoU asset would be amortised in accordance with IAS 16 and IAS 38 requirements (usually resulting in a straight-line depreciation pattern over the lease term).

The lessee may elect to apply the revalued cost method in accordance with IAS 16 if all owned assets in that category are carried at revalued cost.

Concerns

- The proposals in the ED treat all leases as if they were financing transactions. Not all leases are entered into to finance the purchase of an asset.
- The IASB should explain more clearly why leases should be recognised and other executor contracts should not.
- The accounting treatment front loads costs in the initial period of the lease.
- Additional guidance needed for leases denominated in foreign currency.

Re-deliberations

The IASB now proposes that there are two types of leases: finance and other-than-finance leases. Entities should determine to what type a lease arrangement belongs based on requirements to distinguish finance and operating leases in IAS 17 (to be further elaborated by the IASB).

For other-than-finance leases, the amortisation of the RoU should be such that the profit and loss recognition of total cost of the lease (amortisation and interest cost) is consistent with operating lease accounting in IAS 17.

The accounting model - lessors

The ED

The ED proposed a dual accounting model for lessors. At the date of inception of a lease, a lease would be accounted for in accordance with the performance obligation approach or a derecognition approach based on whether the lessor retained exposure to significant risks and benefits associated with the underlying asset.

Under the performance obligation approach, the lessor would maintain the underlying asset on the balance sheet, recognise a receivable and a lease liability at the present value of the future rentals. The receivable would be subsequently measured at amortised cost and the lease liability would be released to profit and loss on the basis of the pattern of use of the underlying asset by the lessee. If the lessor cannot determine a systematic and rationale basis, the lease liability would be released on a straight-line basis over the lease term.

Under the derecognition model, the entity would derecognise a portion of the carrying amount. The residual asset would not be amortised but only subject to impairment.

Concerns

- IAS 17 is not broken in relation to lessor accounting and there is no need to fix it.
- A dual model for lessors is inconsistent with a single accounting model for lessees and repropose in practice the bright line in IAS 17.
- The performance obligation model is not consistent with the notion that a lease is executed when the lessor provides access to the underlying asset.
- The performance obligation grosses up assets and liabilities in the lessor's balance sheet and distorts ratios. It also creates application issues for impairment calculation.
- "Freezing" the initial value of the residual in the derecognition approach prevents from showing the lessor's return on the lease investment.

Re-deliberations

The Board has not redeliberated on the accounting model for lessors. In the April meeting, the Board has instructed the staff to examine the following:

- for other-than-finance leases, a performance obligation approach with a net presentation on the balance sheet, or operating lease accounting;
- for finance leases, the subsequent measurement requirements for the receivable and the residual asset.

Short-term leases

The ED

The ED proposed that:

- lessors could elect not to apply lease requirements to short-term leases;
- lessees could elect not to discount assets and liabilities arising from short-term leases.

The election could be made on a contract-by-contract basis.

Concerns

There is a lack of real relief for lessees that will be obliged to track down a large number of small contracts.

Re-deliberations

The IASB now proposes that both lessors and lessees may elect as an accounting policy for a class of underlying asset not to recognise assets and liabilities arising out of lease arrangements.

- The IASB proposes that in that case lessors and lessees recognise lease payments in profit and loss on a straight-line basis over the lease term, unless another method is more representative of the pattern of consumption of benefits.
- The IASB proposes to define a short-term lease, as a lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less.

Distinguishing a lease from a purchase/sale

The ED

The ED proposed that an arrangement would be considered a purchase/sale of the underlying asset when it transferred control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the asset.

An arrangement that automatically transfers title at the end of the lease term or includes a bargain purchase option would be normally considered a purchase/sale

Concerns

- If a lease is defined properly, there is no need for guidance to distinguish a lease from a sale.
- The criteria to identify a sale in the Leases Standard should be the same as in the Revenue Recognition Standard.
- The term “trivial” is not defined.

Re-deliberations

The IASB now proposed that guidance should not be provided in the Leases standard for distinguishing a lease of an underlying asset from a sale/purchase. If an arrangement does not contain a lease, it should be accounted for in accordance with other applicable standards

Contracts that contain service components and lease components

The ED

The ED required that entities always identify and account separately for services that meet the definition of distinct performance obligations in accordance with the ED on Revenue Recognition.

The ED also required that lessors in a derecognition approach should also account separately for service components that would not meet the definition of distinct performance obligation.

Concerns

- It is practically difficult to allocate consideration between lease and service components in an arrangement.

Re-deliberations

The IASB now proposes that when an arrangement contains both a lease and services, the service components should be accounted for separately. One of the conditions to have a lease arrangement is that the asset is separable from the services (see above for the proposed definition of *separable asset*).

Consideration should be allocated between the lease and the service components based on standalone observable prices. When there is no observable price for any of the components, the whole consideration should be allocated to the lease component.

Purchase and renewal options

The ED

The ED proposed the following treatment for options to purchase and renew (or terminate) leases:

- An arrangement that includes a bargain purchase option should be considered as a purchase/sale arrangement;
- Purchase options that are at non-bargain terms should be accounted for only when exercised;
- Lessors and lessees should measure assets and liabilities arising from lease contracts on the basis of the longest lease term that is more likely than not to occur;
- Entities should consider contractual and business factors to assess the likelihood of each option, as well as the lessee's intentions and past practice.
- Entities should remeasure the lease term when facts and circumstances indicate that there would be a significant change in the amount.

Concerns

- Amounts due under options do not meet the definition of assets and liabilities.
- Assessment of the longest lease term that is more likely than not to occur is complex and may be unreliable.
- All options are similar in nature and there is no conceptual reason to treat a purchase option differently from a renewal. Also, this would create application issues when contracts include both types of options.
- Distinction between bargain and non-bargain purchase options is complex.
- Lessors would be obliged to make assumptions about the future behaviour of lessees.

Re-deliberations

Entities should include in the measurement of assets and liabilities amounts due under options that give a significant economic incentive to exercise. A significant economic incentive may exist because:

the rental in the optional period are at favourable terms;

the lessors offers some incentive in case the lessee exercises the options;

the lessee has made significant investments in the leased asset (i.e. leasehold improvements) that would be lost if the option is not exercised.

Options to purchase and to extend (or terminate) a lease should be treated in the same way.

Contingent rentals

The ED

The ED proposed that amounts due under contingent rental arrangements should be included using an expected outcome technique.

If the contingent rentals depend on an index or a rate, the lessee shall determine the expected lease payments using readily available forward rates or indices

Lessors should only include contingent payments that can be determined reliably.

Concerns

- Amounts due under certain types of contingent rental agreements do not meet the definition of assets and liabilities.
- Assessment is too complex and often may not be reliable.

Re-deliberations

The IASB now proposes that parties include in the measurement:

- Rentals that are contingent on an index or rate;
- Contingent rentals that are in substance fixed minimum payments.

Rentals that are contingent on an index or rate should be initially measured based on the spot rate.

Sale and leaseback

The ED

The ED required entities to assess if the transfer meets the definition of a sale using the guidance to distinguish a sale/purchase from a lease and specific indicators,

If the transfer meets the definition of a lease, the seller/lessee would derecognise the entire asset and apply the lease requirements to the leaseback; the lessor would recognise the purchased asset and apply the performance obligation approach to the leaseback.

If the rentals or the consideration are not at market terms:

- The lessee would adjust the gain on disposal and the measurement of the RoU asset;
- The lessor would adjust the carrying amount of the asset and the lease liability in the performance obligation approach.

Concerns

- There should be no higher threshold or specific guidance to assess if the transfer qualifies as a sale in a sale and leaseback transaction.
- The partial asset approach (where the seller/lessee derecognises only portion of the underlying asset) is more consistent with the conceptual premise.

Re-deliberations

The IASB now proposes that an entity should apply the control criteria described in the revenue recognition project to determine whether a sale has occurred.

The IASB decided that the leases guidance would not prescribe a particular type of lessee accounting model for entities that are accounting for the leaseback part of a sale and leaseback transaction.

Inception and commencement date

The ED

The ED proposed that the lessee would:

- recognise the right-of-use asset and liability to make payments at the commencement date;
- measure the right-of-use asset and liability to make payments at the inception date.

Concerns

- It was unclear how to treat remeasurements between inception and commencement date.
- No guidance on lease incentives.

Re-deliberations

The IASB now proposes that a lessee would recognise and initially measure lease assets and lease at the date of commencement of the lease. The Standard would include application guidance on the accounting for incentives provided by the lessor to the lessee. This would clarify that a lessee will deduct all lease incentives from the initial measurement of the right-of-use asset.

Discount rates

The ED

The ED proposed that:

- The lessee would discount future payments using the lessee's incremental borrowing rate, or, if readily determinable, the rate charged by the lessor.
- The lessor would discount future payments using the rate charged to the lessee.

Concerns

- More guidance needed on how to determine the incremental borrowing rate in specific situations (when the financing is secured at Group level or the market for the underlying asset is very volatile).
- Use of the lessee's incremental borrowing rate may decrease comparability.

Re-deliberations

The IASB now proposes that the lessee uses the incremental borrowing rate to discount future payments for finance leases, and the rate charged by the lessor for other-than-finance leases. However, if the rate charged by the lessor cannot be determined, the lessee uses the incremental borrowing rate.

Guidance will be included to assist determining the incremental borrowing rate for an entity when financing is ensured at Group level.