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What you need to know

- The IASB and the FASB propose that lessees recognise assets and liabilities arising from their involvement in most leases. This would impact tenants (lessees of property) in particular.
- Entities would classify leases as Type A or Type B and this classification would determine how entities recognise lease-related revenue and expense as well as what lessors record on the balance sheet. Landlords (lessors of property) may be impacted.
- Classification would be determined based primarily on the nature of the underlying asset. Leases of property would generally be Type B leases resulting in most tenants of property continuing to recognise lease expense on a straight-line basis. Landlords of property would generally continue with accounting similar, but not identical, to current operating lease accounting.
- The proposed ED would change the existing disclosures requirements.
- The IASB and the FASB are expected to devote significant outreach efforts on this project.
1. Overview

In May 2013, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards), after re-deliberations that took more than two years, issued their latest Exposure Draft Leases (ED or proposal).

The ED differs significantly from the previous exposure draft, which was issued in August 2010, but the fundamental principle remains: the ED features a ‘right-of-use’ model that would require tenants to recognise their commitments under leases on balance sheet as lease liabilities with corresponding right-of-use assets. Like the existing standard for leases (IAS 17 Leases), the ED would require tenants (lessees of property) and landlords (lessors of property) to classify leases by type, but the criteria for classifying leases and the related accounting would be different.

Under the ED, leases would be classified as either Type A or Type B and this would be used principally for determining the method and timing for recognising lease revenue and expense. It would also determine which assets appear on the lessor’s balance sheet. The classification is based on the nature of the underlying asset as either property or other than property assets unless certain exception criteria are met.

Most property leases would be classified as Type B leases. While the accounting for Type A leases is similar to the current accounting for finance leases, the accounting for Type B leases is more similar to existing operating lease accounting.

The ED would require entities to adopt the proposed requirements using either the full retrospective approach or a modified retrospective approach. However, an effective date has not yet been proposed.

How we see it

Like today’s leasing requirements, the proposal requires leases to be classified. At a first glance, classification seems simple because it is based on the nature of the underlying asset, whereby a distinction is made between property and other (i.e., non-property) assets. However, the ED contains exceptions to this basic principle and omits ‘bright lines’.

In contrast to today’s lease accounting, virtually all leases would be recorded by lessees on their balance sheets. This may encourage lessees to seek shorter or more flexible lease terms to reduce the effect on their balance sheet.

Applying the proposal may require both lessees and lessors to expend substantial effort updating their accounting systems.
A high level summary of the proposed ED is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Type A leases</th>
<th>Type B leases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lessors – initial</strong></td>
<td>Lessors would apply an approach similar to today’s finance lease accounting.</td>
<td>Lessors would treat Type B leases similar to today’s operating leases (i.e., lessors would continue to recognise the underlying asset).</td>
</tr>
<tr>
<td><strong>measurement</strong></td>
<td>At commencement, lessors would derecognise the underlying asset and recognise:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. A lease receivable for the right to receive lease payments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. A residual asset representing the lessors’ right to the underlying asset retained</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. A profit (if any) for the portion of the underlying asset leased</td>
<td></td>
</tr>
<tr>
<td><strong>Lessors – subsequent</strong></td>
<td>Lessors would recognise interest income for the accretion of the lease receivable and the residual asset (using the interest method) and reduce the lease receivable for payments received.</td>
<td>Lessors would recognise lease income either on a straight-line basis or another systematic basis if that better represents the pattern in which it is earned.</td>
</tr>
<tr>
<td><strong>measurement</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Lessees – initial</strong></td>
<td>Lessees would initially recognise a lease liability for the obligation to make lease payments (similar to how a lessor recognises a lease receivable) and a right-of-use asset for the right to use the underlying asset for the lease term. Lessees would accrete the lease liability using the effective interest method and lease payments would reduce the liability.</td>
<td>Similar as for Type A leases</td>
</tr>
<tr>
<td><strong>measurement</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Lessees – subsequent</strong></td>
<td>The lease liability would be accreted using the interest method and reduced when payments are made. The right-of-use asset would be amortised on a straight-line basis unless another systematic basis better represents the pattern in which the lessee expects to consume it. The aggregate of interest expense on the lease liability and amortisation of the right-of-use asset would generally result in higher total periodic expense in the earlier periods of the lease.</td>
<td>The lease liability would be accreted using the interest method and reduced when payments are made. The change to the right-of-use asset would be the difference between the periodic straight-line cost and the interest incurred on the lease liability.</td>
</tr>
</tbody>
</table>

This publication considers key implications for entities in the real estate sector. For a broader view of the ED, please read our publications Applying IFRS: How the lease accounting ED might affect your company (August 2013) and Applying IFRS: A closer look at the revised lease accounting ED (May 2013), which are available at www.ey.com/IFRS
2. Identifying lease components

Under the revised ED, it is important to differentiate between arrangements that are (or contain) leases and service contracts as virtually all leases would be recognised on the balance sheet, while service contracts would not.

After determining that a contract is or contains a lease, the ED requires an entity to identify each separate lease component within the contract and to account for them separately from non-lease components of a contract (e.g., service components). The proposed rules also have specific provisions for how entities would allocate the consideration in the contract to each separate lease and non-lease component.

Determining lease components in a contract is important as the lease classification is made separately for each lease component based on the nature of the underlying asset. Sometimes a lease component may contain the right to use more than one asset (e.g., land and a building). In that case, an entity would determine the nature of the underlying asset on the basis of the nature of the primary asset within the lease component. The ED does not define the term ‘primary asset’, but according to the guidance accompanying the ED, the primary asset is the predominant asset for which the lessee has contracted for the right to use.

The following examples, taken from the illustrative examples in the ED, illustrate how an entity would identify separate lease components in a contract and the primary asset within one lease component that conveys the right to use more than one asset to the tenant:

<table>
<thead>
<tr>
<th>Example 1 — Lease of retail space</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fact Pattern:</strong></td>
</tr>
<tr>
<td>A tenant enters into a lease of retail space together with the surrounding land that is used for parking and deliveries. Because of the location of the retail space, a retailer would not lease the building without the surrounding land.</td>
</tr>
</tbody>
</table>

| **Analysis:**                     |
| The contract contains one lease component. The retail space is dependent on the land for parking and deliveries. The tenant would be unable to access the benefits from use of the retail space without the surrounding land for parking and deliveries. Accordingly, the tenant cannot benefit from use of the retail space without also using the surrounding land that is part of the contract. |
| The primary asset is the retail building because it is the predominant asset for which the tenant has contracted for the right to use. The main purpose of the surrounding land for parking and deliveries is to facilitate the tenant obtaining benefits from use of the retail space. |
Example 2 — Lease of retail space plus an additional plot of land

**Fact Pattern:**
Assume the same facts as Example 1, except that the contract also conveys the right to use an additional plot of land that is located adjacent to the retail space. The additional plot of land could, for example, be redeveloped independently of the retail space.

**Analysis:**
The contract contains two lease components — a lease of the retail space (together with the surrounding land for parking and deliveries) and a lease of a plot of land. The plot of land is neither dependent on, nor highly interrelated with, the retail space and vice versa. Accordingly, the tenant can benefit from use of the plot of land on its own and, as described in Example 1, the tenant can benefit from use of the retail space (together with the surrounding land for parking and deliveries) on its own.

**How we see it**
Leases involving real estate often cover several physical assets (e.g., plots of land, buildings, furniture and fittings, etc.). The identification of separate lease components in a contract and the identification of a primary asset within one lease component would often be required.

3. Classifying property leases
Lease classification determines how lease-related revenue and expense are recognised. For landlords, it would also affect what is recorded on the balance sheet. Tenants and landlords would use the same principle to classify leases as either Type A or Type B. For practical purposes, the Boards propose basing classification primarily on the nature of the underlying asset:

Leases of property (land or a building, or part of a building, or both) would be classified as Type B leases unless either of the following conditions exists:
- The lease term is for the major part of the asset’s remaining economic life
- The present value of the lease payments accounts for substantially all of the asset’s fair value at the commencement date

Leases of assets other than property (e.g., equipment) would be classified as Type A leases, unless either of the following conditions exists:
- The lease term is for an insignificant part of the asset’s total economic life
- The present value of the lease payments is insignificant compared with the asset’s fair value at the commencement date

The proposal does not define ‘major part’ or ‘substantially all’, nor does it include much guidance on how these criteria should be applied. However, these terms are used to describe the indicators used in IFRS to distinguish between finance and operating leases. They were introduced into IFRS by borrowing from the principles in US GAAP for the bright-line 75% of the economic life and 90% of the fair value tests used for lease classification. Therefore, this could provide an argument for
applying the 75% and 90% tests often used today and, in line with IFRS, there would be no bright-lines.

The Boards expect most leases of property to be classified as Type B leases. Accordingly, we would expect that most investment property leases would be classified as Type B leases under the ED. The following example, taken from the illustrative example of the revised ED, explains how the principle for classifying leases can be applied in practice:

**Example 3 – Commercial property lease classification**

**Fact Pattern:**
A tenant enters into a 15-year lease of an office building, which has a remaining economic life of 40 years at the commencement date. The lease payments are CU30,000 per year, the present value of which is CU300,000, calculated using the tenant’s incremental borrowing rate. The fair value of the property at the commencement date is CU400,000.

**Analysis:**
The tenant determines that the lease is a Type B lease because of the following:
(a) The underlying asset is property
(b) The lease term is not for a major part of the remaining economic life of the property
(c) The present value of the lease payments does not account for substantially all of the fair value of the property

**How we see it**
The application of the classification principle for property introduces criteria that are similar to the criteria used today to distinguish between finance and operating leases. Accordingly, judgement would still be needed when classifying leases. While most leases of property would be Type B leases, there may also be circumstances, e.g., in case of a 50-year lease of a building, when leases of property would be Type A leases.

4. **Lease term, lease payments, discount rate and reassessment**
Certain key concepts with respect to lease term, lease payments and discount rates would be used by both tenants and landlords to identify, classify, recognise and measure lease contracts.

4.1 **Lease term**
The lease term would be determined at the lease commencement date based on the non-cancellable period of the lease, together with both of the following:
- The periods covered by an option to extend the lease if the tenant has a significant economic incentive to exercise that option
- The periods covered by an option to terminate the lease if the tenant has a significant economic incentive not to exercise that option
The evaluation of whether a significant economic incentive exists involves judgement, but is expected to be interpreted similarly to today's threshold of 'reasonably certain'. However, the proposed principle is fairly straightforward: if a tenant has a significant economic incentive to exercise a renewal option, the substance of the arrangement dictates that the lease term should include the additional periods contemplated in the renewal provision.

The principle would be similarly applied to leases that contain termination options: the lease term would exclude any period beyond the termination option date unless a significant economic incentive to not exercise the option exists.

Purchase options would be assessed in the same way as options to extend the lease term. The Boards reasoned that purchasing an underlying asset is economically similar to extending the lease term for the remaining economic life of the underlying asset. When a lease contains a purchase option and the tenant has a significant economic incentive to exercise that option, the lease would be classified as Type A.

How we see it
The definition of what constitutes a 'significant economic incentive' leaves considerable room for judgement. Below are some typical circumstances that could indicate the existence of such an incentive:

a) The right to extend a lease at a considerably lower-than-market rent
b) Significant tenant investments in the leased assets
c) The right to exercise an option to buy the leased asset at a price significantly below its expected fair value

4.2 Lease payments
The present value of the lease payments over the lease term would be recognised as a lease liability for lessees. Lease payments would include the aggregate of:

- Fixed lease payments, less any lease incentives received or receivable from the landlord (including payments in renewal periods, if the tenant has a significant economic incentive to exercise an option to renew)
- Variable payments that depend on an index or a rate
- In-substance fixed lease payments structured as variable payments
- Exercise price of a purchase option if the tenant has a significant economic incentive to exercise that purchase option
- Payments for penalties for terminating a lease, determined consistently with the determination of the lease term
- Amounts expected to be payable under residual value guarantees (tenant only)
- Fixed payments structured as residual value guarantees (landlord only)

Variable lease payments that depend on an index or a rate would be included in the lease payments (e.g., rents subject to a CPI based rent review) and measured using the prevailing index or rate at the measurement date. Forward rates and forecasting techniques would not be considered.
In contrast, variable rents not based on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset, would not be included as lease payments. Rather these type of variable rents would be recognised in profit or loss when they are incurred (tenant) or earned (landlord), similar to current lease accounting.

As landlords would typically classify their leases as Type B, they would normally not recognise lease receivables, consistent with current practice for operating leases. However, landlords would need to disclose more information on lease payments in their notes to the financial statements.

4.3 Discount rate

Discount rates would be determined on a lease-by-lease basis and used to determine the present value of lease payments.

Tenants would use the rate the landlord charges the tenant if that rate can be readily determined. In practice, tenants may not know the rate the landlord charges the tenant. When the rate is not readily determinable, the tenant may use its own incremental borrowing rate.

Landlords would use the rate implicit in the lease whenever it is available. The rate implicit in the lease would be the rate that causes the fair value of the underlying asset to equal the sum of the following:

- The present value of payments to be made by the tenant for the right to use the underlying asset
- The present value of the amount the landlord expects to derive from the underlying asset following the end of the lease

If the rate implicit in the lease is not available for leased property, the landlord would be permitted to use another rate, such as the 'property yield'.

How we see it

'Property yield' is not defined in the standard. As the real estate sector uses several concepts of property yields, such as net yield, gross yield or exit yield, there may be diversity in practice.

4.4 Reassessment

After the commencement date of a lease, in certain circumstances, both lessees and lessors (in a Type A lease) may be required to reassess the lease payments resulting in a remeasurement of the lease liability and the right of use asset (for a lessee) or the lease receivable and the residual asset (for a lessor). Examples of circumstances in which a reassessment is required are changes of lease terms, changes of 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, or changes in an index or a rate used to determine lease payments during the reporting period.1

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1 The accounting following a reassessment can be complicated. For further details, refer to our publication, Applying IFRS: A closer look at the revised lease accounting ED (May 2013).
5. Landlord accounting for Type B property leases

The accounting by landlords for Type B leases would be similar, but not identical, to current operating leases.

Landlords would continue to measure and record the underlying asset (i.e., the property) subject to a Type B lease in accordance with other applicable standards. For example, if the property meets the definition of an investment property in the scope of IAS 40 *Investment Property*, the property would be measured either at cost or fair value depending on which accounting policy the entity elects to apply to all its investment properties.

Lease income would be recognised on a straight-line basis or another systematic basis if that better represents the pattern in which income is earned from the underlying asset. A ‘pattern in which income is earned’ (emphasis added) would be a change from the current requirements in IAS 17, under which lease income from operating leases is recognised in income on a straight-line basis, unless another systematic basis is more representative of the time pattern in 'which use benefit derived from the leased asset is diminished'.

How we see it

For landlords who currently lease their properties under operating leases only, the proposed changes to lease accounting would, in most cases, have limited impact on the balance sheets and statements of profit or loss. However, the pattern of recognition of rental income could differ in some circumstances, for instance, when rent contracts are subject to fixed stepped rent increases that are designed to compensate for general price increases.

5.1 Stepped rents

In the ED’s basis for conclusions, the Boards set out their view that recognising rental income on a straight-line basis may not always reflect the pattern in which income is earned from the underlying asset. For example, the Boards concluded that it would be simpler to, and more consistent with, their proposed accounting for variable lease payments to recognise lease income arising from variable lease payments for Type B leases in the period in which they are receivable, rather than on a straight-line basis.

In addition, for stepped rent increases, when those stepped rents are expected to compensate the landlord for increases in general market prices, the Boards agreed with some respondents to the 2010 ED that recognising lease income as lease payments are received would better reflect the pattern in which income is earned from the underlying asset. For such leases, although the yield that the landlord earns on the underlying asset may not change over the lease term, the amount of lease income earned in later periods may be higher, reflecting that the economic benefits derived from use of the underlying asset has increased in value over the lease term.

Consequently, the Boards decided that a landlord could recognise rental income on a systematic basis, that is not straight-line, if that basis were more representative of the pattern in which income is earned from the underlying asset. Nonetheless, landlords would recognise lease payments on a straight-line basis when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front-loading or back-loading of payments or when rent-free periods exist in a lease).
Example 4 — Stepped rent increases

Fact Pattern:
A landlord enters into a three-year lease of property, with annual payments of CU100,000 in the first year, which are increased by 2% each subsequent year (i.e., to CU102,000 in year 2 and to CU104,040 in year 3). The stepped rents are expected to compensate the landlord for increases in market rentals for the property. The lease is classified as a Type B lease.

Analysis:
The landlord should recognise lease income on a straight-line basis or another systematic basis that better represents the pattern in which income is earned from the underlying asset. The use benefit that is derived from the property will be constant throughout the lease term. However, the income which is earned from the property increases throughout the lease term, as the rent increases to reflect assumed market rent increase. Rather than recognising a straight-line income of CU102,013 per year ((CU100,000+ CU 102,000+ CU 104,040)/3) as it would be required under IAS 17, under the ED it may be appropriate to recognise lease income of CU100,000 in year 1, CU102,000 in year 2 and CU104,040 in year 3, as this would better represent the pattern in which income is earned from the property.

Example 5 — Rent-free period

Fact Pattern:
A landlord enters into a four-year Type B lease of a property, with a rent-free period in year 1 and annual payments of CU100,000 in years 2, 3 and 4. The landlord considers the rent-free period as an incentive for the tenant to enter into the lease contract.

Analysis:
The timing in which the lease payments are made does not represent the pattern in which income is earned from the property. Even though the landlord does not receive any lease payments in year 1, one would expect that this shortage of lease payments in year 1 is compensated by higher rents in years 2, 3 and 4. Accordingly, it seems that straight-lining of lease income would better represent the pattern in which income is earned from the underlying asset, i.e., the landlord would recognise lease income of CU75,000 per year in each year (=CU100,000+CU100,000+CU100,000)/4).

6. Right-of-use assets that are investment properties

The ED also proposes to change the accounting for property interests held under leases (i.e., a head-lease/sublease scenario), which meet the definition of investment property. IAS 40 allows lessees a choice to either account for an investment property held under a lease using the fair value model in IAS 40—the property interest and the lease liability would be recognised on the balance sheet, or to treat it as an operating lease under IAS 17—the property interest would not be recognised on the balance sheet. As this choice is available on a property-by-property basis, it gives the preparers of financial statements some flexibility. Instead, the ED would require the lessee in a head lease that is sub-leased under a Type B lease to always recognise these property interests on the balance sheet.
sheet at fair value if the lessee/landlord applies the fair value model in IAS 40 to account for its investment property.

If the tenant applies the cost model to account for its investment property, then the lessee/landlord is required to measure its right-of-use asset in accordance with the general provisions of the ED. The lessee/landlord would measure the right-of-use asset initially in accordance with the general requirements of the ED, typically at the present value of the lease payments plus any initial direct costs incurred and, subsequently, amortise the right-of-use asset depending on the type of lease:

- For Type A leases, the right-of-use asset would be amortised on a straight-line basis (unless another systematic basis would be more representative of the pattern in which the tenant expects to consume the right-of-use asset's future economic benefits)
- For Type B leases, the right-of-use asset would be amortised in such a way that the periodic lease costs (comprising the amortisation of the right-of-use asset and the interest expense on the lease liability) would be constant throughout the lease term

### Example 6 – Accounting for a leased investment property interest under the ED

#### Fact Pattern:

On 1 January 20X3, Real Estate Company A (A) enters into a 10-year head-lease of an office building comprising four floors with annual payments of CU100,000. A intends to hold the office building to earn rental income from subleasing it, meeting the definition of an investment property. At 1 January 20X3, the (gross) fair value of the property interest (not taking into consideration any lease payments to be made under the headlease) is CU750,000, which equals the present value of the lease payments at that date, discounted using the rate the landlord charges to A, 5.6%. The head-lease is arranged by an agent who receives a fee of CU40,000 from A. Due to an increase in market rents, the (gross) fair value of the remaining leasehold property interest is CU740,000 at the end of 20X3 (gross fair value decreased from initial measurement due to one less year, which was partially offset by increase due to increase in market rents).

A applies the cost model to account for its investment properties.

#### Analysis:

If A applies the cost model to account for its investment properties, it would recognise the right-of-use asset initially at the present value of the lease payments (CU750,000) plus the fees paid to the agent (CU40,000). The fees paid to the agent are considered initial direct costs as they are directly attributable to negotiating and arranging the lease contract and would not have been incurred without entering into the lease.

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2 In practice, valuations of interests in investment property are often done on a net basis, which include all payments expected to be made (i.e., the cash inflows from the sublease rental income and the cash outflows from making the head-lease payments). Accordingly, the fair value of the interest in the investment property is generally close to zero. If fair value is applied on a net basis, paragraph 50(d) of IAS 40 would require entities to add back any recognised lease liability to arrive at the carrying amount of the interest in the investment property (i.e., the asset). To distinguish between these two different values, we refer to the carrying amount of the interest in the investment property (i.e. the fair value increased by the recognised lease liability) as ‘gross fair value’.
### Example 6 - Accounting for a leased investment property interest under the ED (continued)

A would also recognise a lease liability measured at the present value of the lease payments (CU750,000). A would classify the head lease as a Type B lease, as the lease term is neither for the major part of the remaining economic life of the building, nor does the present value of the lease payments account for substantially all of the fair value of the building at the commencement date. The periodic lease costs would be determined to be CU104,000 per year \([(10 \times CU100,000 + CU40,000) / 10]\).

At the end of 20X3, the lease liability would have decreased from CU750,000 to CU692,033. The movement would consist of interest expense of CU42,033 (CU750,000 x 5.6%) and the lease payment of CU100,000.

The change in the right-of-use asset would be CU61,967, determined by the difference between the interest expense of CU42,033 and the periodic lease costs of CU104,000. Accordingly, the carrying amount of the right-of-use asset would have decreased from CU790,000 to CU728,033 at the end of 20X3.

In 20X3, A would have recognised total costs of CU104,000.

### Example 7 - Accounting for a leased investment property interest under the fair value model

#### Fact Pattern:

Same fact pattern as Example 6, except that A applies the fair value model for its investment properties.

#### Analysis:

A would recognise the right-of-use asset initially at cost, which consists of the present value of the lease payments (CU750,000) plus the fees paid to the agent (CU40,000). As A would subsequently measure the right-of-use asset at fair value, it would not classify the head lease as Type A or Type B, but would be required to treat it as Type A lease when applying the applicable presentation and disclosure requirements.

A would also recognise a lease liability measured at the present value of the lease payments (CU750,000).

At the end of 20X3, the lease liability would have decreased from CU750,000 to CU692,033. The movement would consist of interest expense of CU42,033 (CU750,000 x 5.6%) and the lease payment of CU100,000.

The right-of-use asset would need to be measured at fair value. As the fair value decreased to CU740,000 compared to the initial measurement (CU790,000), A would need to recognise a loss from the measurement of its investment property of CU50,000.

In 20X3, A would have recognised interest expense of CU42,033 and a revaluation loss of CU50,000 (CU92,033 in total) when applying the fair value model.
When comparing the total costs incurred in the first period in Example 6, in which the cost model is applied and Example 7, in which the fair value model is applied, it is worth noting that, under the fair value model, initial direct costs are recognised as an expense at the first measurement date as an adjustment to the fair value of the asset.

**How we see it**
Consistent with the requirement to have all leases on balance sheet, the ED would eliminate the current policy choice for an investor who leases a property under an operating lease and subsequently enters into sub-leasing arrangements, to either capitalise the sub-leased investment property using the fair value model in IAS 40 or not. These head-leases would always be on-balance sheet, measured using either the requirements in the ED or the fair value model in IAS 40. This proposed change would improve consistency among real estate investors.

7. Expanded disclosure requirements for all leases
The ED expands disclosures related to lease agreements and, in particular, the details surrounding the measurement of the assets and liabilities and the basis for amounts recorded. Entities would need to present information on the assumptions and judgements related to amortisation methods. Similar to current practice, the lease obligation and related cash flows would need to be disclosed in the footnotes through the term of the lease.

7.1 Landlords
The ED would require new quantitative and qualitative disclosures for landlords to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows, including the amount of lease-related assets and liabilities recognised, significant judgements and assumptions made in applying the standard (e.g., lease terms, payments, existence of residual value guarantees and options to extend or terminate a lease). A discounted lease payment maturity analysis, by lease type, would also be required.

New quantitative disclosures for Type A leases would include reconciliations of the opening and closing balances of both lease receivables and residual assets, as well as a tabular disclosure of lease income recognised in the reporting period. Landlords of Type A leases would also provide information about how they manage the risks associated with the residual assets.

7.2 Tenants
The ED would require new quantitative and qualitative disclosures to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows, including the amount of lease-related assets and liabilities recognised, significant judgements and assumptions made in applying the standard (e.g., the existence of residual value guarantees and options to extend or terminate the lease and restrictions or covenants imposed by leases).

The proposed quantitative disclosures would include separate reconciliations of the opening and closing balances of Type A and Type B right-of-use assets by asset class. For lease liabilities, both a reconciliation of the opening and closing balances and a maturity analysis of the lease liability balance at the reporting date are required.
How we see it

The proposed disclosure requirements for lessees with a significant number of leases (e.g., a retailer with more than 1,000 property leases) may require significant effort and entities would need to collect substantial amounts of information to comply with the proposed disclosure requirements.

8. Business impact

There is already a tendency for tenants to secure lease arrangements with shorter lease terms in order to reduce their financial commitments and increase flexibility. For example, the British Property Federation/IPD (Investment Property Database) Annual Lease Review, published in May 2012, showed that average lease lengths have decreased steadily since 2007 (the average length of all lettings fell from 6.2 years in 2007 to 4.8 years in 2011). The IPD German Annual Lease Review, published in May 2012, shows a similar picture for Germany, where the average length of all lettings fell from 6.9 years in 2010 to 5.9 years in 2011.

The ED might encourage tenants to seek further lease-term reductions in order to minimise the impact on their financial statements. However, reducing the lease terms of their arrangements may result in higher lease costs and risk of disruption to the tenants’ operations if leases cannot be extended or replaced on a timely basis.

Landlords should continue to consider the impact that shorter lease terms would have on their business, including their financing costs, the value of the properties and, perhaps, increased operating costs as more frequent lease negotiations are held.

How we see it

Tenants of property would be required to analyse and evaluate the impact of their lease obligations not only at the first time application of the ED or whenever they enter into a new lease contract, but also subsequently on a continuous basis (as a consequence of the new provisions that require a reassessment of the lease liabilities in certain circumstances). Companies with a reliance on real estate to generate revenue, such as retailers and those with large customer service operations, would be impacted, in particular. Because the revised calculation of lease obligations may impact existing financial statement ratios, companies may need to approach lenders to renegotiate their debt covenants. Lenders, conversely, would need to be prepared for these requests and consider if their loan documentation includes appropriate flexibility to anticipate the changing ratios created under the proposal.

The administrative burden could be significant since accounting systems would need to be developed to analyse and calculate the initial and subsequent rights and obligations.

Owners and investors of real estate might expect tenants to request modification of terms of existing lease contracts, e.g., in respect of the length of the non-cancellable lease term, options to renew and contingent rent clauses. More dramatically, if the changes lead to tenants demanding shorter lease terms, this may impact the ability to finance some developments, or persuade some tenants towards the ownership of property rather than leasing.
9. Next steps
The comment letter period ended on 13 September 2013. We encourage entities to further monitor the developments of the IASB on the lease project and to participate in the Boards' outreach process, which is expected to be extensive.
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