Practical guide
A look at current financial reporting issues

6 June 2013

What's inside:

Leases

Type A? Type B? Wondering what to do?

A look at the revised exposure draft

Overview

At a glance

- The FASB and IASB (the "boards") issued a revised *Leases* exposure draft (the 'revised ED') on 16 May 2013. The proposals, which continue to attract a diverse range of views among constituents, would fundamentally change the accounting for lease transactions and are likely to have significant business implications. Comments on the revised ED are requested by 13 September 2013.

- The revised ED retains the previously proposed 'right-of-use' concept and requirement for lessees to reflect all leases (except short-term leases) on the balance sheet. However, it represents a significant shift from the original ED (issued in 2010) in key areas. Perhaps the most significant is the proposal of a dual model for lease accounting and lessee expense recognition. It also proposes a higher threshold for including extension options when measuring lease assets and liabilities; a simplified treatment of many types of variable lease payments; and new guidance to determine whether a contract contains a lease.

- The revised ED allows entities to apply a either a full retrospective approach or a modified retrospective approach for transition. Preparers will need to apply the guidance to all leases existing as of the beginning of the earliest comparative period presented (that is, no grandfathering).

- Issuance of a final standard and determination of the effective date is unlikely before 2014.

Background of the project

1.1. Leasing arrangements satisfy a wide variety of business needs, from short-term asset use to long-term asset financing. Leases allow lessees to use a wide range of assets, including office and retail space, equipment, trucks/cars, and aircraft, without having to make large initial cash outlays. Sometimes, leasing is the only option to obtain the use of a physical asset when it is not available for purchase (for example, it is generally not possible to buy one floor of an office building).

1.2 Many observers have long believed that the accounting model for an operating lease is inconsistent with the boards' conceptual frameworks, which provide the underpinnings for their accounting standards. They argue that the model allows lessees to structure lease transactions to comply with operating lease classification, and therefore benefit from off-balance sheet financing.

1.3 In response to a report by the SEC in June 2005, and as part of their global convergence process, the boards added a joint project on leases to their agendas in 2007 and they have been working since then to create a single, converged, global leasing standard. An initial ED was published by the boards in August 2010. For more information on the background of this project and the initial ED, refer to the practical guides, 'Practical guide to leasing: overhauling lease accounting' and 'Leasing proposals: the results are in'.

1.4 The revised ED proposes changes to both lessee and lessor accounting. Nevertheless, the proposed standard is likely to impact lessees' financial statements significantly more than lessors. Accordingly, while many of the descriptions in this practical guide also apply to lessors, it is written principally from a lessee's perspective. Where appropriate we will highlight lessor considerations throughout the document.

1.5 A high level summary of the key changes from current IFRS can be found in Appendix A.

Scope of the proposals

2.1 The following types of leases are excluded from the scope of the revised ED:

- Intangible assets.
- Leases to explore for, or use, minerals, oil, natural gas and similar non-regenerative resources.
- Biological assets.
- Service concession arrangements within the scope of IFRIC 12.

2.2 In addition, both lessees and lessors can elect, by class of underlying asset, to account for leases with a maximum term of up to 12 months in a similar way to current operating lease accounting.

2.3 From a lessor perspective, leases (or licences) of intangible assets fall within the scope of the proposals set out in the exposure draft on 'Revenue from contracts with customers' (refer to the practical guide, 'Boards finalise redeliberations of revenue from contracts with customers'). From a lessee perspective, IAS 38 would be the relevant standard, although lessees would be permitted to apply the proposals in the revised ED.

Identifying a lease

3.1 The revised ED defines a lease as *"a contract that conveys the right to use an identifiable asset (the underlying asset) for a period of time in exchange for consideration"*. The legal form does not matter – a lease can be embedded in a larger arrangement such as a service contract. This requires assessing whether:

a. the fulfillment of the contract depends on the use of an **identifiable asset**; and

b. the contract conveys the **right to control** the use of the identifiable asset for a period of time.

PwC observation:

There is likely to be a greater focus on identifying whether a component of an arrangement meets the definition of a lease, given the proposal that all leases (except short-term leases) will be recognised on the balance sheet. Currently, there are many arrangements that contain embedded operating leases. But many lessees do not separate the embedded lease from the contract because the accounting for an operating lease and a service/supply arrangement is generally the same (that is, there is no recognition on the balance sheet and straight-line expense is recognised over the contract period). This practice will change because virtually all leases will be recorded on the balance sheet.

It's also important to note that this is not an all or nothing evaluation — the contract might include both a lease and a service component, requiring the apportionment of contract consideration.

What is an identifiable asset?

3.2 An asset is generally considered identifiable where it is either explicitly or implicitly specified in a contract. However, if the supplier has the substantive right to substitute the asset, the asset might not be identifiable even if it is explicitly specified in the contract.

3.3 For substitution rights to be substantive, it must be practical and economically feasible for the supplier to substitute the asset at any time without the customer's consent and without economic disincentives to the supplier's substitution. For example, it is not practical for a lessor to substitute a branded, customised aeroplane with another aeroplane (assuming the lessor's cost to customise the replacement aeroplane is significant); such a contract would typically depend on an identifiable asset. Also, if the right to substitute an asset existed only if the asset was not operating properly, the substitution right could be more analogous to a warranty and would not change the conclusion that the asset is identifiable.

3.4 An identifiable asset could be a physically distinct portion of a larger asset, such as one floor of a multi-level building. A non-physically distinct portion of an asset would not typically be an identifiable asset (for example, a contract for the right to use a percentage of an oil pipeline's capacity). But, if the customer has the right to obtain substantially all of the potential economic benefits from an asset, even if the contract is structured to give the customer the right to only a capacity portion of the asset, it could be concluded that fulfilment of the contract depends on the use of an identifiable asset. In this case, the identifiable asset would be the underlying asset and not the capacity portion.

PwC observation:

For the majority of lease contracts, we do not believe that significant judgement will be required to determine whether an asset is an 'identifiable asset'. Some believe that a lease contract must specify a serial or other identifying number of an asset to be considered an 'identifiable asset'. Contracts, such as master lease agreements, rarely contain such information. From a practical perspective, however, when the vendor delivers goods or services, a particular asset has often been delivered to and accepted by the customer. At this point, it may be difficult to assert that it does not meet the definition of an 'identifiable asset', subject to an evaluation of any substitution clauses in the contract.

What is the right to control?

3.5 A contract conveys the right to control the use of an identifiable asset if the customer has the ability to **direct the use** of, and **derive the benefits** from, the asset throughout the term of the arrangement. The table below details indicators of the right to control.

The right to control	
Ability	**Indicators**
Directing the use of an asset	The customer directs the use of an asset if it has the ability to make decisions that significantly affect the economic benefits received. Examples of such decisions are as follows: • **how** and **for what purpose** the asset is used during the term of the contract, subject to what is permitted by the contract; • **how** the asset **is operated** during the term of the contract; or • **who** the **operator** of the asset is, if the customer is unable or chooses not to operate the asset itself. Restrictions on a customer's use of an asset typically do not, in isolation, prevent the customer from having the ability to direct the use of an asset. The ability to specify the output of an asset without other decision-making rights would not, in isolation, mean that the customer has the ability to direct the use of that asset. If a customer has the ability to make decisions about the use of an asset at or before the lease commencement date, those decisions should be considered in determining if the customer has the ability to direct the use of an asset.
Deriving the benefits from the use of an asset	A customer derives the benefits from the use of an asset if it has the right to obtain substantially all of the potential economic benefits from the use of the asset throughout the term of the contract. An asset's economic benefits include the following: • primary output • by-products in the form of products and services; and • other economic benefits arising from the use of the asset that could be realised from a commercial transaction with a third party (for example, renewable energy credits (RECs) that are, in addition to physical electricity output, generated by power plant assets). Tax benefits are not considered an economic benefit for the purposes of this assessment. A customer does not have the ability to derive the benefit from the use of an asset if the only way the customer can obtain the benefit is in conjunction with additional goods or services provided by the supplier, and these goods or services are not sold separately by the supplier or other suppliers.

Example

Entity A enters into an IT outsourcing agreement, whereby it agrees to lease 50 laptop computers from entity B for three years. The serial or other identifying number of each laptop computer is not included in the agreement. On delivery, the delivery documents identify the serial number of the unit delivered. The laptops will remain in entity A's possession during the three-year period, and entity A can load any software it chooses. If a laptop is, or becomes, faulty, entity B will replace it at a time convenient to entity A; but, in any other circumstances, the laptop cannot be exchanged for another. The specific laptop is returned on the expiration of the three-year period.

Does the arrangement contain a lease?

Entity A should assess the arrangement as follows:

Is there an identifiable asset? The contract depends on the use of laptop computers. Although each laptop is not specified in the master outsourcing agreement, a particular asset has been identified at the time the laptops are provided. Absent a warranty matter, entity B cannot substitute the laptops; so, the laptops are identifiable assets.

Is there a right to control? Entity A has the right to control the use of the laptops because (a) it has the right to derive substantially all of the potential economic benefits from the use of the laptops (that is, it possesses the equipment during the contract term, regardless of whether it uses the equipment), and (b) it directs the use of the laptop by operating the laptop itself.

Since both the identifiable asset and the control criteria are met, the outsourcing agreement represents a lease.

PwC observation:

The notion of control in the proposed guidance could significantly change prevailing accounting practice in certain industries (for example, certain types of power purchase arrangements and take-or-pay contracts). However, we expect that a number of other application questions will arise as constituents work through the revised ED to determine whether a customer has the right to control the use of an asset.

Separating a lease from other elements in an arrangement

4.1 Lease and non-lease components of an arrangement (for example, services and executory costs) must be identified and accounted for separately. Only the lease components fall within the scope of the revised ED. Separable lease components are considered to exist when:

- the lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee; and

- the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

4.2 Lessees should allocate an arrangement's consideration between lease and non-lease components based on their relative standalone purchase prices, where such prices exist. If there are observable standalone prices for some, but not all, of the components in an arrangement, a residual method should be used to allocate a price to components with no observable purchase prices. But, when there are no observable prices for any of the components, lessees must account for the entire contract as a lease.

4.3 Lessors should consider the guidance set out in the exposure draft, 'Revenue from contracts with customers' in order to determine the accounting for the non-lease components of a transaction.

Example

A customer enters into a contract to lease a specialised piece of equipment for four years. The lessor will perform all maintenance service on the equipment during the lease term. The arrangement is priced as a package, so, the contract does not specify the price for the use of the equipment and the price for the maintenance. The total consideration for the contract is C1,000. The payments will be made in four annual instalments of C250.

How should the lessee separate the components of the contract?

The lessee should look to obtain an observable stand-alone price for one of the components of the contract. In this example, assume the lessee can obtain an observable stand-alone price for the maintenance component, based on information available from other suppliers. The price for maintenance services on similar equipment over a four year period is C200.

Therefore, the lessee would ascribe the remaining C800 of the total payments made under the contract to the lease.

4.4 If the payments made in a contract containing multiple components change after lease commencement, lessors and lessees must determine the change attributable to each component. If the entity is not able to determine the amount of change attributable to each component, the entity must allocate the change on the same basis as it did when initially allocating the contract consideration.

PwC observation:

The allocation of consideration between lease and non-lease components will gain importance because of the requirement for lessees to always recognise assets and liabilities for the lease component of the contract.

The boards presume that vendors/lessors, in a transaction that includes non-lease elements, are able to allocate the consideration from the arrangement between the lease and non-lease elements. Lessees, on the other hand, may not have the information to do so.

So, in some situations, lessees would account for the entire contract as a lease (and, therefore, on balance sheet) while vendors/lessors in transactions that contain non-lease elements would not reflect the non-lease element in measuring the lease receivable.

Lease component considerations

4.5 If a lease component within an arrangement contains the right to use more than one asset, an entity shall determine the nature of the underlying asset on the basis of the nature of the primary asset. An entity would use the asset type and economic life of the primary asset within the lease component when classifying the lease.

4.6 Notwithstanding the above, if a lease component contains both land and a building, an entity should regard the economic life of the building to be the economic life of the underlying asset when classifying the lease.

Initial measurement by lessees

General concepts

5.1 **All leases (except short-term):** While the dual models proposed by the boards will affect both lessors and lessees, one of the most significant impacts of the proposed standard will be on the lessee's balance sheet. At the commencement date (that is, the date on which the lessor makes the underlying asset available to the lessee), a lessee is required to record the following:

- **lease liability** equal to the present value of the lease payments to be made during the lease term, discounted using the rate that the lessor charges the lessee. If this rate is not available, the payments will be discounted using the lessee's incremental borrowing rate; and

- **right-of-use ('ROU') asset** measured at the initial measurement amount of the lease liability, plus any lease payments made to the lessor at or before the commencement date (less any cash incentives received from the lessor), and any initial direct costs.

PwC observation:

The concept of having all leases (except short-term leases) on balance sheet is consistent with the boards' overall objective from the beginning of this project A core principle of the project has been that lease contracts give rise to assets and liabilities on the balance sheets of both lessees and lessors.

Short-term leases

5.2 Lessees can elect to account for leases that have a **maximum possible** term of 12 months or less (including any options to renew or extend) in a manner similar to current accounting for operating leases. Rent-free periods should also be considered when determining if the lease is short-term. Lessees would make an accounting policy choice to follow the simplified short-term lease guidance on an asset class basis.

5.3 When assessing the length of lease term in order to determine if there is a short-term lease, only the non-cancellable period should be considered. A lease is cancellable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

PwC observation:

This simplification for short-term leases will alleviate the burden of identifying and tracking short-term leases at each reporting period, and might alleviate the need to determine if certain short-term contracts include an embedded lease. However, it also allows lessees the flexibility of recording on the balance sheet short-term lease commitments for asset classes that are deemed to be significant.

The intention of this provision is to ease the application burden for some lessees (for example, those in the construction industry) where shorter term lease contracts are structured on more of a 'pay as you go' basis. However, one would need to determine whether there was a right to extend the term of use to evaluate whether the short-term lease exception is an option. It's not clear how many contracts will meet the definition of cancellable leases and be eligible for this relief.

Calculating the initial lease liability and right-of-use asset

5.4 In order to calculate the lease liability and the right-of-use asset, as described in paragraph 5.1 above, a lessee must perform the following steps

Steps for measuring the initial lease liability and right-of-use asset

Step 1) Determine the lease term

5.5 The lease term is the non-cancellable term of the lease plus any options to extend when a significant economic incentive to exercise such options exists.

5.6 An entity should consider all contract-based, asset-based, entity-based and market-based factors together in assessing whether a lessee has a significant economic incentive to exercise an option.

5.7 The revised ED provides factors that a lessee should consider when assessing whether the threshold of significant economic incentive has been met. These factors are as follows:

- Explicit contractual terms that could affect whether the lessee exercises the option when compared to market rates, such as the amount of lease payments in any optional period (discounted, market or fixed rate).
- The existence or amount of any variable lease payments or other contingent payments under termination penalties or residual value guarantees.
- The terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- Leasehold improvements that are expected to have significant economic value to the lessee when the option to extend or to purchase the asset becomes exercisable.
- Costs associated with returning the underlying asset in a contractually specified condition or location.
- The importance of that underlying asset to the lessee's operations (considering, for example, whether the underlying asset is a specialised asset or the location of the underlying asset).

PwC observation:

In reassessing the threshold for including extension options from the initial ED, the boards made a practical compromise that is less complex and more operational while still providing reasonable protection against structuring concerns. The higher threshold will generally result in shorter lease terms and lower amounts recognised on the balance sheet than would have resulted under the initial ED. It's also closer to the current treatment for renewal periods (that is, when they are 'reasonably certain' of being exercised). Existing thresholds are well understood in practice, and retaining them will smooth transition.

As noted above, one of the primary reasons for including extension options (and not limiting the accounting to the non-cancellable lease term) is to avoid the potential for structuring opportunities. For example, one could theoretically structure a 20-year lease as a daily lease with 20 years' worth of daily renewals. In practice, such an arrangement is unlikely and potentially costly (because the lessor would want to be compensated for the related uncertainty and would need to recover tenant-specific improvements in a real estate lease).

It is unclear how to weight the individual factors when making the significant economic incentive determination. For example, consider a flagship store that is considered a 'mission-critical asset' because of its unique geographical location. Significant judgement would be needed to determine if market price renewal options relating to the store should be included in the determination of the lease term and whether the unique geographical location of the store creates a significant economic incentive for the lessee to renew the store lease.

Step 2) Identify the lease payments

5.8 For the purpose of measuring the lease liability and right-of-use asset, lease payments comprise the following:

- Fixed payments, less any lease incentives receivable from the lessor.
- Variable lease payments based on a rate or an index (such as CPI or LIBOR).
- Variable lease payments that are, in substance, fixed because the variability lacks economic substance.
- Any amount expected to be payable by the lessee under a residual value guarantee.
- The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option.
- Payments or penalties for terminating a lease if the lease term reflects that the lessee has a significant economic incentive to terminate the lease.

5.9 It follows that variable payments that are usage or performance-based (for example, based on the number of miles a leased car is driven) are not lease payments for the purpose of measuring the lease liability and right-of-use asset.

PwC observation:

Determining whether a contingent payment is a 'disguised' or in-substance fixed lease payment will likely require a significant judgement. For example, consider leases that have no, or nominal, fixed payments and require contingent lease payment based on a percentage of sales (for example, a retail store) or based on output (for example, wind or solar farms). If such payments are entirely excluded, such contingent payment structures would result in no on-balance sheet accounting by the lessee. This may be entirely appropriate, but it will be necessary to consider whether there are any minimum performance guarantees or other features that mean there is little or no variability in the lease payments.

5.10 Variable lease payments based on a rate or index should initially be measured at the rate that exists at lease commencement. For example leases with payments based on LIBOR would use one current spot rate to measure all lease payments.

5.11 Leases with payments based on an index (for example, CPI) would use the absolute index at lease commencement and not the expected rate of change in that index. Thus, a lease with fixed payment increases of 2% per annum as a proxy for inflation will include such adjustments in the initial measurement, while a lease with rental increases based on changes to CPI (which is expected to increase at the same rate of 2% per annum) will not. In the latter case, subsequent changes to the index will result in an adjustment to the asset and liability once the actual increase is known. The adjustment will affect current and all future periods subject to the escalation.

5.12 Variable lease payments that are not included in the measurement of the lease liability and right-of-use asset (such as usage or performance-based payments) are recognised in profit and loss in the period in which the obligation for those payments is incurred.

PwC observation:

The proposal strikes a balance between the complexity of including contingencies and the concern over structuring opportunities if all contingencies were excluded. The elimination of the requirement to estimate future changes in variable payments using a probability-weighted approach, as proposed in the initial ED, will also improve operationality of the standard.

Step 3) Determine the appropriate discount rate

5.13 A lessee should use the rate it is charged by the lessor, where this is known. The rate the lessor charges the lessee is the discount rate that takes into account the nature of the transaction as well as the terms and conditions of the lease. The rate the lessor charges the lessee could be, for example, the rate implicit in the lease, or the property yield.

5.14 In the absence of knowledge of the rate the lessor is charging, the lessee should use its incremental borrowing rate at the lease commencement date. A lessee's incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

5.15 Both rates should reflect the nature of the transaction and the specific terms of the lease (for example, timing of the lease payments, term, security underlying the lease, the nature of the underlying asset and the economic environment).

PwC observation:

Lessees are not obliged to seek out the rate the lessor is charging in the lease. The rate the lessor is charging is more likely to be identifiable in equipment leases, particularly where the lease contains a residual value guarantee, or where the equipment can also be purchased outright. For other types of leases, including real estate leases with rents based on cost per square foot, the lessee rarely knows the rate that the lessor is charging because it is typically not relevant to negotiations.

Private companies with no third party debt, and group entities where lease arrangements are executed by different subsidiaries, might find determining the incremental borrowing rate more challenging.

Step 4) Identify the additional components of the right-of-use asset

5.16 In addition to the lease liability amount, the following are also included in the lessee's initial measurement of the right-of-use asset at the lease commencement date:

- **Initial direct costs, net of any reimbursements by the lessor:** These costs are defined as costs that are directly attributable to negotiating and arranging a lease that would not have been incurred if the lease transaction had not been entered into. Examples include: commissions, legal fees, payments made to existing tenants to obtain the asset for lease, preparing/processing lease documents and negotiating the lease terms.

- **Lease payments made to the lessor at or before lease commencement, less any lease incentives received from the lessor:** Prior to lease commencement, a lessee should recognise these payments as a prepayment.

- **Embedded derivatives:** A lessee is required to assess whether a lease contains any embedded derivatives and, if they exist, to account for those separately in accordance with IAS 39 or IFRS 9. As such, the guidance remains the same as for current lease accounting. The proposals would not, in themselves, require variable lease payments that depend on an index or rate to be measured at fair value.

5.17 For a worked example of how a lessee initially measures the lease liability and right-of-use asset, refer to example 1 in Appendix C.

Lease classification and subsequent measurement

6.1 Probably the most significant change since the 2010 ED (although it represents less of a change from current requirements) is that the boards are now proposing two different expense recognition patterns for different types of lease: some (termed 'type A' leases) will apply the approach proposed in 2010, similar to current finance lease accounting with its resultant expense front-loading; and others ('type B' leases) will apply a straight-line expense recognition pattern, similar to current operating lease accounting. The approach to be applied will depend on whether the lessee acquires or consumes more than an insignificant portion of the underlying asset. Where this is the case, the lease will be treated as a type A lease; otherwise, it will be treated as type B.

6.2 The following table summarises the proposed model:

Type A	
Interest expense	**Amortisation**
Recognise interest expense by unwinding the present value 'discount' on the lease liability using a constant rate of interest. Interest expense will be reported separately in the income statement.	Recognise amortisation expense on a straight-line basis, unless another systematic basis is more representative of the pattern of consumption of the right-of-use asset. Amortisation will be shown separately in the income statement.
Type B	
Single lease expense	
The total cost (minimum lease payments due under the lease) plus initial direct costs are divided by the initial lease term to produce a constant rent expense over the lease term. The expense is reflected as a single line item in profit and loss. This is achieved as follows: **Lease liability**: Amortisation of the liability is calculated in the same manner as for a type A lease.	

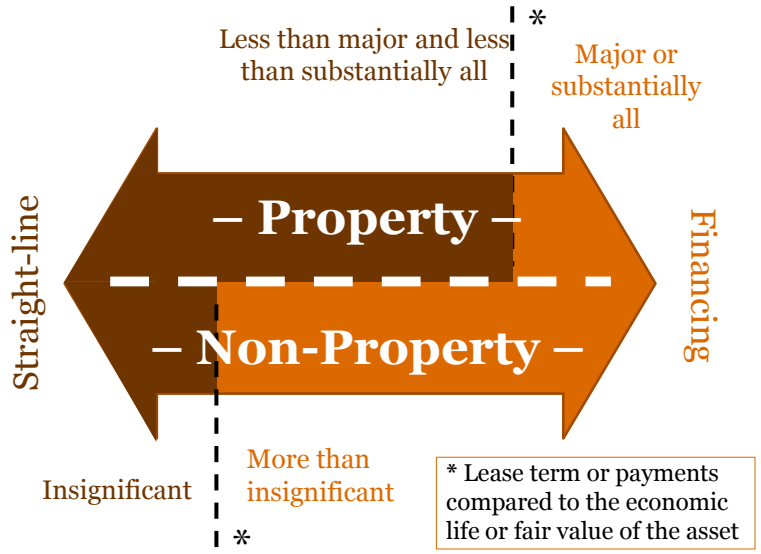
Right-of-use asset: Asset amortisation is a balancing figure, calculated as the difference between the straight-line expense and the amortisation of the discount on the lease liability.

6.3 At the commencement date, the lessor and lessee must classify a lease as either Type A or Type B. This classification should not be reassessed after the commencement date. The classification is based on the lessee's consumption of that asset. Acknowledging the practical difficulties inherent in this approach, the boards have proposed a series of presumptions depending on the nature of the underlying asset. Leases of property (that is, land and/or buildings) should be presumed to be type B while leases of assets other than property (such as vehicles or equipment) should be presumed to be type A. However, these presumptions are rebutted in the circumstances described in the following table.

Asset type	Presumption	The presumption is rebutted if the following factors exist:
Non-property	Type A	The lease term is an insignificant portion of the underlying asset's economic life; or The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.
Property	Type B	The lease term is for the major part of the underlying asset's economic life; or The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

6.4 When classifying a sub-lease, an entity should evaluate the sub-lease with reference to the underlying asset (for example, the property, plant or equipment that is the subject of the lease), rather than the right-of-use asset.

6.5 The following illustration depicts the dual model. In determining which approach to apply, significant judgement will be required for property leases that are on the borderline of 'major part or substantially all' (for example, a 30-year lease of commercial real estate) and those equipment leases that are on the borderline of insignificant (for example, a five-year ship lease).



PwC observation:

The decision to introduce a new dividing line into the model is likely to generate significant interest and debate, given that one of the project's objectives was to remove the existing 'bright-lines' between operating and finance leases. Some of the questions this could generate include:

- What is meant by the phrases 'substantially all' and 'insignificant'? Are they purely quantitative thresholds (for example, 90%, 10%) or is a qualitative analysis needed?
- How broadly should 'property' be interpreted? Should it include assets such as telecommunication towers or advertising hoardings?
- In applying the practical expedient to long-term land leases (for example, those greater than 25 years), a quantitative analysis would likely indicate the lessee is obtaining 'substantially all' of the fair value of the underlying asset and would imply that type A classification is appropriate. However, some may consider this inconsistent with the underlying concept of consumption.

6.6 For a detailed example of how a lessee subsequently measures the lease expense, refer to example 2 in Appendix C.

Lessee reassessment

7.1 **Lease liability:** A lessee should remeasure the lease liability to reflect any changes in the following:

- lease term;
- relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset;
- variable lease payments based on an index or rate used to determine lease payments; or
- amounts expected to be payable under a residual value guarantee.

7.2 The discount rate is reassessed when there is a change in the lease payment due to:

- a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend the lease or purchase the underlying asset; or
- a change in reference interest rates, if variable lease payments are determined using those reference interest rates.

7.3 Changes in the measurement of the lease liability because of a reassessment would be recorded as an adjustment to the right-of-use asset other than in the following circumstances (which should be recognised in the income statement):

- changes in an index or a rate used for variable lease payments that are attributable to the current period; or
- if the carrying amount of the right-of-use asset would be reduced below zero.

7.4 **Reassessing the lease classification:** Lease classification is only reassessed when there is a substantive contract modification. An entity should account for the modified contract as a new contract at the date that the modifications become effective.

7.5 Examples of a substantive change arising from a contract modification include changes to the contractual lease term or to the amount of contractual lease payments that were not part of the original terms and conditions of the lease.

PwC observation:

As noted above, the boards decided that, even though the lease term can change after lease commencement, the lease classification should not be reassessed. The boards compared this situation to current IFRS where, absent a modification, lessees and lessors would not reassess the lease classification for changes in circumstances.

Lease term reassessment

7.6 The lease term would be reassessed if either of the following occurs:

- There is a change in relevant factors that results in the lessee having or no longer having a significant economic incentive to exercise an extension option or not to exercise a termination option. A change in market-based factors in isolation does not trigger reassessment of the lease term.
- The lessee either elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so, or does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

7.7 A lessee would revise the lease payments based on the new lease term or to reflect the change in amounts payable under purchase options or termination penalties.

7.8 A lessee would perform the following steps to reassess the lease liability and right-of-use asset:

Type A Lease	
Step 1)	Calculate the present value of the remaining lease payments over the revised term, using the discount rate at the reassessment date. Compare this amount to the carrying value of the lease liability at the reassessment date and adjust the right-of-use asset by the same amount.
Step 2)	Revise the expense recognition as follows: **Interest expense** will be based on the revised lease liability at the reassessment date. **Amortisation expense** will be revised prospectively over the revised lease term.

Type B Lease	
Step 1)	Same as Type A lease above.
Step 2)	Revise the straight-line expense as follows: a) Adjust the total lease costs for the change in undiscounted lease payments that arose due to the reassessment b) Subtract the expense already recognised from the amount calculated in a) above c) Divide the amount calculated in b) above by the remaining periods in the lease term
Step 3)	Subsequently measure the lease liability and right-of-use asset based on the revised amounts calculated above

7.9 For a detailed example of how a change in lease term should be accounted for, refer to example 3 in Appendix C.

7.10 Reassessment of purchase options would follow the same accounting as discussed above for renewal options. A lessee should determine the revised lease payments on the basis of the new lease term or to reflect the change in amounts payable under the purchase options.

PwC observation:

The requirement to reassess the lease term is a significant change from the 'set it and forget it' model that is currently used. From a practical perspective, changes as a result of a reassessment are likely to be more aligned with the timing of actual business decisions. But the requirement to reassess requires judgement. The ongoing systems and processes that will need to be maintained to produce the data to make those judgements are likely to add to the cost of implementation, particularly for entities with a significant portfolio of lease contracts.

Variable lease payment reassessment

7.11 Variable lease payments will require reassessment as rates and indices change, which may be as often as each reporting period. Reassessing lease payments based on a rate or index will require lessees to re-measure their right-of-use asset and lease obligation, and lessors to re-measure their receivable asset, each time rates and indices change. Lessees would account for this change in profit and loss where it relates to a past or current accounting period and as an adjustment to the right-of-use asset when it relates to a future period. Lessors would account for all changes in the right to receive lease payments due to changes in a rate or an index immediately in the income statement.

7.12 Refer to example 4 in Appendix C for how a lessee should account for a change in rate upon reassessment.

Residual value guarantee reassessment

7.13 Lessees should reassess the amounts payable under a residual value guarantee when events or circumstances indicate that there has been a significant change in the amounts expected to be payable. Lessors include the total guaranteed payment in their receivable recorded at lease commencement, so there is no need to reassess.

Impairment

7.14 Lessees would follow existing guidance on impairment of assets in IAS 36 with respect to right-of-use assets. Lessors would follow the same guidance for assets subject to a Type B lease, as well as for the residual asset recorded under a Type A lease. Loan impairment guidance in IAS 39/IFRS 9 applies to lease receivables recorded under a Type A lease.

PwC observation:

A right-of-use asset accounted for under a Type B lease would have a higher risk of impairment due to the fact that amortisation is slower than that for other comparable assets. This is because amortisation expense for a Type B lease is back-end loaded. If there is an impairment charge for this type of leased asset, the right-of-use asset will be impaired without a corresponding change to the value of the lease liability.

Fair value measurement

7.15 If a leased property meets the definition of an investment property under IAS 40, and an accounting policy to carry investment properties at fair value is chosen, a lessee should measure the right-of-use asset in accordance with the fair value model under IAS 40.

7.15 A lessee may measure right-of-use assets relating to a class of property, plant and equipment at a revalued amount in accordance with IAS 16 if the lessee revalues all assets within that class of property, plant and equipment.

Presentation and disclosure

Presentation

8.1 The following table details the presentation requirements for lessees:

Lessee Presentation Requirements		
Financial Statement	**Type A Lease**	**Type B Lease**
Statement of financial position	Right-of-use assets and lease liabilities are either: • presented separately; or • disclosed within the notes. If the assets and liabilities are not presented separately, the line item that includes the right-of use assets and liabilities must be disclosed. The right-of use asset must be included in the same line item that the leased asset would have been included in if it was owned by the lessee.	The requirements are the same as Type A. However Type A and Type B components should not be combined but should be presented/disclosed separately.
Statement of comprehensive income	Amortisation expense on the right-of-use assets and interest expense on lease liabilities are presented separately.	Amortisation expense on the right-of use assets and interest expense on lease liabilities are combined in a single line item as rent expense.
Statement of cash flows	Each lease payment has a principal and interest component. The interest component is the interest expense associated with the period that covers the payment. The principal payment is the remaining amount. • 'Principal' payments should be classified as financing activities. • 'Interest' payments should be classified in accordance with IAS 7	All cash payments are classified within operating activities.

PwC observation:

Statement of financial position: Most lessees will present the right-of-use asset within property, plant, and equipment. But, for financial institutions, it is not clear how regulators will view the right-of-use asset for the purposes of determining minimum regulatory capital requirements. If regulators view the right-of-use asset as an intangible, it might not be considered an asset included in the denominator of Tier One leverage ratios and would be subject to a higher risk weighting for the risk-based capital ratios.

Statement of comprehensive income: Due to the variety of changes to the statement of comprehensive income (that is, interest expense, amortisation expense, etc), lessees with Type A leases will need to assess the potential impact on covenants, compensation agreements, and other contracts. Such an assessment may require significant time. As such, we suggest companies begin the process well in advance of the effective date.

Statement of cash flows: For Type A leases, the statement of cash flows will become more complex. This is because lease payments will be split between operating and financing cash flows. These changes in classification might require changes to some compliance ratios included in lessees' bank covenant arrangements.

See Appendix B for a summary of the potential impact on a selection of typical key performance measures.

Disclosure

8.2 The proposed model will require more extensive disclosures (both qualitative and quantitative) than under current standards. The principles for both lessees and lessors are that information about the following should be provided:

- information about the nature of the lease arrangements;
- the significant judgements applied to those leases; and
- the amounts recognised in the financial statements.

8.3 Preparers should carefully consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. Disclosures can be aggregated or disaggregated so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

8.4 For a detailed list of the proposed disclosure requirements, refer to Appendix D.

Transition

9.1 Lessors and lessees should recognise and measure all leases (except short-term leases) that exist at the date of initial application. The date of initial application is the start of the earliest comparative period presented in the financial statements in which the lessee first applies the guidance in the revised ED.

9.2 Lessors and lessees must determine the lease type in order to calculate the transition adjustment. All evidence available can be used to classify the lease.

9.3 The revised ED prescribes a modified retrospective approach to transition. But it also allows for lessors and lessees to apply the new guidance on a full retrospective basis.

9.4 The boards decided not to provide relief for leases that are outstanding at the date of transition but that expire prior to the effective date of the new standard. Further, arrangements that currently meet the definition of a lease, but do not meet the definition of a lease in the revised ED, would cease applying lease accounting on the transition date. The arrangement would be reclassified under other existing guidance and a cumulative catch-up adjustment would be recognised in retained earnings.

PwC observation:

The definition of a lease should be applied retrospectively — that is, any contracts in place as of the beginning of the earliest period presented, that are determined to be leases under the revised definition at the transition date, would follow the new rules. The lack of grandfathering for existing leases will mean that extensive data-gathering will be required to inventory all contracts. For each lease, a process will need to be

established to capture information about lease term, renewal options, and fixed and contingent payments. The information required under the revised ED will typically exceed that needed under current IFRS. Depending on the number of leases, the inception dates, and the records available, gathering and analysing the information could take considerable time and effort. Beginning the process early will help to ensure that implementation of the final standard is orderly and well controlled. Management should also be aware of the proposed model when negotiating lease contracts between now and the effective date of a final standard.

Full retrospective approach

9.5 Both lessors and lessees can elect to apply the guidance in the revised ED to each outstanding lease at its commencement date. The guidance in IAS 8 should be followed.

Modified retrospective approach

9.6 **Existing finance leases**: No adjustments to existing assets and liabilities are required. Lessors and lessees will continue to recognise existing carrying amounts at the beginning of the earliest comparative period presented.

9.7 **Existing operating leases**: The following approach is applied by lessees for existing operating leases:

Type A	
Lease Liability	Measure at the present value of the remaining lease payments using the incremental borrowing rate at the effective date.
Right-of use asset	Measure at the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined above. The applicable proportion is the remaining lease term at the beginning of the earliest comparative period presented relative to the total lease term. A lessee should adjust the right-of-use asset recognised by the amount of any previously recognised prepaid or accrued lease payments.
Based on the above, the difference between the lease liability and right-of-use asset is recorded in retained earnings.	

Type B	
Lease Liability	This is calculated in the same manner as the Type A lease.
Right-of use asset	This amount equals the lease liability amount. However, a lessee should adjust the right-of-use asset recognised by the amount of any previously recognised prepaid or accrued lease payments.

9.8 All evidence available (including hindsight) can be used to measure the lease term and variable lease payments at transition. For example, if a lessee exercised a renewal option prior to the effective date of the new standard, it could reflect that throughout the comparative periods without having to determine whether there was ever a significant economic incentive to exercise the option in prior periods. For leases with payments based on an index or rate, this would mean using the actual index or rate that was

applicable during past periods and the index or rate as of the effective date for future periods.

9.9 Lessors and lessees are not required to evaluate initial direct costs for contracts that began before the effective date. Therefore initial direct costs may be excluded from the measurement of the right-of-use asset (or lease receivable for lessors) at transition.

9.10 As noted above, the lessee will use its incremental borrowing rate at the effective date, rather than at the lease commencement date, to measure the lease liability on transition. In selecting the discount rate applicable to a portfolio of leases, a separate discount rate would not be needed for each individual lease; instead, a discount rate would be determined based on some stratification of the portfolio of leases with reasonably similar characteristics, most likely considering remaining lease term and similarity of payment profile. But a lessor would use the rate it charges the lessee at lease commencement as the discount rate.

9.11 For an illustration of the modified retrospective approach to transition from operating lease to Type A lease, refer to example 5 of Appendix C.

PwC observation:

A lessee could record a different straight-line expense on a Type B lease after transition date when compared to prior operating lease accounting because the lease term is assessed as of the transition date and it could be different to the initial lease term assessed under the previous accounting.

The deferred tax implications that will arise on transition as a result of changes that will be made to both the balance sheet and income statement presentation of existing leases need to be considered. The effect on retained earnings of these transition-related deferred tax adjustments, especially for Type A leases, could be significant.

Lessor accounting considerations

10.1 Similar to lessee accounting, the boards are proposing that lessors apply two approaches to accounting for leases. A lessor with a Type A lease (presumed for most leases other than property) would apply the 'receivable and residual' approach described further below. A lessor with a Type B lease (presumed for most leases of property) would apply an approach that is similar to the existing straight-line operating lease accounting, with no derecognition of the underlying asset or gain/loss recognised at lease commencement.

Type A leases - the 'receivable and residual' approach

10.2 Under this approach, the lessor at lease commencement will:

- Derecognise the entire carrying amount of the leased asset.
- Recognise a receivable measured at the present value of the lease payments, discounted at the rate the lessor charges the lessee.
- Recognise a residual asset, measured as an allocation of the carrying amount of the underlying asset. This comprises a gross residual asset and a deferred profit component.

10.3 For the purpose of measuring the lease receivable, lease payments are determined in the same way as for lessees, with one key difference. While lessees include only the portion of any residual value guarantee that they are *expected* to pay, lessors include the total guaranteed amount.

10.4 Under this approach, day one profit is recognised on the portion of the underlying asset conveyed to the lessee via a right-of-use. This profit would be measured as the difference between the present value of the lease receivable and the cost of the underlying asset allocated to the lease receivable. Any profit on the portion of the underlying asset retained by the lessor (related to the lessor's residual interest in the leased asset) would be deferred and only recognised when the residual asset is sold or re-leased. If the underlying asset is re-leased, a new lease calculation for profit to be recognised over the new lease term is performed, with a portion of the remaining profit deferred. If the underlying asset is sold at the end of the lease term, the remaining profit would generally be recognised.

10.5 The lease receivable is subsequently measured using the effective interest rate method and would be subject to the same impairment assessment as any other financial asset. Interest would also be recognised on the gross residual asset.

10.6 Detailed worked examples for the initial and subsequent measurement of a Type A lease can be found in examples 6 and 7 in Appendix C.

Type B leases - the lessor accounting approach similar to operating lease accounting

10.7 Under this approach:

- The underlying leased asset remains on the lessor's balance sheet.
- No lease receivable or gain/loss is recorded at lease commencement.
- Rental revenue is recognised on a straight-line basis over the lease term, or another systematic basis if that is more representative of the pattern in which income is earned.

Presentation and disclosure

10.8 The table below details the presentation requirements for lessees:

Lessor Presentation Requirements		
Financial Statement	**Type A Lease**	**Type B Lease**
Statement of financial position	Present lease assets (that is, the sum of the lease receivable and residual asset) separately from other assets. The separate carrying amounts are presented either in the statement of financial position or in the notes.	Present the underlying asset in accordance with other applicable standards
Statement of comprehensive income	Present the profit or loss recognised at lease commencement in a manner that best reflects the lessor's business model: • Revenue and cost of sales if the lessor uses leases as an alternative means of realising value from assets that it would otherwise sell;	Income is recognised on a straight-line basis over the lease term, or another systematic basis if that is more representative of the pattern in which income is earned. Initial direct costs are recognised as an expense on the same basis as lease income.

	• Single line item if lessor uses leases as a means of providing finance. The ED does not specify where income earned over the lease term should be presented.	
Statement of cash flows	All cash receipts are classified within operating activities.	All cash receipts are classified within operating activities.

10.9 For a detailed list of the proposed disclosure requirements, refer to Appendix D.

Transition

10.10 As noted in section 9 above, the revised ED prescribes a modified retrospective approach, but lessees and lessors can elect to apply the guidance in the revised ED on a full retrospective basis to each outstanding lease at its commencement date. If a full retrospective approach is applied, the guidance in IAS 8 should be followed.

Modified retrospective approach

10.11 **Existing finance leases:** Lessors must classify existing assets held under a finance lease (net investment in the lease) as lease receivables arising from Type A leases and subsequently measure the lease receivables in accordance with the revised ED's proposed requirements. If a modification to the contractual terms and conditions of any of those leases results in a substantive change to the lease, lessors should account for the lease as a new lease in accordance with the revised ED's proposed requirements.

10.12 **Existing operating leases:** The following approach is applied by lessors for existing operating leases:

Type A	
Underlying asset	Derecognise the underlying asset, adjusted by the amount of any previously recognised prepaid or accrued lease payments.
Lease receivable	Measure at the present value of the remaining lease payments, discounted using the rate the lessor charges the lessee determined at the commencement date, subject to any adjustments required to reflect impairment.
Residual asset	Measure the residual asset in accordance with the revised ED's proposed requirements for normal Type A leases.

For existing operating leases that are classified as Type B leases, lessors will continue to recognise existing carrying amounts at the beginning of the earliest comparative period presented.

Lessor Application issues

10.13 Given that the principle for determining which lessor accounting approach should be used is the same as that used for determining lessee accounting, the application issues for lessors are likely to mirror those for lessees. These include determining what is significant and insignificant, how broadly the term 'property' should be defined and application of the guidance for arrangements involving multiple assets.

Business combinations

11.1 Both lessors and lessees should account for a lease acquired in a business combination as a new lease at the acquisition date.

11.2 If the acquiree is a lessee, the acquirer should recognise a liability to make lease payments and a right-of-use asset. The acquirer should measure:

- the liability as the present value of remaining lease payments at the acquisition date.
- the lessee's right-of-use asset at the same amount as the lease liability, adjusted for any off-market terms in the lease contract and any other intangible assets associated with the lease (for example, a lease of gates at an airport or retail space in a prime shopping area that might provide entry into a market or other future economic benefits).

11.3 Similarly, if the acquiree is a lessor with Type A leases, the acquirer should recognise a receivable and a residual asset. The acquirer should measure:

- the receivable at the present value of remaining lease payments at the acquisition date.
- the residual asset as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable. The acquirer should take into account the terms and conditions of the lease in calculating the acquisition-date fair value of the underlying asset (that is, the acquirer does not recognise a separate asset or liability in respect of off-market lease terms).

11.4 Where the acquiree is a lessor with Type B leases, the acquirer should take into account the terms and conditions of the lease in calculating the acquisition-date fair value of the underlying asset (that is, the acquirer does not recognise a separate asset or liability in respect of off-market lease terms).

11.5 If the acquiree has short-term leases, the acquirer should not recognise separate assets or liabilities related to the lease contract at the acquisition date. Determining whether a lease qualifies for the short-term lease exception will be based on the maximum remaining term at the date of acquisition (that is, leases with a maximum possible term of 12 months or less at the acquisition date will meet the definition of a short-term lease).

11.6 If an entity has previously recognised an asset or liability in respect of favourable or unfavourable terms of an operating lease acquired as part of a business combination, it must:

- derecognise those assets and liabilities; and
- adjust the carrying amount of the right-of-use asset by a corresponding amount.

Sale and leaseback transactions

12.1 In order to determine whether a transaction is accounted for as a sale and leaseback, it is first necessary to determine whether a sale has occurred. Entities would apply the control criteria in the exposure draft on revenue from contracts with customers to determine whether a sale has occurred.

12.2 The existence of a leaseback does not, in isolation, prevent the transferee/lessor from obtaining control of the underlying asset. But, if the leaseback provides the transferor/lessee with the ability to direct the use of and obtain substantially all of the remaining benefits from the underlying asset, the transferee/lessor does not obtain control of the underlying asset and the transfer is not a sale. For this purpose, the

transferor/lessee is considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, if either of the following conditions are met:

- the lease term is for the major part of the remaining economic life of the asset; or
- the present value of the lease payments accounts for substantially all of the fair value of the asset.

12.3 If a sale has not occurred, the entire transaction would be accounted for, by both lessee and lessor, as financing.

PwC observation:

The criteria for determining whether the transferor/lessee has retained control of the underlying asset are similar to those for identifying property transactions that may be classified as Type A leases. In practice, this may mean that some leases currently accounted for as sale and finance leaseback transactions will instead be treated as financing transactions within the scope of the financial instruments standards.

12.4 When a transaction is accounted for as a sale and leaseback, both the sale and the lease are accounted for in accordance with the relevant standards. When the consideration received for the sale does not equal the fair value of the asset sold, or the lease payments are not at market rates:

- the transferor/lessee should measure the right-of-use asset and the gain or loss on disposal of the underlying asset to reflect current market rates for lease payments for that asset, and subsequently account for the lease to reflect those current market rates.

- the transferee/lessor should measure the lease receivable and the residual asset for Type A leases, or the underlying asset for Type B leases, to reflect current market rates for lease payments for that asset, and subsequently account for the lease to reflect those current market rates.

Transition

12.5 The transition requirements depend on how the lease was originally accounted for.

- **Sale/Finance lease:** The existing lease accounting will run its course without any transition adjustments. The deferred gain or loss that was previously recognised will continue to be amortised.

- **Sale/Operating lease or the transaction did not achieve sale accounting under existing IFRS:** Both the seller/lessee and buyer/lessor would reevaluate the sale transaction on transition in accordance with the proposed revenue recognition guidance. If the sale conditions are met, the seller/lessee should measure the right-of-use asset and lease liability under the ED. Any deferred gain remaining on the balance sheet at the transition date would be recognised in opening retained earnings upon transition.

Disclosure

12.6 A transferor/lessee that enters into a sale and leaseback transaction must:

- disclose the terms and conditions of that transaction; and
- identify any gains or losses arising from the transaction separately from gains or losses on other disposals of assets.

PwC observation:

Seller/lessees that completed a sale and leaseback transaction under existing IFRS that resulted in an operating lease are likely to be concerned with the proposed transition accounting. This is because any deferred gain on the original sale and leaseback will be reclassified into retained earnings at the transition date and will not provide the lessor with any future income over the remaining term of the lease.

Sub-leases

12.7 Sub-leases would be accounted for as two separate transactions. That is, a sub-lessor would use lessee accounting on the head lease and lessor accounting on the sub-lease.

Consequential amendments to IAS 40

13.1 The revised ED proposes consequential amendments to IAS 40 that widen the scope of that standard as it relates to leased property meeting the definition of investment property. Currently, IAS 40 must be applied to investment property that a lessee holds under a finance lease. Where a lessee holds investment property under an operating lease, it is permitted (but not required) to apply IAS 40 in accounting for that property interest. This choice is available on a property-by-property basis. However, if the lessee chooses to apply IAS 40, the fair value model must be applied to that leased property and all other investment property held by the lessee.

13.2 The consequential amendments remove this choice, such that IAS 40 would be applied to any leased asset that meets the definition of investment property. The amendments would also mean the choice between applying IAS 40's cost or fair value models would not be affected by whether a lessee has chosen to account for particular leased assets as investment property, as is the case currently. Where an entity opts to apply IAS 40's cost model, the requirements of the revised ED would be applied to right-of-use assets arising from leased investment property. Fair value disclosures required by IAS 40 where an entity adopts the cost model would equally be required for those right-of-use assets.

13.3 The proposed amendments will likely result in an increase in leased property interests being classified and accounted for as investment property. For example, a lessee may sub-let property held under an operating lease to a third party because the property is surplus to its requirements. Under current IFRS, whilst the lease interest meets the relevant parts of the investment property definition (that is, property that is held to earn rentals), the lessee would not be required to account for it as such. However, the proposed amendments would require the related right-of-use asset to be classified and measured as investment property under IAS 40.

Will convergence be achieved?

14.1 The FASB and IASB are aligned on most key decisions, although some US GAAP / IFRS differences will remain relating to guidance that interacts with the proposals.

The path forward

15.1 The revised ED has a 120 day comment period. Comments are due by 13 September 2013. We encourage management to engage in the comment letter process and we suggest that companies respond formally to the questions included in the revised ED.

15.2 The boards are expected to begin re-deliberations in the final quarter of 2013 after the comment period has ended, with a view to issuing a final standard in 2014.

If you have questions about the proposals in the revised ED or require further information, speak to your regular PwC contact.

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Appendix A Key changes from existing IFRS

The table below summarises the key changes from existing IFRS.

	Key changes from existing IFRS	
Topic	**Proposals**	**Observations**
Identifying a lease	A lease is present where an arrangement provides 'control' over an 'identified asset'.	While the definition of a lease is essentially unchanged, guidance to determine whether an arrangement contains a lease is more detailed, and is likely to be more important since virtually all leases will require recognition of an asset and liability.
Lease classification	Leases are classified as 'Type A' or 'Type B' on the basis of whether the lessee expects to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. Leases of property are presumed to be Type B while all other leases are presumed to be Type A.	Judgement will be required to determine whether leases are 'property' or 'non property.' The inclusion of a rebuttable presumption (based on the nature of the asset) will help, but the difference between 'property' and 'non-property' may not follow current practice or even existing legal definitions. In practice, almost all equipment leases currently classified as operating leases will be classified as Type A and so will be accounted for similarly to current finance leases. This will have an impact on the profile of reported profits over the term of the lease, and significantly affect key measures such as EBITDA.
Balance sheet recognition and initial measurement	Lessees will recognise a right-of-use asset and a liability (both measured initially at the present value of the future lease payments) for virtually all leases. Initial accounting by lessors depends on the lease classification: • **Type A:** the lessor derecognises the leased asset and recognises both a receivable and a residual asset. The receivable is measured at the present value of future lease payments, while the residual asset is measured at the present value of the	The elimination of off-balance sheet treatment for leases currently classified as operating will represent a significant change for lessees.

	estimated residual value of the leased asset at the end of the lease term, net of any deferred profit allocated to the residual asset. • **Type B:** the lessor continues to recognise the underlying asset.	
Income and expense recognition and presentation	Income and expense recognition will depend on the lease classification. <u>Lessees</u> • **Type A:** lessees will recognise both interest on the lease liability and amortisation of the right-of-use asset, similar to current finance lease accounting. • **Type B:** lessees will recognise a single expense normally on a straight line basis over the lease term, similar to current operating lease accounting. <u>Lessors</u> • **Type A:** lessors will recognise a portion of the profit (if any) from the 'sale' of the right-of-use asset at the commencement of the lease, and recognise interest income on both the receivable and residual asset over the lease term. • **Type B** Lessors will recognise income on a straight line basis over the lease term, similar to current operating lease accounting.	The patterns of income and expense recognition will be similar to current finance and operating lease accounting. But, as noted above, lessees will be required to recognise almost all leases on the balance sheet and the basis for classifying leases will be different.
Disclosure	The revised ED proposes more extensive disclosure – both qualitative and quantitative – than under current standards.	Whilst the proposed disclosure requirements are extensive, management might wish to supplement these with information about the impact of the new proposals on key performance indicators.

Appendix B Impact on KPIs

The following has been extracted from Appendix A of the Basis for Conclusions of the revised ED:

Effect of the proposals on key financial ratios of a lessee with operating leases (IASB-only)

These ratios are based on the information that would be reported in accordance with IAS 17 and with this Exposure Draft and do not take into account any subsequent adjustments to reported amounts that would be made by users. Those adjustments may mean that the changes arising from these proposals are less pronounced. The table compares the accounting for leases classified as operating leases according to IAS 17 with the accounting for Type A and Type B leases according to the proposals.

Name of ratio	What it measures	How it is calculated	Applicable to which class of leases	Expected effect using reported information	Explanation
Gearing	long-term	liabilities/equity	All	increase	increase because reported debt increases (and equity would decrease for Type A leases)
Current ratio	liquidity	current assets/current liabilities	All	decrease	decrease because lease liabilities would increase while current assets would not
Asset turnover	profitability	sales/total assets	All	decrease	decrease because lease assets will be reported
Interest cover	long-term solvency	profit before interest and tax/interest expense	Type A (no change for Type B)	depends	depends on whether the ratio of lease amortisation/lease interest expense is higher or lower than the existing ratio (short-term leases have higher ratios than long-term leases), and on the proportion of total interest that relates to lease interest (higher proportion will have a larger effect)
EBIT	profitability	profit before Interest and tax	Type A (no change for Type B)	increase	increase because the amortisation added is lower than the operating lease expense eliminated

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Name of ratio	what it measures	How it is calculated	Applicable to which class of leases	Expected effect using reported information	Explanation
EBITDA	profitability	profit before interest, tax, depreciation and amortisation	Type A (no change for Type B)	increase	increase because there will be no operating lease expense included
EBITDAR	profitability	profit before interest, tax, depreciation amortisation and operating lease expense	All	no change	no change because all lease-related expenses excluded
Operating profit	profitability	n/a	Type A (no change for Type B)	increase	increase because the amortisation added is lower than the operating lease expense eliminated, ie interest would be reported below the operating profit line
Net income	profitability	n/a	Type A (no change for Type B)	depends	depends on the characteristics of the lease portfolio and the tax rate
EPS	shareholder	net income/number of shares in issue	Type A (no change for Type B)	depends	depends on the effect on net income, which depends on characteristics of the lease portfolio and the tax rate
ROCE	profitability	EBIT/total assets less current liabilities	All	depends	the ROCE ratio may need to be adjusted because lease assets reported are not comparable with purchased assets for leases shorter than the economic life of the underlying asset – ie for those leases, the lease asset reported will be smaller than the asset reported if the underlying asset were purchased. For Type B leases, the entire lease expense will also be included in EBIT (ie part of the lease payments is not reported as interest) whilst the lease liability is a financial liability

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Name of ratio	What it Measures	How it is calculated	Applicable to which class of leases	Expected effect using reported information	Explanation
ROE	profitability	net Income/equity	Type A (no change for Type B)	depends	depends on the effect on net income, which depends on the lease portfolio – if there is no effect on net income, then the ratio will be higher because reported equity will decrease
Operating cash Flow	profitability	n/a	Type A (no change for Type B)	increase	increase because at least part of the lease payments (those payments relating to the principal) will be moved to the financing section
Net cash flow	profitability	n/a	All	no change	no change because the proposals do not affect cash

Appendix C Examples of applying the proposed models

This Appendix provides the following illustrative examples of applying the proposed models in the revised ED :

Example 1: Lessee initial measurement

Example 2: Lessee expense recognition

Example 3: Lessee lease term reassessment

Example 4: Lessee reassessment based on changes in an index

Example 5: Modified retrospective approach: existing lessee operating lease

Example 6: Initial measurement of lessor receivable and residual

Example 7: Subsequent measurement of lessor receivable and residual

Example 1: Lessee initial measurement

Background: On 1 January 20x0, entity A (the 'lessee') enters into a contract to lease factory space from entity B (the 'lessor').

Key Terms of the lease contract	
Lease commencement date	1 January 20x0
Initial lease term	5 years
Extension option	3 years
Annual contractual payments in the initial term	C110,000 (The annual payment includes C10,000 per year for executory costs.)
Annual lease payments in the extension period	At fair market value. There are no renewal penalties or qualitative factors that indicate the lessee has a significant economic incentive to renew.
Payment date	31 December of each year
Initial direct costs	C10,000
Discount rate	The lessee does not know the rate implicit in the lease
Variable payment based on changes in the Consumer Price Index ('CPI')	The annual lease payment increases in line with the annual increase in CPI. The payment is based on the CPI on 1 January of the same year. For example, the payment due on 31 December 20x0 is based on the CPI rate at 1 January 20x0. The CPI rate at lease commencement is 120.
Variable payment based on sales	An additional lease payment of 1% of annual sales from the product generated by the lease equipment is due on each lease payment date.

Issue: How should the lessee initially measure the lease liability and right-of-use asset?

Analysis: The lessee calculates the initial lease liability and right-of-use-asset by performing the following:

Step 1) Determine the lease term: Based on conditions that exist at the commencement date, the lessee determines that it does not have a significant economic incentive to exercise the extension option; therefore the lease term is five years.

Step 2) Identify the lease payments: The annual contractual payment is C110,000. However, C10,000 of each annual payment is for executory costs. The amount allocated to the executory costs is not included in the measurement of the lease liability. Therefore, the payments to be used for initial measurement are the annual payments allocated to the lease of the space, which is of C100,000 due on 31 December of each year. The variable payments based on sales are not included because they are not based on a rate or an index.

Step 3) Determine the discount rate: The lessee does not know the interest rate implicit in the lease agreement, so it will use its incremental borrowing rate for similar terms as in the lease (amount, term, and collateral) which is 5%.

Step 4) Identify the additional components of the right-of use asset: The lessee paid initial direct costs of C10,000.

The amounts recorded on the balance sheet on 1 January 20x0 are as follows:

Lease liability is C432,948, calculated as follows:

Payments made at the end of each year						
Year	*1*	*2*	*3*	*4*	*5*	***Total***
Payment	100,000	100,000	100,000	100,000	100,000	**500,000**
Discount	4,762	9,297	13,616	17,730	21,647	**(67,052)**
Present value	95,238	90,703	86,384	82,270	78,353	**432,948**

Right-of-use asset is C442,948, calculated as follows:

Component	Amount
Lease Liability	432,948
Initial Direct Costs	10,000
Total right-of-use asset	**442,948**

Example 2: Lessee expense recognition

Background: Assume the same facts as in example 1 for initial measurement.

Issue: How should the lessee recognise expense?

Analysis: For the purposes of this example, both Type A and Type B expense recognition will be shown.

Type A

Interest expense: The table below details the interest expense calculation for each year.

Year	Lease payment balance	Discount	Liability Beginning Balance	**Interest expense**	Lease payment	Liability Ending Balance
1	500,000	67,052	432,948	**21,647**	100,000	354,595
2	400,000	45,405	354,595	**17,730**	100,000	272,325
3	300,000	27,675	272,325	**13,616**	100,000	185,941
4	200,000	14,059	185,941	**9,297**	100,000	95,238
5	100,000	4,762	95,238	**4,762**	100,000	-

Amortisation expense: The lessee has concluded that it expects to consume the right-of-use asset's future economic benefits evenly over the lease term. Therefore, the annual straight-line amortisation is as follows:

	Year				
Component	*1*	*2*	*3*	*4*	*5*
Beginning balance	442,948	354,358	265,769	177,179	88,590
Annual amortisation	**88,590**	**88,590**	**88,590**	**88,590**	**88,590**
Ending balance	354,358	265,769	177,179	88,590	0

Total annual interest and amortisation expense based on the CPI index at lease inception is as follows:

Expense Type			
Year	*Interest*	*Amortisation*	*Total*
1	21,647	88,590	110,237
2	17,730	88,590	106,319
3	13,616	88,590	102,206
4	9,297	88,590	97,887
5	4,762	88,590	93,351
Total	**67,052**	**442,948**	**510,000**

Variable payments: Variable lease payments associated with sales will be expensed in the period incurred. The lease liability must be reassessed each period for the change in CPI. See example 4 for this illustration.

Type B

For a Type B lease, a lessee will show a single lease expense on the statement of comprehensive income. The annual single lease expense will be the straight-line amount of the lease costs calculated as follows:

Component	Lease Cost (a)	Lease Term (b)	Straight-line expense (a)/(b)
Lease payments	500,000	5	100,000
Initial direct cost	10,000	5	2,000
Total lease cost	**510,000**		**102,000**

However, the single lease expense must be allocated to amortisation of the discount on the lease liability and the right-of-use asset. See below for details.

Lease liability: The lease liability is subsequently measured in the exact same fashion as the Type A lease. Therefore, the interest component of the straight-line expense will be the same as for the Type A lease in the example above.

Right-of-use asset: The right-of-use asset "amortisation" is based on the liability adjustment ("interest" component in the table below) and the straight-line expense calculated above. See the table below for details.

Year	Asset beginning balance	"Interest" component (d)	Straight-line expense (e)	"Amortisation" component (e) – (d)	Asset ending balance
1	442,948	21,647	102,000	80,353	362,595
2	362,595	17,730	102,000	84,270	278,325
3	278,325	13,616	102,000	88,384	189,941
4	189,941	9,297	102,000	92,703	97,238
5	97,238	4,762	102,000	97,238	-

Variable payments: Variable lease payments associated with sales will be expensed in the period incurred. The lease liability must be reassessed each period for the change in CPI. See example 4 for this illustration.

Example 3: Lessee lease term reassessment

Background: Assume the same facts as in examples 1 and 2 for initial measurement and subsequent measurement. As noted in example 1, the lessee did not have a significant economic incentive to exercise the 3 year extension option at the lease commencement date. But, on 31 December 20x2 (the last day of year 3 of the lease), the lessee installed a large piece of unique equipment into the factory with an estimated 5 year economic life. The lessee determined that its investment in this equipment is of such significance that it will only recover the cost of the equipment if it exercises the extension option. Therefore, on the equipment installation date, the lease term is reassessed to be 8 years instead of 5 years. Annual lease payments in the extension period are assumed to be at fair value of C110,000. For the purposes of this example, CPI increases in the lease payments have been ignored.

The lessee's incremental borrowing rate based on the revised term of the lease is 6% on 31 December 20x2. The initial discount rate used in example 1 was 5%.

Issue: How should the change in lease term be accounted for?

Analysis: This example will illustrate the accounting for both a Type A and Type B lease.

Type A

The lessee must do the following based on the date that it determines that there is a significant economic incentive to exercise the extension option. In this example, the relevant date is 31 December 20x2 (that is, the end of year 3 of the lease).

1. Calculate the adjustment to the lease liability and the right-of-use asset:

The lease liability is recalculated based on the present value of the remaining future lease payments for the new lease term using the revised discount rate of 6%. The new term is now eight years. The reassessment occurred at the end of year 3, so the next payment occurs at the end of year 4. The revised lease liability is C445,026, calculated as follows:

Payments made at the end of each year						
Year	*4*	*5*	*6*	*7*	*8*	*Total*
Payment	100,000	100,000	110,000	110,000	110,000	530,000
Discount	5,660	11,000	17,642	22,870	27,802	84,974
Present value	94,340	89,000	92,358	87,130	82,198	445,026

The adjustment is calculated as follows:

Component	Amount
Revised liability balance per above	445,026
Liability balance at the end of year 3 *(see example 2 for this balance)*	185,941
Adjustment	**259,085**

The adjustment is recorded as follows:

Journal Entry	Debit	Credit
Right-of-use asset	259,085	
Lease liability		259,085

2. **Revise the expense recognition:** The interest and amortisation expense will change based on the revised terms and discount rate. The changes are shown below. There will be no change to the variable lease payments as discussed in example 2.

Interest expense: The interest expense would be updated to reflect the revised discount rate and lease term, as follows:

Year	Lease payment balance	Discount	Liability Beginning Balance	Interest expense	Lease payment	Liability Ending Balance
4	530,000	84,974	445,026	26,702	100,000	371,728
5	430,000	58,272	371,728	22,304	100,000	294,031
6	330,000	35,969	294,031	17,642	110,000	201,673
7	220,000	18,327	201,673	12,100	110,000	103,774
8	110,000	6,226	103,774	6,226	110,000	-

Amortisation expense: The revised straight-line amortisation is as follows:

Component	Amount
Original asset balance at the end of year 3 *(see example 2 for this amount)*	177,179
Adjustment calculated above	259,085
Total revised balance	**436,264**
Revised remaining lease term	5
Annual amortisation	**87,253**

The balance of the right-of-use asset at each period end is as follows:

	Year				
Component	*4*	*5*	*6*	*7*	*8*
Beginning Balance	436,264	349,011	261,758	174,506	87,253
Annual Amortisation	87,253	87,253	87,253	87,253	87,253
Ending Balance	349,011	261,758	174,506	87,253	-

Type B

The lessee must perform the following steps based on the date that it determines that there is a significant economic incentive to exercise the extension option. In this example, the relevant date is 31 December 20x2 (that is, the end of year 3 of the lease).

1. **Calculate the adjustment to the lease liability and the right-of-use asset:** The adjustment to the lease liability and the right of use asset is the same as in a Type A lease discussed above. Therefore, the revised lease liability is C445,026. The revised right-of-use asset is as follows:

Component	Amount
Right-of-use asset at the end of year 3 *(see example 2 for this balance)*	189,941
Adjustment per above	259,085
Revised right-of-use asset balance	**449,026**

2. **Recalculate the straight-line expense:** The single lease expense will change based on the revised term. The changes are shown below. As in the Type A lease, there will be no change to the variable lease payments as discussed in Example 2.

   a. The lessee must first adjust the initial total lease costs for the change in undiscounted lease payments that arose due to the change in the lease term. This is calculated as follows:

Component	Amount
Initial lease payments	500,000
Initial direct costs	10,000
Additional lease payments in the extension period	330,000
Total revised lease costs	**840,000**

   b. Next, the lessee recalculates the straight-line lease expense based on the revised total lease cost and term as follows:

Component	Amount
Total revised lease costs per above	840,000
Less lease costs already recognised	306,000*
Adjusted lease costs	**534,000**
Revised remaining lease term	5
Revised straight-line expense	**106,800**

*Lease costs already recognised in this example is calculated as follows:

Component	Amount
Initial annual straight-line lease expense	102,000
Annual periods with expense recognised	3
Total lease costs already recognised	**306,000**

3. **Subsequent measurement:**

The lessee would subsequently measure the lease liability in the same manner as for the Type A lease shown above. The lessee would subsequently measure the right-of-use asset as follows:

Year	Asset beginning balance	"Interest" expense	Straight-line expense	"Amortisation" expense	Asset ending balance
4	449,026	26,702	106,800	80,098	368,928
5	368,928	22,304	106,800	84,496	284,431
6	284,431	17,642	106,800	89,158	195,273
7	195,273	12,100	106,800	94,700	100,574
8	100,574	6,226	106,800	100,574	-

Example 4: Lessee reassessment based on changes in an index

Background: Assume the same facts as in examples 1 and 2 for initial measurement and subsequent measurement. As noted in example 2, the CPI rate at lease inception (1 January 20x0) was 120 and the first annual payment due on 31 December 20x0 was based on this CPI rate. The next annual payment is due on 31 December 20x1 and the amount due is based on the CPI rate at 1 January 20x1. The CPI rate at 1 January 20x1 is 125.

Issue: How should the change in CPI rate be accounted for?

Analysis: This example will illustrate the accounting for both Type A and Type B leases.

Type A

The lessee must do the following on the date of the CPI change (1 January 20x1).

1. Calculate the adjustment to the lease liability and the right-of-use asset:

First, the future lease payments are calculated based on the new CPI rate of 125 as follows:

CPI at 1 January 20x1	125
CPI at 1 January 20x0	120
Change in index	(5)
% Change	4%
Annual lease payment in prior year	100,000
Revised annual lease payment based on % change in CPI	104,000

Next, the lease liability is recalculated based on the present value of the revised future lease payments of C104,000. The discount rate of 5% used at lease inception is still used to determine the present value of these payments. The revised lease liability at 1 January 20x1 is C368,779, calculated as follows:

	Payments made at the end of each year				
Year	*2*	*3*	*4*	*5*	*Total*
Revised payments	104,000	104,000	104,000	104,000	416,000
Present Value Discount	4,952	9,669	14,161	18,439	47,221
Present value	99,048	94,331	89,839	85,561	368,779

The adjustment is calculated as follows:

Component	Amount
Revised liability balance per above	368,779
Liability balance at the end of year 1 *(see example 2 for this balance)*	354,595
Adjustment	**14,184**

The adjustment is recorded as follows:

Journal Entry	Debit	Credit
Right-of-use asset	14,184	
Lease liability		14,184

2. **Revise the expense recognition:** The interest and amortisation expense will change based on the revised lease payments. The changes are shown below.

Interest expense: The revised interest expense based on the new CPI rate is as follows:

Year	Lease payment balance	Discount	Liability Beginning Balance	Interest expense	Lease payment	Liability Ending Balance
2	416,000	47,221	368,779	18,439	104,000	283,218
3	312,000	28,782	283,218	14,161	104,000	193,379
4	208,000	14,621	193,379	9,669	104,000	99,048
5	104,000	4,952	99,048	4,952	104,000	-

Amortisation expense: The revised straight-line amortisation is as follows:

Component	Amount
Original asset balance at the end of year 1 *(see example 2 for this amount)*	354,358
Adjustment calculated above	14,184
Total revised balance	**368,542**
Remaining lease term	4
Annual amortisation	**92,135**

The balance of the right-of-use asset at each period end is as follows:

	Year			
Component	*2*	*3*	*4*	*5*
Beginning balance	368,542	276,406	184,271	92,135
Annual amortisation	92,135	92,135	92,135	92,135
Ending balance	**276,406**	**184,271**	**92,135**	**-**

Type B

The lessee must do the following on the date of the CPI change (that is, 1 January 20x1).

1. **Calculate the adjustment to the lease liability and the right-of-use asset:** The adjustment to the lease liability and the right of use asset is the same as for a Type A lease discussed above. Therefore, the revised lease liability is C368,779. The revised right of use asset is as follows:

Component	Amount
Right of use asset at the end of year 1 *(see example 2 for this balance)*	362,595
Adjustment per above	14,184
Revised right-of-use asset balance	376,779

2. **Recalculate the straight-line expense:** The single lease expense will change based on the revised payments. The changes are shown below.

   a. The lessee must first adjust the initial total lease costs for the change in undiscounted lease payments that arose due to the change in the lease term. This is calculated as follows:

Component	Amount
Initial lease payments	500,000
Initial direct costs	10,000
Additional lease payment based on increased CPI rate *(C4,000 annual increase x 4 years)*	16,000
Total revised lease costs	**526,000**

   b. Next, the lessee recalculates the straight-line lease expense based on the revised total lease cost as follows:

Component	Amount
Total revised lease costs per above	526,000
Less lease costs already recognised	102,000*
Adjusted Lease Costs	**424,000**
Remaining lease term	4
Revised straight-line expense	**106,000**

*Lease costs already recognised in this example is calculated as follows:

Component	Amount
Initial annual straight-line lease expense (see example 2)	102,000
Annual periods with expense recognised	1
Total lease costs already recognised	**102,000**

3. **Subsequent measurement**:

The lessee would subsequently measure the lease liability in the same manner as for the Type A lease shown above. The lessee would subsequently measure the right-of-use asset as follows:

Year	Asset beginning balance	"Interest" expense	Straight-line expense	"Amortisation" expense	Asset ending balance
2	376,779	18,439	106,000	87,561	289,218

3	289,218	14,161	106,000	91,839	197,379
4	197,379	9,669	106,000	96,331	101,048
5	101,048	4,952	106,000	101,048	-

Example 5: Modified retrospective approach: existing lessee operating lease

Background: Assume that the effective date of the proposed guidance is 1 January 20x1. A lessee has an existing operating lease with the following terms:

Key Terms	
Lease Commencement Date	1 January 20x0
Initial Lease Term	5 years
Annual lease payments for the first two years	100,000
Annual lease payments for the last three years	110,000
Payment date	31 December of each year
Initial direct costs	10,000
Accrued rent balance at 1 January 20x1	6,000
Discount rate at the effective date	5%

Issue: How should the lessee record the lease at the effective date of 1 January 20x1?

Analysis: The lessee first needs to determine the lease classification (that is, Type A/Type B) based on the proposed guidance. Assume for the purposes of this example that it is a Type A lease. Next, the lessee initially measures the lease liability and right-of-use asset at the transition date.

Lease liability is C380,531 calculated as follows:

	Payments made at the end of each year				
Year	*20x1*	*20x2*	*20x3*	*20x4*	*Total*
Payment	100,000	110,000	110,000	110,000	430,000
Discount	4,762	10,227	14,978	19,503	49,469
Present value	95,238	99,773	95,022	90,497	380,531

Right-of-use asset is calculated based on the following steps:

Step 1: Calculate an average of the remaining lease payments:

Payment Date	Annual lease payments
31 December 20x1	100,000
31 December 20x2	110,000
31 December 20x3	110,000
31 December 20x4	110,000
Total lease payments	**430,000**
Remaining lease term	4
Average remaining lease payments	107,500

Step 2: Determine the present value of the average lease payments for the entire lease term as of the effective date to determine the estimated commencement date lease liability:

	Payments made at the end of each year					
Year	*20x0*	*20x1*	*20x2*	*20x3*	*20x4*	*Total*
Payment	107,500	107,500	107,500	107,500	107,500	537,500
Discount	5,119	9,994	14,637	19,059	23,271	72,081
Present value	102,381	97,506	92,863	88,441	84,229	465,419

Step 3: Multiply the amount calculated in step 2) by the remaining lease term:

Estimated commencement date lease liability per above		465,419
Remaining lease term	X	4
		1,861,675

Step 4: Divide the amount calculated in step 3) by the entire lease term

Amount calculated above	1,861,675
Divided by the initial lease term	5
Right of use asset before accrued rent adjustment	372,335

Based on the above, the lessee records the following journal entries:

Account	Debit	Credit
Right-of-use asset	372,335	
Retained earnings		8,196
Lease liability		380,531
Accrued rent	6,000	
Right-of-use asset		6,000

Example 6: Initial measurement of lessor receivable and residual

Background: On 1 January 20x0, entity A (the 'lessee') enters into a contract to lease a large piece of equipment used in entity A's manufacturing process from entity B (the 'lessor').

Key Terms of the lease contract	
Lease commencement date	1 January 20x0
Initial lease term	5 years
Extension option	3 years
Annual contractual payments in the initial term	C110,000 (The annual payment includes C10,000 per year for executory costs.)
Annual lease payments in the extension period	At fair market value. There are no renewal penalties or qualitative factors that indicate the lessee has a significant economic incentive to renew.
Payment date	31 December of each year
Fair value of equipment at lease commencement	C565,000
Book value of equipment at lease commencement	C555,000
Expected residual value of equipment at end of initial lease term	C250,000
Initial direct costs	C10,000
Discount rate	The rate the lessor is charging the lessee is 8.24%[1].

[1] – Rounded from 8.241426156%. This is the rate that causes the present value of the lease payments and the estimated value of the equipment at the end of the lease term to equal the fair value of the equipment at the commencement date.

Issue: How should the lessor initially measure the lease receivable and the residual asset?

Analysis: The lessor calculates the initial lease receivable and residual asset by performing the following:

Step 1) Determine the lease term: Based on conditions that exist at the commencement date, the lessor determines that the lessee does not have a significant economic incentive to exercise the extension option; so the lease term is five years.

Step 2) Identify the lease payments: The annual contractual payment is C110,000. However, C10,000 of each annual payment is for executory costs. The amount allocated to the executory costs is not included in the measurement of the lease receivable. Therefore, the payments to be used for initial measurement are the annual payments allocated to the lease of the equipment, which is C100,000 due on 31 December of each year.

Step 3) Determine the discount rate: The rate the lessor charges the lessee is 8.24%.

Step 4) Identify the additional components of the lessor receivable: The lessor paid initial direct costs of C10,000. Such costs are to be included in the initial measurement of the lease receivable. These costs should amortise as a reduction of interest income over the term of the lease using the effective interest method.

The journal entry recorded on 1 January 20x0 is as follows:

Dr. Lease receivable	C396,743	
Dr. Residual asset	C168,257	
Cr. Equipment		C555,000
Cr. Profit on receivable		C7,022

Cr. Deferred profit on residual		C2,978

Dr. Lease receivable (initial direct costs)	C10,000	
Cr. Cash (initial direct costs)		C10,000

Lease receivable is C396,743 and is calculated as the present value of each payment of C100,000 discounted back over the appropriate number of years (that is, years 1 through 5) at 8.24%.

* Note the actual lease receivable recorded on the balance sheet at inception of the lease would also include the C10,000 initial direct costs incurred by the lessor (C396,743 + C10,000 = C406,743) as shown in the separate journal entry above.

Residual asset is C168,257 and is calculated as the present value of C250,000 discounted back 5 years at 8.24%.

Equipment is removed from the books with a credit to its cost basis of C555,000.

Profit on the receivable and deferred profit on the residual is C7,022 and C2,978, respectively. Profit and deferred profit are calculated as follows:

The cost basis of C555,000 is allocated between the receivable and residual in proportion to the fair value of each respective component:

- Receivable (C396,743/C565,000) * C555,000 = C389,721
- Residual (C168,257/C565,000) * C555,000 = C165,279

	Fair Value (A)	Cost Basis (B)	Profit (A - B)
Receivable	C396,743	C389,721	C7,022
Residual	C168,257	C165,279	C2,978
Total	**C565,000**	**C555,000**	**C10,000**

Example 7: Subsequent measurement of lessor receivable and residual

Background: Assume the same facts as in example 6 for initial measurement.

Issue: How should the lessor subsequently account for the lease receivable and the residual asset?

Analysis: The lessor calculates interest income on the lease receivable and accretion income on the residual asset by performing the following:

Step 1) Calculate the amount of interest income to be recorded each period: Since the initial direct costs are included in the receivable, the lessor must determine the imputed rate that will reduce the balance of the lease receivable to zero by the end of the lease term. The imputed rate for this lease is 7.3%. The lessor should apportion each payment received by the lessee between interest income and principal reduction of the receivable balance using the effective interest method.

Accounting for the Lease Receivable				
Year	*Gross lease payments to be received*	*Interest Income*	*Principal Reduction of Receivable*	*Remaining Lease Receivable Balance*
Initial Lease Receivable				406,743
1	100,000	29,694	70,306	336,437
2	100,000	24,561	75,439	260,998
3	100,000	19,054	80,946	180,052
4	100,000	13,144	86,856	93,196
5	100,000	6,804	93,196	-

Step 2) Recognise accretion income on the residual asset: The residual asset must be accreted up to its estimated fair value at the end of the 5 year lease term of C250,000. This is calculated and recorded as follows:

Accounting for the Residual Asset			
Year	*Residual Asset Balance (Beginning of Year)*	*Accretion of Residual Asset*	*Residual Asset Balance (End of Year)*
1	168,257	13,867	182,123
2	182,123	15,010	197,133
3	197,133	16,247	213,380
4	213,380	17,586	230,965
5	230,965	19,035	250,000

Note: accretion of the residual asset is calculated as the beginning of the residual asset multiplied by the rate implicit in the lease (that is, 8.24%).

Refer to the following summary of the transaction economics as compared to the total income recorded over the five year lease period by the lessor:

Total lessor interest income recorded over the lease term			
Year	*Interest Income on Lease Receivable*	*Accretion Income on Residual Asset*	*Total Income Recognised Each Year*
1	29,694	13,867	43,560
2	24,561	15,010	39,571
3	19,054	16,247	35,300
4	13,144	17,586	30,730
5	6,804	19,035	25,838
Total			**175,000**

Summary of Overall Economics	
Total cash payments to be received by lessor	500,000
Expected residual value of asset at end of lease	250,000
Less: Initial direct costs incurred by lessor	(10,000)
Less: Cost basis of equipment on lessor's books	(555,000)
Economic profit from transaction	**185,000**
Interest income recorded over 5 years	175,000
Day 1 profit recognised on the receivable	7,022
Deferred profit on residual asset	2,978
Total profit & loss recorded by lessor	**185,000**

Appendix D Disclosure requirements

Disclosure requirements		
Topic	**A lessee must disclose:**	**A lessor must disclose:**
Nature of the lease	• a general description of the nature of its leases; • variable lease payment information; • the details of extension/termination options including which options are included/ excluded from the right-of-use asset; • residual value guarantees; • restrictions or covenants imposed by the lease; and • sub-lease information.	• a general description of the nature of its leases; • variable lease payment information; • the details of extension/termination options; and • the details of purchase options.
Leases that have not yet commenced	• significant rights and obligations created by the lease prior to lease inception.	N/a
Significant assumptions and judgements	information about: • the determination of whether the contract contains a lease; • the allocation of the consideration in a contract between lease and non-lease components; and • the determination of the discount rate.	information about: • the determination of whether the contract contains a lease; • the allocation of the consideration in a contract between lease and non-lease components; and • the initial measurement of the residual asset.
Reconciliation of opening and closing balances of the asset(s) held on the balance sheet	• additions due to leases commencing or being extended • reclassifications when a lease exercises a purchase option • reductions due to leases being terminated • remeasurements relating to a change in an index or rate used to determine lease payments • amortisation • effects of business combinations • impairment A lessee that measure the right-of-use assets arising from leased investment property in accordance with the fair value model in IAS 40 may elect not to provide this reconciliation for those right-of-use assets.	for Type A leases: • a reconciliation of opening and closing balances of the lease receivable. • a reconciliation of opening and closing balances of the residual asset
Reconciliation of opening and closing balances of the lease liability	• liabilities created due to lease commencing or being extended; • liabilities extinguished due to leases being terminated; • remeasurement relating to a change in an index or a rate used to determine lease payments; • unwinding of the discount;	N/a

	• cash paid; • foreign currency effects; and • effects of business combinations. The above must be disclosed separately for Type A and Type B leases.	
Income (lessor only)	N/a	for Type A leases: • profit/loss recognised at the commencement date; and • interest income recognised from the unwinding of the discount on the receivable and residual assets; for Type B leases: • income recognised on a straight line basis; for all leases: • any income related to variable payments not included in the lease receivable; and • any short-term lease income
Maturity analysis	• maturity analysis of the lease liability by providing the annual undiscounted cash flows for each of the first five years of the lease and a total for the remaining years; and • reconciliation of the undiscounted cash flows to the lease liability in the balance sheet.	• maturity analysis of lease payments by providing the annual undiscounted cash flows for each of the first five years and a total for the remaining years; and • reconciliation of the undiscounted cash flows to the lease receivable in the balance sheet. The above must be disclosed separately for Type A and Type B leases.
Other	• costs recognised in the period relating to variable lease payments not included in the lease liability; • the acquisition of right-of-use assets in exchange for lease liabilities, arising from both Type A and Type B leases, as a supplemental non-cash transactions disclosure; and • short-term leases accounted for under the simplified short-term lease guidance	for Type A leases only: • its risk management strategy for lease receivables and residual assets; • the carrying amount of residual assets covered by residual value guarantees; and • any other means by which the lessor reduces its residual asset risk (for example, buy-back arrangements or variable lease payments for use in excess of specified limits).