Applying IFRS
Leases

New standard on leases is taking shape

April 2015
5. Lessor accounting ................................................................. 33
   5.1 Finance leases ............................................................... 33
   5.2 Operating leases ......................................................... 35
   5.3 Presentation ............................................................... 36
   5.4 Disclosure ................................................................. 36
6. Other considerations .......................................................... 39
   6.1 Subleases ................................................................. 39
   6.2 Business combinations ............................................... 40
   6.3 Sale and leaseback transactions ................................. 42
7. Effective date and transition ................................................ 45
   7.1 Effective date ............................................................ 45
   7.2 Transition ................................................................. 45
Appendix A: Summary of lessee and lessor reassessment
   requirements ....................................................................... 48
Appendix B: Key differences between IFRS and US GAAP ......... 49
What you need to know

- The IASB and the FASB have substantially completed redeliberations on new leases standards that, when issued, would require lessees to recognise assets and liabilities for most leases.
- Lessees applying IFRS would have a single recognition and measurement model for all leases (with certain exemptions).
- Lessors applying IFRS would classify leases using the principle in IAS 17; in essence, lessor accounting would not change.
- The Boards have made different decisions about lease classification and the recognition, measurement and presentation of leases for lessees. In some cases, these differences would result in similar transactions being accounted for differently under IFRS and US GAAP.
- The Boards will set effective dates before issuing the new standards. We expect the Boards to issue the standards in the second half of 2015.
Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) have substantially completed redeliberations on new standards that would significantly change the accounting for leases and could have far-reaching implications for a company’s finances and operations.

The standards the IASB and the FASB plan to issue would require lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. For IFRS reporters, lessor accounting, in essence, would not change. The standards would incorporate feedback the Boards received from constituents on their 2013 exposure draft1 (2013 ED).

As with IAS 17 Leases, the standard the IASB plans to issue (the new standard) would require lessors to classify most leases into two types. During redeliberations, the Boards referred to the two types of leases as Type A and Type B. However, given the IASB’s decision to retain the principle and, essentially, the accounting in IAS 17, for purposes of this publication we will refer to the IASB’s two types of lessor leases as they are in IAS 17, i.e., finance and operating leases.

Lessees, however, would apply a single model for all recognised leases and would have the option not to recognise and measure leases of small assets and leases with a lease term of 12 months or less. The standard the FASB plans to issue would require both lessees and lessors to classify most leases as either ‘Type A’ (generally today’s finance/sales-type and direct financing leases) or ‘Type B’ (generally today’s operating leases) leases using a principle generally consistent with IAS 17.

Lease classification under both the IASB’s and FASB’s new standards would determine how and when a lessor would recognise lease revenue and what assets a lessor would record. Under the FASB’s new standard, classification also would determine how and when a lessee would recognise lease expense.

Generally, the profit or loss recognition pattern for lessors would not be expected to change. For lessees, however, interest and amortisation expense would be recognised separately in the statement of profit or loss.

For lessees, recognising lease-related assets and liabilities could have significant financial reporting and business implications, such as:

- Key balance sheet metrics could change
- Debt covenants and borrowing capacity might be affected
- Decisions about whether to lease or buy significant assets might change

The IASB has not yet discussed an effective date, but plans to address it in drafting the new standard. Given the current timeline, an effective date of 1 January 2018 or later is becoming likely.

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1 See the Exposure Draft: Leases on the IASB’s website.
Companies would adopt the new standard using either a full retrospective or a modified retrospective approach. Under the modified retrospective approach, lessees of leases previously classified as operating leases would not restate comparative figures, but, instead, would recognise the cumulative effect of initially applying the new standard as an adjustment to the opening balance of retained earnings (or some other component of equity, as appropriate) at the date of initial application. Neither lessees nor lessors would change their accounting for finance leases existing at the date of initial application of the new standard, nor would lessors of leases previously classified as operating leases (with the exception of subleases).

This publication discusses how the IASB’s standard would be applied and is intended to help companies consider the effects of adopting it. Please note that our publication is based on available information regarding the IASB’s decisions in redeliberations. Until a new standard is issued, these decisions are tentative. The IASB may also clarify its decisions in the new standard. The discussions and illustrations in this publication also represent our preliminary thoughts.
1. Identifying a lease

1.1 Scope and scope exclusions

The IASB’s new standard would apply to leases of all assets, except for the following, which would be specifically excluded:

- Lessor’s leases of intangible assets
- Leases to explore for or use natural resources (e.g., minerals, oil, natural gas and similar non-regenerative resources)
- Leases of biological assets
- Service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements

Lessees’ leases of intangible assets would not be required to be accounted for as leases under the IASB’s new standard.

Leases of property that meet the definition of investment property in IAS 40 Investment Property would be included in the scope of the new standard. In addition, the new standard would require a lessee to measure right-of-use assets arising from leased property in accordance with the fair value model in IAS 40 if the leased property meets the definition of investment property and the lessee elects the fair value model in IAS 40 as an accounting policy. This represents a change from the existing scope of IAS 40. Under existing requirements, this is an election that is available on a property-by-property basis.

How we see it

Although lessees’ leases of intangibles would not be required to be accounted for as leases, this leaves open the possibility that an entity could choose, as an accounting policy election, to account for leases of intangible assets under the new leases standard.

Key differences between IFRS and US GAAP

The FASB’s new standard would exclude both lessors’ and lessees’ leases of intangible assets from its scope.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

1.2 Definition of a lease

A lease would be defined as a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) that conveys the right to use an asset (i.e., the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract would have to meet both of the following criteria:

- Fulfillment of the contract depends on the use of an identified asset
- The contract conveys the right to control the use of the identified asset
1.2.1 Identified asset

The IASB indicated that a contract’s dependence on an identified asset is fundamental to the definition of a lease. This concept is generally consistent with the ‘specified asset’ concept in IFRIC 4 Determining whether an Arrangement contains a Lease. Under the new standard, an identified asset could be either implicitly or explicitly identified in a contract and could be a physically distinct portion of a larger asset (e.g., a floor of a building). However, a capacity portion of an asset that is less than substantially all of that asset’s capacity (e.g., 60% of a pipeline’s capacity) would not be an identified asset because it is not physically distinct from the remaining capacity of the asset.

**Illustration 1 – Identified asset**

**Scenario A**
Assume that Customer X enters into a 12-year contract for the right to use a specified capacity of a supplier’s data transmission within a fibre optic cable between New York and London. The contract identifies three of the cable’s 20 fibres. The three fibres are dedicated solely to Customer X’s data for the duration of the contract term.

*Analysis:* The three fibres would be identified assets because they are specified in the contract and are physically distinct from the other 17 fibres in the cable. Whether the arrangement would constitute a lease would further depend on whether the contract conveys the right to control the use of the identified assets, as discussed in section 1.2.2 below.

**Scenario B**
Assume the same facts as in Scenario A, except that the supplier is free to use any of the cable’s 20 fibres, at any time during the contract term, to transmit any of its customers’ data, including Customer X’s data.

*Analysis:* The fibres are not identified assets because the contract allows the supplier to use any of the cable’s 20 fibres to fulfil its obligations to Customer X, whose portion of the cable’s capacity is not physically distinct from the cable’s remaining capacity.

A contract would not involve the use of an identified asset if a supplier has the substantive right to substitute the asset used to fulfil the contract. A substitution right would be substantive if both of the following conditions are met:

- The supplier has the practical ability to substitute the asset
- The supplier can benefit from exercising the right to substitute the asset

A customer would presume that fulfilment of a contract depends on the use of an identified asset when it is impractical for the customer to evaluate either of these conditions. No presumption for suppliers is necessary because they generally have sufficient information to make such a determination.

Contract terms that allow or require a supplier to substitute other assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available would not create a substantive substitution right.
The IASB intends for the conditions above to mitigate the risk that customers and/or suppliers would structure arrangements with non-substantive substitution clauses to avoid applying lease accounting.

**Illustration 2 — Substitution rights**

**Scenario A**
Assume that an electronic data storage provider (supplier) provides services through a centralised data center that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single, accessible location and is permitted to and can easily substitute another server without the customer’s consent. Further, the supplier would benefit from substituting an alternative asset, because it allows the supplier flexibility to optimise the performance of its network while incurring only nominal cost.

**Analysis:** Fulfilment of this contract would not depend on the use of an identified asset. Specifically, the supplier has the practical ability to substitute the asset and would benefit from such a substitution.

**Scenario B**
Assume the same facts as in Scenario A except that Server No. 9 is customised, and the supplier would not have the practical ability to substitute the customised asset. Additionally, the supplier would not obtain any benefits from sourcing a similar alternative asset. For example, the server may contain the customer’s confidential information, requiring the destruction of the asset’s primary components (e.g., hardware, software) adding significant costs to the supplier without benefiting the supplier, if substituted.

**Analysis:** Because it is not practical for the supplier to substitute the asset and the supplier would not benefit from substituting the asset, the substitution right would be non-substantive, and Server No. 9 would be an identified asset. In this scenario, neither of the conditions is met, but it is important to note that both conditions must be met for the supplier to have a substantive substitution right. Whether the arrangement would constitute a lease would further depend on whether the contract conveys the right to control the use of the identified asset as discussed in section 1.2.2 below.

**How we see it**
The requirement that a substitution right must benefit the supplier in order to be substantive is a new concept that will bring added scrutiny to this evaluation.

**1.2.2 Right to control the use of the identified asset**
A contract would convey the right to control the use of an identified asset if, throughout the contract term, the customer has the right to both:

- Direct the use of the identified asset
- Obtain substantially all of the potential economic benefits from directing the use of the identified asset

Requiring a customer to have the right to direct the use of an identified asset would be a change from IFRIC 4. A contract may meet IFRIC 4’s control criterion if, for example, the customer obtains substantially all of the output of an underlying asset. Under the new standard, these arrangements would no longer
be considered leases unless the customer also has the right to direct the use of the identified asset.

1.2.2.1 **Right to direct the use of the identified asset**

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

The determination of whether a customer has the right to direct how and for what purpose an asset is used would focus on whether the customer has the right to make the decisions that most significantly affect the economic benefits that can be derived from the use of the underlying asset. This right may include directing how, when, whether and where the asset is used and what it is used for throughout the contract term. Importantly, this right would permit the customer to change its decisions throughout the contract term without approval from the supplier. The customer would not necessarily need to have the right to operate the underlying asset to have the right to direct its use. That is, the customer may direct the use of an asset that is operated by the supplier’s personnel.

If neither the customer nor the supplier directs how and for what purpose the asset is used throughout the period of use (e.g., when the contract specifies how and for what purpose the asset is used or when decisions are made jointly throughout the period of use), the customer would have the right to direct the use of the identified asset in either of the following circumstances:

- The customer has the right to operate the asset or direct others to operate the asset in a manner that it determines, with the supplier having no right to change those operating instructions
- The customer designed the asset, or caused it to be designed, in a way that predetermines how and for what purpose the asset will be used or how the asset will be operated

A supplier’s protective rights, in isolation, would not prevent the customer from having the right to direct the use of an identified asset. The IASB believes that protective rights typically define the scope of the customer’s use of the asset without removing the customer’s right to direct the use of the asset. Protective rights are intended to protect a supplier’s interests (e.g., its interests in the asset, its personnel, compliance with laws and regulations) and may take the form of a specified maximum amount of asset use or a requirement to follow specific operating instructions.

## How we see it

- We understand that the IASB does not intend for the assessment of whether a customer has the right to direct ‘how’ and ‘for what purpose’ an asset is used to be two separate determinations. Instead, the assessment would be ‘holistic’, encompassing how, when, whether and where an asset is used and what it is used for (including the right to change these decisions) throughout the period of its use.
- We still have questions about how the definition would be applied to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be challenging.
Customer enters into a contract with Supplier to use Automobile A for a three-year period. Automobile A is specified in the contract. Supplier cannot substitute another vehicle unless Automobile A is not operational (e.g., it breaks down).

Under the contract, Customer operates Automobile A (i.e., drives the vehicle) or directs others to operate Automobile A (e.g., hires a driver). Customer decides how to use the vehicle (within contractual limitations, discussed below). In addition, Customer decides where Automobile A goes, as well as when or whether it is used, and what it is used for, throughout the period of use. Customer can also change its decisions throughout the period of use.

Under the contract, Supplier provides scheduled maintenance services and specifies that Customer can use Automobile A for a maximum of 12,000 miles per year without a substantive penalty. In addition, Supplier prohibits certain uses of Automobile A (e.g., moving it overseas) and modifications of Automobile A to protect its interest in the asset.

Analysis: Customer has the right to direct the use of Automobile A. Customer has the right to direct how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for. Customer also has the right to change the aforementioned decisions.

Supplier’s limits on annual mileage and certain uses for the vehicle are considered protective rights that define the scope of Customer’s use of the asset but do not affect the assessment of whether Customer directs the use of the asset within that scope.

1.2.2.2 Right to obtain substantially all of the potential economic benefits from directing the use of the identified asset

A customer’s right to control the use of an identified asset also depends on its right to obtain substantially all of the potential economic benefits from directing the use of the asset during the contract term. The customer can obtain economic benefits either directly or indirectly through the asset’s primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits). However, other tax benefits, such as those related to the ownership of the asset (e.g., excess tax depreciation benefits), would not be considered potential economic benefits of use.

How we see it

The term ‘substantially all’ was not defined in the 2013 ED and was not addressed during redeliberations. However, entities might consider the term similarly to how it is used in IAS 17 to classify a lease.

The IASB decided against including an additional requirement that, for a contract to contain a lease, a customer must have the ability to derive benefits from directing the use of an identified asset on its own or together with other resources (e.g., goods or services) that are either sold separately by the supplier or any other supplier or can be sourced in a reasonable period of time. Some members of the IASB indicated that such a requirement would have made applying the definition more complex, and the costs would have outweighed the benefits. They also noted that the IASB’s staff was unable to identify
arrangements in which the conclusion would change as a result of the additional requirement.

1.3 Cancellable leases
The new standard would apply to contracts that are referred to as ‘cancellable’, ‘month-to-month’, ‘at will’, ‘evergreen’, ‘perpetual’ or ‘rolling’ if they create enforceable rights and obligations. Any non-cancellable periods in contracts meeting the definition of a lease would be considered part of the lease term. See section 2.2 below.

For example, consider an agreement with an initial non-cancellable period of one year and an extension for an additional year if both parties agree. The initial one-year non-cancellable period would meet the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period would not be a contract because either party could unilaterally elect not to extend the arrangement without incurring a substantive penalty.

1.4 Short-term leases
Lessees could make an accounting policy election, by underlying asset class, to apply a method similar to current operating lease accounting to leases with a lease term of 12 months or less (short-term leases). To evaluate whether a lease qualifies for this accounting, the lease term would be determined in a manner consistent with the lease term of all other leases. For example, the lease term would only include periods covered by lease renewal options that a lessee is reasonably certain to exercise and would also include periods covered by lease termination options that a lessee is reasonably certain not to exercise. See section 2.2 below.

Illustration 4 — Short-term lease

<table>
<thead>
<tr>
<th>Scenario A</th>
</tr>
</thead>
<tbody>
<tr>
<td>A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates.</td>
</tr>
</tbody>
</table>

**Analysis**: The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease similar to operating lease accounting under IAS 17 today.

<table>
<thead>
<tr>
<th>Scenario B</th>
</tr>
</thead>
<tbody>
<tr>
<td>A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease term for four months. At the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at market rates and there are no other factors that would make exercise of the renewal option reasonably certain.</td>
</tr>
</tbody>
</table>

**Analysis**: The lease term is 12 months or less (i.e., nine months). Therefore, the lessee may, subject to its accounting policy, by class of underlying asset, account for the lease in a manner similar to an operating lease under IAS 17 today.
The short-term lease accounting policy election is intended to reduce the cost and complexity of applying the new standard. Lessees making the election would recognise lease expense on a straight-line basis over the lease term. Although such leases would not be recognised on the balance sheet, they would still meet the definition of a lease. As such, certain disclosures would be required for short-term leases if a lessee makes such a policy election.

**How we see it**
- In its 2013 ED, the IASB proposed making the short-term lease accounting policy election available to lessees and lessors. However, given the IASB’s decisions on lessor accounting, we believe the election will not be available to lessors in the new standard.
- Also under the 2013 ED, any lease that contains a purchase option would not be considered a short-term lease. Because the IASB did not discuss this provision during redeliberations, it appears that such leases would not be short-term leases under the new standard.

### 1.5 Leases of small assets

The IASB’s new standard would include an exemption from its recognition and measurement provisions for leases of small assets for lessees. It would specify that the exemption only applies to leases of assets that are not dependent on, or highly interrelated with, other leased assets. The Basis for Conclusions of the new standard would include a discussion of the quantitative threshold the IASB considers appropriate in applying the exemption. In its redeliberations, the IASB discussed a threshold of US$5,000. This was intended to help preparers determine what is meant by ‘small’ and would be expressed in terms of the value of the underlying asset when new. The IASB does not expect the application of the exemption for leases of small assets to give rise to the omission of material assets and liabilities when a quantitative threshold is used.

Although such leases would not be recognised on-balance sheet, they would still meet the definition of a lease. As such, certain disclosures would be required.

**How we see it**
Although not specified in the IASB’s deliberations, we believe lessees would recognise lease expense associated with leases of small assets on a straight-line basis over the lease term, or another systematic basis that better represents the pattern of the lessees’ benefit from the use of the leased asset.

**Key differences between IFRS and US GAAP**
The FASB’s new standard would not include an exemption for lessees’ leases of small assets.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.
1.6 Identifying and separating lease and non-lease components and allocating contract consideration

1.6.1 Identifying and separating lease from non-lease components of contracts

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For these contracts, the non-lease components would be identified and accounted for separately from the lease component (except when a lessee applies the practical expedient, as discussed in section 1.6.1.1 below). The non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to the new revenue recognition standard (i.e., IFRS 15 Revenue from Contracts with Customers) by lessors (suppliers).

How we see it

Identifying non-lease components of contracts may change practice for some lessees. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases would be recognised on the balance sheet under the new standard, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.

Activities or lessor costs in a contract that do not provide the lessee with an additional good or service would not be considered lease or non-lease components, and lessees and lessors would not allocate contract consideration to these activities or costs (discussed in section 1.6.3 below). An example would be administrative costs a lessor charges a lessee. However, activities or lessor costs such as a lessor providing services (e.g., maintenance, supply of utilities) or operating the underlying asset (e.g., vessel charter, aircraft wet lease) would generally represent non-lease components.

1.6.1.1 Practical expedient – lessees

The new standard would provide a practical expedient that would permit lessees to make an accounting policy election, by class of underlying asset, to account for the lease and non-lease components of a contract as a single lease component. The IASB expects the practical expedient to be used most often when the non-lease components of a contract are not significant when compared with the lease components of a contract.

Lessees that make the policy election to account for the lease and non-lease components of contracts as a single lease component would allocate all of the contract consideration to the lease. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset would be higher than if the policy election were not applied. See section 4 below for a discussion of measurement of lease liabilities and right-of-use assets.

1.6.2 Identifying and separating lease components

For contracts that contain the rights to use multiple assets (e.g., a building and equipment), the right to use each asset would be considered a separate lease component if both of the following criteria are met:

- The lessee can benefit from the use of the asset either on its own or together with other readily available resources (i.e., goods or services that are sold
or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events)

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

If one or both of these criteria are not met, the right to use multiple assets would be considered a single lease component.

### Illustration 5 – Identifying and separating lease components

#### Scenario A
Assume that a lessee enters into a lease of a warehouse and the surrounding parking lot that is used for deliveries and truck parking. The lessee is a local trucking company that intends to use the warehouse as the hub for its shipping operations.

**Analysis:** The contract contains one lease component. The lessee would be unable to benefit from the use of the warehouse without also using the parking lot. Therefore, the warehouse space is dependent upon the parking lot.

#### Scenario B
Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional plot of land that is adjacent to the parking lot. This plot of land could be developed by the lessee for other uses (e.g., to construct a truck maintenance facility).

**Analysis:** The contract contains two lease components: a lease of the warehouse (together with the parking lot) and a lease of the adjacent plot of land. Because the adjacent land could be developed for other uses independent of the warehouse and parking lot, the lessee can benefit from the adjacent plot of land on its own or together with other readily available resources. The lessee can also benefit from the use of the warehouse and parking lot on its own or together with other readily available resources.

### 1.6.3 Allocating contract consideration

#### 1.6.3.1 Allocating contract consideration
Lessees that do not make an accounting policy election to use the practical expedient to account for a lease and non-lease components of a contract as a single lease component would allocate contract consideration to the lease and non-lease components on a relative standalone price basis. Lessees would use observable standalone prices (i.e., prices that the lessor or a similar supplier would charge separately for a similar lease, good or service component of a contract) when available. If observable standalone prices are not available, lessees would be permitted to estimate standalone prices. In doing so, lessees would be required to maximise the use of observable information and to apply estimation methods in a consistent manner. This would be similar to how lessees allocate contract consideration under current IFRS.

Lessor would be required to apply IFRS 15 to allocate contract consideration between the lease and non-lease components of a contract.
1.6.3.2 Allocating contract consideration - reassessment

Lessees would be required to reallocate consideration upon either:

- A contract modification that is not accounted for as a separate, new lease
- A reassessment of the lease term or a lessee's purchase option (i.e., whether the lessee is reasonably certain to exercise the option)

**How we see it**

Although the IASB decided to require lessees to reallocate contract consideration upon the reassessment of the lease term or a lessee's purchase option, we believe the IASB intended for lessees to reallocate contract consideration only when a reassessment results in a change to either the lease term or the lessee's conclusion about whether it is reasonably certain that the lessee will exercise a purchase option. This means that when reassessment does not result in a change to either the lease term or the lessee's conclusion about whether it is reasonably certain that it will exercise a purchase option, no reallocation of consideration would be required.

Lessors would be required to reallocate contract consideration upon a modification that is not accounted for as a separate, new lease.

Modifications resulting in a separate, new lease for lessors and lessees would require consideration to be allocated to the lease and non-lease components, as applicable, as with any new lease (see section 1.7 below).

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

1.7 Lease modifications

The new standard would define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease.

Lessees and lessors would account for a lease modification as a separate, new lease when both of the following conditions are met:

- The modification grants the lessee an additional right of use (e.g., an additional underlying asset, the same underlying asset for an additional period of time not contemplated by a renewal option) not included in the original lease
- The additional right of use is priced commensurate with its standalone price

This type of modification would result in a lessee and lessor accounting for two separate leases, the unmodified original lease and the new lease.

For a lease modification that does not result in a separate, new lease, lessees would generally remeasure the existing lease liability and right-of-use asset without affecting profit or loss. However, for a modification that decreases the scope of a lease (e.g., reducing the square footage of leased space, shortening a lease term), lessees would remeasure the lease liability and recognise a proportionate reduction (e.g., the proportion of the change in the lease liability to the pre-modification lease liability) to the right-of-use asset. Any difference between those adjustments would be recognised in profit or loss.
For lessors, a modification that is not a separate, new lease would be accounted for, as follows:

- A modification to an operating lease would be, in effect, a new lease. The lease payments would be equal to the remaining lease payments of the modified lease, adjusted for any prepaid or accrued rent from the original lease.
- A modification to a finance lease would be accounted for in accordance with IFRS 9 Financial Instruments.

### 1.8 Contract combinations

The new standard would require that two or more contracts entered into at or near the same time with the same counterparty (or related party) be considered a single transaction if either of the following is met:

- The contracts are negotiated as a package with a single commercial objective
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract

These criteria are intended to address the IASB’s concern that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction. SIC 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease will be removed from IFRS upon transition to the new standard.

### 1.9 Portfolio approach

Many constituents had expressed concerns that the cost of applying the 2013 ED would exceed the benefits for leases involving a large number of assets that have similar characteristics (e.g., leases of a fleet of similar cars). In response, the IASB acknowledged that lessees and lessors would be able to use a portfolio approach, rather than a lease-by-lease approach, when they reasonably expect that doing so would not result in a material difference from accounting for the leases on an individual basis. The new standard would not define ‘reasonably expect’ and ‘material’. However, the IASB decided to include guidance on the portfolio approach in the Application Guidance of the new standard.

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**Key differences between IFRS and US GAAP**

The FASB decided to include a discussion of the portfolio approach in the Basis for Conclusions (i.e., a non-authoritative section) of its new standard.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

**How we see it**

The IASB decided to include the portfolio approach to be consistent with IFRS 15. A decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather than capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.
2 Key concepts

Lessees and lessors would generally apply the same key concepts when they identify, classify, recognise and measure lease contracts, and both lessees and lessors would apply the concepts consistently.

2.1 Lease commencement and inception date

The lease commencement date would be the date on which the lessor makes an underlying asset available for use by the lessee. Lessees and lessors (for finance leases) would initially recognise and measure lease-related assets and liabilities on the commencement date (except for lessees that apply the small asset and short-term lease exemptions). Entities would consider other standards to determine how to account for and disclose the existence of other rights or obligations created between the lease inception date (i.e., the date on which the principal terms of the lease are agreed to) and the commencement date.

2.2 Lease term

2.2.1 Determining the lease term

The lease term would be determined at the lease commencement date based on the non-cancellable term of the lease, together with both of the following:

- The periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- The periods after the exercise date of an option to terminate the lease if the lessee is reasonably certain not to exercise that option

The phrase ‘reasonably certain’ is used in IAS 17 and, as such, the IASB does not anticipate a change in practice.

Purchase options would be assessed in the same way as options to extend the lease term or terminate the lease. The IASB 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 lessor believes the lessee is reasonably certain to exercise that option, the lessor would classify the lease as a finance lease (see section 3 below).

2.2.2 Evaluating lease renewal, termination and purchase options

When initially evaluating the lease term and lease payments (discussed in section 2.3 below), the new standard would require lessees and lessors to consider any factors associated with exercising lease renewal, termination and purchase options. The evaluation of whether it is reasonably certain that those options will be exercised would consider all contract, asset, entity and market-based factors, including:

- The existence of a purchase option or lease renewal option and its pricing (e.g., fixed rates, discounted rates, ‘bargain’ rates)
- The existence of a termination option and the amount of payments for termination or non-renewal
- Contingent amounts due under residual value guarantees
- Costs of returning the asset in a contractually specified condition or to a contractually specified location
- Significant customisation (e.g., leasehold improvements), installation costs or relocation costs
The importance of the leased asset to the lessee’s operations

A sublease term that extends beyond the non-cancellable period of the head lease (e.g., a head lease that has a non-cancellable term of five years with a two-year renewal option, and the sublease term is for seven years)

### Illustration 6 – Determining the lease term

#### Scenario A
Assume that Entity P enters into a lease for equipment that includes a non-cancellable term of four years and a two-year market-priced renewal option. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.

**Analysis:** At the lease commencement date, the lease term would be four years.

#### Scenario B
Assume that Entity Q enters into a lease for a building that includes a non-cancellable term of four years and a two-year market-priced renewal option. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realised through continued occupancy of the leased property.

**Analysis:** At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period. At lease commencement, Entity Q would conclude that the lease term is six years.

### 2.2.3 Reassessment of the lease term

After lease commencement, lessees would monitor leases for significant changes that could trigger a change in the lease term. Lessees would be required to reassess the lease term upon the occurrence of significant events or significant changes in circumstances that are within the lessee's control (i.e., market-based events or changes would not trigger a reassessment). The IASB expects that such events, and the related assessment, would occur infrequently.

If the lease term changes, a lessee would remeasure the lease liability, using revised inputs (e.g., discount rate, allocation of contract consideration) at the reassessment date, and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognise any remaining amount in profit or loss.

Lessors would not be required to reassess the lease term after lease commencement.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

### 2.3 Lease payments

Lease payments would be payments, made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term. The present value of the lease payments (excluding lease incentives received by the lessee) would be recognised as a lease liability by lessees or as part of the net investment in the lease by lessors in finance leases, as discussed in sections 4 and 5 below.
Lease payments would include:

- Fixed lease payments, less any lease incentives received or receivable from the lessor
- Variable payments that depend on an index or a rate
- In-substance fixed lease payments structured as variable payments
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option
- Payments for penalties for terminating a lease, if the lease term reflects the lessee exercising an option to terminate the lease
- Amounts expected to be payable under residual value guarantees (lessee only)
- Fixed payments structured as residual value guarantees (lessor only)

Lease payments would not include payments allocated to the non-lease components of a contract, except when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component (as described in section 1.6 above).

2.3.1 Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate would be included in the lease payments using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). The IASB reasoned that despite the measurement uncertainty associated with changes to index or rate-based payments, the payments meet the definition of an asset (lessor) and a liability (lessee) because they are unavoidable. These types of variable lease payments are treated differently from other contingent lease payments that do not depend on an index or rate (e.g., lease payments based on usage) because contingent lease payments that do not depend on an index or rate are generally avoidable. See section 2.3.7 below.

Under the new standard, lessees would be required to reassess variable lease payments that depend on an index or rate when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term) and upon a change in the cash flows resulting from a change in the reference index or rate (i.e., when an adjustment to the lease payments takes effect). For example, if the contractual lease payments change every two years and the change is linked to a change in the consumer price index (CPI) during the two-year period, a lessee would reassess the lease liability every two years when the contractual payments change, not each time the CPI changes.

If a reassessment results in a remeasurement of the lease liability, a lessee would use revised inputs at the reassessment date and would adjust the right-of-use asset, except that:

- The amount of the remeasurement arising from a change in an index or a rate that is attributable to the current period would be recognised in profit or loss
- If the right-of-use asset is reduced to zero, a lessee would recognise any remaining amount in profit or loss
Illustration 7 — Variable lease payment that depends on an index or rate

Assume that Entity A enters into a 10-year lease of property. The lease payment for the first year is CU1,000. The lease payments are linked to the annual change in CPI. The CPI at the beginning of the first year is 100. At the end of year 1, the CPI is 105.

Analysis: At the lease commencement date, the lease payments would be CU1,000 for 10 years. Entity A does not take into consideration the potential changes in the index. At the end of year 1 when the lease payments change, Entity A updates the remaining nine lease payments to CU1,050 (CU1,000 / 100 * 105).

Lessor would not be required to reassess variable lease payments that depend on an index or rate.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Key differences between IFRS and US GAAP

Under the FASB’s new standard, lessees would reassess variable lease payments that depend on an index or rate only when the liability is remeasured for other reasons (e.g., due to a change in the lease term).

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

2.3.2 In-substance fixed lease payments structured as variable payments

Some lease agreements include payments that are described as variable but are in-substance fixed payments because the contract terms ensure that the payment of a fixed amount is unavoidable. Such payments would be included in the lease payments at lease commencement and thus used to measure entities’ lease assets and lease liabilities.

2.3.3 The exercise price of a purchase option

Entities would consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (see section 2.2 above). That is, if the lessee is reasonably certain to exercise a purchase option, the exercise price would be included as a lease payment.

2.3.4 Payments for penalties for terminating a lease

The determination of whether to include lease termination penalties as lease payments would be similar to the evaluation of lease renewal options. If it is reasonably certain that the lessee will not terminate a lease, the lease term would be determined assuming that the termination option would not be exercised, and any termination penalty would be excluded from the lease payments. Otherwise, the lease termination penalty would be included as a lease payment.

2.3.5 Amounts expected to be payable under a residual value guarantee – lessees only

A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. Such guarantees represent enforceable obligations that the lessee has assumed by entering into the lease. Uncertainty related to a lessee’s guarantee of a lessor’s residual value affects the measurement of the obligation rather than the existence of an obligation.
Illustration 8 — Residual value guarantee included in lease payments

Entity R (lessee) enters into a lease and guarantees that Entity P (the lessor) will realise CU15,000 from selling the asset to another party at the end of the lease. At lease commencement, Entity P estimates that the underlying asset will have a value of CU9,000 at the end of the lease.

Analysis: Entity R expects to pay the lessor CU6,000 under the residual value guarantee and would include that amount as a lease payment.

How we see it

We expect the IASB to include in the new standard a provision of the 2013 ED that would require the remeasurement of a lessee's lease liability and adjustment of the right-of-use asset if the amounts expected to be payable under residual value guarantees change during the lease term. If the right-of-use asset is reduced to zero, the provision would require the remaining adjustment to be recognised in profit or loss. The IASB did not discuss this provision in redeliberations.

The residual value guarantee reassessment provision would not apply to lessors.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

2.3.6 Residual value guarantees — lessors only

Lessors' lease payments would generally exclude amounts receivable under residual value guarantees (from either the lessee or a third party). However, fixed lease payments structured as residual value guarantees (typically from the lessee, but possibly from another party) would be included as lease payments.

For example, assume a lessor obtains a guarantee for the entire residual value of the underlying asset from the lessee, also the contract states that the lessor will pay to the lessee, or the lessee can retain, any difference between the selling price of the underlying asset and the residual value guarantee specified in the contract. In these cases, the lessee is exposed to all of the upside and downside risks of changes in the value of the asset, and the lessor would receive a fixed amount (i.e., the guarantee specified in the contract) at the end of the lease. The amount the lessor would receive is economically similar to a fixed balloon lease payment at the end of the lease. Consequently, such amounts would be included as lease payments.

2.3.7 Variable lease payments that do not depend on an index or rate

Variable payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), would not be included as lease payments. These payments would be recognised in profit or loss when they are incurred (lessee) or earned (lessor), in a manner similar to today's accounting. For example, a variable payment based on the annual sales of a leased store would not be included in the lessee's right-of-use asset or lease liability. Instead, the variable payment would be recognised as an expense (by the lessee) and as income (by the lessor) as the sales at the store occur and an obligation for the lessee to make the contingent payment is created.
2.4 Discount rate

Discount rates would be used to determine the present value of the lease payments, which are used to determine the lessor's lease classification (finance or operating – see section 3 below) and to calculate the lessor's net investment in the lease (finance leases only) and the lessee's lease liability. Under the new standard, the rate the lessor charges the lessee would be defined as 'the rate implicit in the lease'. The rate implicit in the lease would reflect the nature and specific terms of the lease and would be consistent with the current definition in IFRS.

2.4.1 Lessors

Lessors would use the rate implicit in the lease that causes the sum of:

- The present value of lease payments made by the lessee for the right to use the underlying asset
- The present value of the amount the lessor expects to derive from the underlying asset at the end of the lease, excluding any amount included in lease payments

To equal the sum of:

- The fair value of the underlying asset
- The lessor's initial direct costs (in the case of finance leases without recognised selling profit)

A lessor's initial direct costs for finance leases with recognised selling profit would be expensed at lease commencement. Therefore, they would be excluded from the calculation of the rate implicit in the lease for those leases (see section 5 below).

2.4.2 Lessees

Lessees would also use the rate implicit in the lease, as described above, if that rate can be readily determined. When the lessee cannot readily determine that rate, it would use its incremental borrowing rate. The lessee's incremental borrowing rate would be the rate of interest that the lessee would have to pay to borrow the funds necessary to obtain an asset of a similar value to the right-of-use asset, over a similar term (i.e., consistent with the lease term) and security (i.e., collateral) in a similar economic environment. This definition would be generally consistent with the definition in IAS 17.

How we see it

The rate implicit in the lease would not necessarily be the rate stated in the contract and would reflect the lessor's initial direct costs and estimates of residual value. Therefore, lessees may find it difficult to determine the rate implicit in the lease.
Key differences between IFRS and US GAAP

Under the FASB's new standard, lessees that are not public business entities (as defined in the Accounting Standards Codification Master Glossary) would be permitted to make an accounting policy election to use the risk-free rate for the initial and subsequent measurement of lease liabilities.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

2.4.3 Reassessment of the discount rate

Lessees would reassess the discount rate only upon a lease modification, a change to the lease term or a change in whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.

If a reassessment results in a change to the discount rate, lessees would remeasure the lease liability using a revised discount rate at the reassessment date and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognise any remaining amount in profit or loss.

Lessor would not be required to reassess the discount rate unless a contract modification results in a new lease.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

2.5 Initial direct costs

Initial direct costs would be costs such as commissions that would not have been incurred if a lease had not been executed. Lessees and lessors would apply the same definition of initial direct costs. From the lessor's perspective, initial direct costs would be consistent with the concept of incremental costs in IFRS 15.

The new standard would require lessors to include initial direct costs in the initial measurement of their net investments in finance leases. However, initial direct costs related to finance leases that include recognised selling profit would be expensed at lease commencement. Lessors would recognise initial direct costs associated with operating leases over the lease term on the same basis as lease income.

The new standard would require lessees to include their initial direct costs in their initial measurement of the right-of-use asset. Costs that a lessee incurs in a lease modification that meet the definition of an initial direct cost would be included in the measurement of the new right-of-use asset (i.e., for a modification that results in a separate, new lease) or the adjustment to the right-of-use asset (i.e., for a modification that does not result in a separate, new lease).

The IASB's decision to clarify that only incremental costs would qualify as initial direct costs is consistent with the May 2014 IFRS Interpretations Committee discussions on incremental costs under IAS 17.
2.6 Economic life
The new standard would define the economic life of an asset as either:

- The period over which an asset is expected to be economically usable by one or more users
- Or

- The number of production or similar units expected to be obtained from the asset by one or more users

This definition of economic life is the same as the definition in IAS 17.

2.7 Fair value of the underlying asset
Under today’s accounting, the fair value of leased assets is measured under IAS 17, not IFRS 13 Fair Value Measurement. Under the IASB’s new standard, leased assets will be in the scope of IFRS 13 as a result of consequential amendments to IFRS 13. IFRS 13 provides a framework for measuring fair value, defines fair value within that framework and establishes fair value measurement disclosure requirements. Importantly, the general definitions of fair value in IFRS 13 would apply for the purposes of lease classification and measurement under the new standard.

How we see it
- The definition of fair value in IFRS 13 is based on an exit price notion, which is different from a transaction or entry price. Under IAS 17, preparers have more flexibility to consider prices other than an exit price when measuring fair value. The IASB’s decision to include fair value measurements related to lease transactions in the scope of IFRS 13 would result in more consistent measurement of fair value for amounts recorded in financial statements.
- It is unclear whether the new standard will contain a ‘fair value’ constraint that would set a maximum amount that could be used when recording a right-of-use asset.

Key differences between IFRS and US GAAP
The general definitions of fair value in US GAAP would not apply to fair value measurements for the purposes of lease classification and measurement (with certain exceptions) under the FASB’s new standard.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.
3. Lease classification

As discussed previously, lessees applying the IASB’s new standard would use a single recognition and measurement approach for all leases, with options not to recognise and measure both leases of small assets and short-term leases.

Lessees, however, would classify all leases using the classification principle in IAS 17. Consistent with IAS 17, the new standard would distinguish between two types of leases: finance and operating. Lease classification would determine how and when a lessor would recognise lease revenue and what assets are recorded (i.e., the underlying leased asset for operating leases or the net investment in finance leases), as it does today.

The classification of leases in IAS 17 is based on the extent to which the risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract, and lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a finance lease:

- The lease transfers ownership of the asset to the lessee by the end of the lease term
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised (frequently called a ‘bargain purchase’ option)
- The lease term is for the major part of the economic life of the asset even if title is not transferred
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset
- The leased assets are of a specialised nature, such that only the lessee can use them without major modifications being made

In addition, IAS 17 lists the following indicators of situations that, individually or in combination, also could lead to a lease being classified as a finance lease:

- If the lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee
- Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example, in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease)
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

Lessors would classify leases using the principle in IAS 17.
3.1 Lease component with the right to use more than one interrelated asset

If a lease component contains the right to use more than one interrelated asset, the primary asset in the component would be used to determine lease classification. The primary asset would be the predominant asset for which the lessee has contracted the right to use. Any other assets in that lease component would facilitate the lessee’s use of the primary asset. Entities would also refer to the economic life of the primary asset when making lease classification assessments.

3.2 Residual value guarantees included in lease classification

As noted above, for the purposes of determining lease classification, the new standard would require lessors to include in the ‘substantially all’ example the full amounts of residual value guarantees provided by third parties unrelated to the lessor, including the lessee.

Residual value guarantees would be treated differently when determining lease payments. Lessors’ lease payments would generally exclude amounts receivable under residual value guarantees (from either the lessee or a third party) unless the residual value guarantee is, in substance, a fixed lease payment (see section 2.3 above).

3.3 Reassessment

Lease classification would not be reassessed after lease commencement. If a contract modification results in a separate, new lease (see section 1.7 above), that new lease would be classified using the criteria described above. Also, refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Key differences between IFRS and US GAAP

The Boards agreed that lessors would classify leases based on the concept underlying existing US GAAP and IFRS lessor accounting, but they reached different decisions on classification for lessees.

As discussed above, lessees applying the IASB’s new standard would use a single recognition and measurement model for all leases, with options not to recognise and measure both leases of small assets and short-term leases. However, lessees applying the FASB’s new standard would use a dual model to recognise and measure leases with an option not to recognise and measure short-term leases.

The IASB members who favoured the single model indicated that it is more conceptually sound because they believe that all leases contain a financing element. Some IASB members also indicated that the single model would be less costly to apply because preparers would not have to consider a classification test. The FASB members who favoured the dual model indicated that the FASB’s new standard would be less costly for preparers to apply and for users to understand, because it would use a lease classification principle similar to the one in current US GAAP.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.
4. Lessee accounting

The new standard would require lessees to recognise all leases on the balance sheet, except for leases of small assets and short-term leases if they choose to apply those exemptions. At the commencement date of a lease, a lessee would recognise a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

4.1 Initial recognition and measurement

The lease liability would be initially measured based on the present value of the lease payments to be made over the lease term. Lessees would apply the concepts described in section 2 above to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease.

The right-of-use asset would initially be measured at cost and would consist of all of the following:

- The amount of the initial measurement of the lease liability
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor (see section 4.3 below)
- Any initial direct costs incurred by the lessee (see section 2.5 above)

4.2 Subsequent measurement

4.2.1 Lease liabilities

The IASB believes that a lease liability should be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). Consequently, the lease liability would be accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment and a change in the discount rate have not been triggered). Lease payments would reduce the lease liability when paid.

4.2.2 Right-of-use assets

Amortisation of the right-of-use asset would be recognised in a manner consistent with existing standards for non-financial assets that are measured at cost. Lessees would amortise the right-of-use asset on a straight-line basis, unless another systematic basis better represents the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. The right-of-use asset would generally be amortised over the shorter of the lease term or the useful life of the right-of-use asset. The amortisation period would be the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise a purchase option or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. Lessees would also have the option to revalue right-of-use assets and to measure right-of-use assets that meet the definition of investment property at fair value (see section 4.2.4 below).
Illustration 9 — Lessee accounting

Entity H (lessee) enters into a three-year lease of equipment. Entity H agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options), payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of approximately 4.235%). Entity H uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity H determines the right-of-use asset should be amortised on a straight-line basis over the lease term.

**Analysis:** At lease commencement, Entity H would recognise the lease-related asset and liability:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 33,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 33,000</td>
</tr>
</tbody>
</table>

**To initially recognise the lease-related asset and liability**

The following journal entries would be recorded in the first year:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>CU 1,398</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 1,398</td>
</tr>
</tbody>
</table>

**To record interest expense and accrete the lease liability using the interest method (CU33,000 x 4.235%)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortisation expense</td>
<td>CU 11,000</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 11,000</td>
</tr>
</tbody>
</table>

**To record amortisation expense on the right-of-use asset (CU33,000 ÷ 3 years)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>CU 10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>CU 10,000</td>
</tr>
</tbody>
</table>

**To record lease payment**

A summary of the lease contract’s accounting (assuming no changes due to reassessment) is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 10,000</td>
<td>CU 12,000</td>
<td>CU 14,000</td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 1,398</td>
<td>CU 1,033</td>
<td>CU 569</td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>11,000</td>
<td>11,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Total periodic expense</td>
<td>CU 12,398</td>
<td>CU 12,033</td>
<td>CU 11,569</td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 33,000</td>
<td>CU 22,000</td>
<td>CU 11,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU (33,000)</td>
<td>CU (24,398)</td>
<td>CU (13,431)</td>
</tr>
</tbody>
</table>

Because a consistent interest rate would be applied to the lease liability, which decreases as cash payments are made during the lease term, more interest expense would be incurred in the early periods and less would be incurred in the later periods. This trend in the interest expense, combined with the straight-line amortisation of the right-of-use asset, would generally result in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of finance leases under IAS 17.
The separate recognition of interest and amortisation expense is consistent with the IASB’s view that all leases result in a lessee obtaining the right to use an underlying asset and the provision of financing. That is, leases are financing activities and create ‘debt-like’ liabilities.

4.2.3 Changes in foreign currency exchange rates
Lessees would apply IAS 21 The Effects of Changes in Foreign Exchange Rates to leases denominated in a foreign currency. Lessees would remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date. Any changes to the lease liability due to exchange rate changes would be recognised in profit or loss. Because the right-of-use asset is a non-monetary asset measured at historical cost, it would not be affected by changes in the exchange rate.

4.2.4 Alternative measurement bases for the right-of-use asset
A lessee would be required to measure right-of-use assets arising from leased property in accordance with IAS 40 if the leased property meets the definition of investment property in IAS 40 and the lessee elects the fair value model in IAS 40 as an accounting policy.

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

Key differences between IFRS and US GAAP
The option to revalue right-of-use assets and to measure right-of-use assets that meet the definition of investment property at fair value is not applicable under US GAAP.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

4.3 Other lessee matters
4.3.1 Lease incentives received or receivable at lease commencement
Lessees often receive incentives (e.g., an up-front cash payment for leasehold improvements or relocation expenses) for entering into a new lease. Today’s operating lease accounting requires lessees to recognise lease incentives over the lease term as a reduction of lease expense.

Under the new standard, lease incentives that are receivable from the lessor at the commencement date (i.e., amounts are paid by the lessor after the lease commencement date) would be deducted from the lease payments and the corresponding lease liability and right-of-use asset. Separately, lease incentives that a lessee receives from the lessor at or before lease commencement would reduce the initial measurement of the right-of-use asset. Similar to the result under current operating lease accounting, lease incentives would reduce lease expense over the lease term.

4.3.2 Lease incentives not received or receivable at lease commencement
The 2013 ED did not address lease incentives that are contingently receivable by the lessee at the lease commencement date (i.e., lease incentives that are not received or receivable until the occurrence of an event subsequent to lease commencement) nor were such incentives discussed during redeliberations.
Examples include reimbursements for moving costs or leasehold improvements that become receivable by the lessee when the lessee incurs these costs.

**How we see it**
It remains unclear whether and, if so, how incentives that are not received or receivable at lease commencement would be considered in the recognition and measurement of lessees’ lease-related assets and liabilities.

### 4.3.3 Income tax accounting

The new standard would also affect lessees’ accounting for income taxes. For lessees, the new standard would change the measurements of lease-related assets and liabilities, including the recognition of amounts that are not on the balance sheet today (i.e., amounts related to leases that are operating leases today), and the expense recognition pattern. These changes would affect many aspects of accounting for income taxes, such as:

- Recognition and measurement of deferred tax assets and liabilities
- Assessment of the recoverability of deferred tax assets

### 4.3.4 Impairment

Lessees’ right-of-use assets would be subject to IAS 36 *Impairment of Assets*. IAS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit of which the asset is a part - the CGU). The entity has to recognise an impairment loss if the recoverable amount is less than the carrying amount of the asset (or the CGU). After an impairment loss is recognised, the adjusted carrying amount of the right-of-use asset would be its new basis for amortisation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined, after depreciation or amortisation, had there been no impairment.

Lessees currently apply the same impairment analysis to assets held under finance leases. This analysis would be new for leases currently accounted for as operating leases and could significantly affect the timing of expense recognition.

**How we see it**

- For leases that are not currently on the balance sheet, the requirement to test right-of-use assets for impairment could accelerate expense recognition (i.e., if an impairment occurs).
- When performing an impairment test (assuming the CGU to which the asset belongs consists solely of the right-of-use asset), we believe lessees would consider the recoverable amount of the remaining right-of-use asset without regard to the remaining lease payments.
4.4 Presentation
While the new standard would change balance sheet presentation for lessees, the statement of profit or loss and statement of cash flows presentation requirements would be similar to the current requirements for finance leases.

The following table summarises how lease-related amounts and activities would be presented in lessees’ financial statements:

<table>
<thead>
<tr>
<th>Financial statement</th>
<th>Lessee presentation</th>
</tr>
</thead>
</table>
| **Balance sheet**   | ✷ Right-of-use assets presented either:  
                          ✷ Separately from other assets (e.g., owned assets)  
                          ✷ Together with the corresponding underlying assets as if they were owned, with disclosures of the balance sheet line items that include right-of-use assets and their amounts  
                          ✷ Lease liabilities presented either:  
                          ✷ Separately from other liabilities  
                          ✷ Together with other liabilities, with disclosure of the balance sheet line items that include lease liabilities and their amounts |
| **Statement of profit or loss** | ✷ Lease-related amortisation and lease-related interest expense would be presented separately (i.e., lease-related amortisation and interest expense could not be combined). |
| **Statement of cash flows** | ✷ Cash payments for the principal portion of the lease liability would be presented within financing activities and cash payments for the interest portion would be presented based on an accounting policy election in accordance with IAS 7 *Statement of Cash Flows*.  
                          ✷ Lease payments for leases of small assets and short-term leases not recognised on the balance sheet and variable lease payments not included in the lease liability would be presented within operating activities.  
                          ✷ Non-cash activity (e.g., initial recognition of the lease at commencement) would be disclosed as a supplemental non-cash item. |

**Key differences between IFRS and US GAAP**
Under the FASB’s new standard, cash paid for interest on Type A leases would be presented within operating activities consistent with ASC 230 *Statement of Cash Flows*; lease payments for Type B leases also would be presented within operating activities.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

4.5 Disclosure
The objective of lessee disclosures would be to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases. Lessees would exercise judgement to determine the appropriate level at which to aggregate, or disaggregate, disclosures so that meaningful information will not be obscured by insignificant details or by groupings of items with different characteristics.
4.5.1 Quantitative disclosures

Lessees would be required to disclose the following quantitative information:

- Amortisation of right-of-use assets, split by class of underlying asset
- Interest on lease liabilities
- Short-term lease expense for such leases with a lease term greater than one month
- Small asset lease expense
- Variable lease expense
- Income from sub-leasing right-of-use assets
- Total cash outflow for leases
- Additions to right-of-use assets
- Gains and losses arising from sale and leaseback transactions
- Closing carrying amount of right-of-use assets, split by class of underlying asset

The new standard would require lessees to present all lessee disclosures in a single note or separate section in its financial statements. All quantitative lessee disclosures would be required to be presented in tabular format, unless another format is more appropriate.

Lessees would also be required to disclose a maturity analysis of lease liabilities in accordance with paragraphs 39 and B11 of IFRS 7 Financial Instruments: Disclosures. Lessees would be required to disclose this maturity analysis separately from the maturity analyses of other financial liabilities.

4.5.2 Qualitative disclosures

Lessees would be required to disclose sufficient additional information to satisfy the overall disclosure objective. The new standard would supplement this requirement with a list of specific disclosure objectives and illustrative examples to demonstrate how a lessee might comply with this requirement.

Key differences between IFRS and US GAAP

The FASB’s new standard would require specific qualitative disclosure requirements, such as information about the nature of lease arrangements; significant judgements and assumptions made in accounting for leases; and the main terms and conditions of any sale and leaseback transactions.

The IASB and the FASB differ on specific lessee quantitative disclosure requirements mainly because of differences in the lessee accounting models. The FASB’s new standard would require the disclosure of Type B lease expense, which is not applicable under the IASB’s single recognition and measurement approach (with certain exemptions) in its new standard. In addition, the FASB would not require a specific format for lessee quantitative disclosures.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.
5. Lessor accounting

Under the new standard, lessors would account for leases using the approach in IAS 17.

5.1 Finance leases

5.1.1 Initial recognition and measurement

Upon commencement of a finance lease, lessors would:

- Derecognise the carrying amount of the underlying asset
- Recognise the net investment in the lease
- Recognise, in profit or loss, selling profit or loss (if any)

5.1.1.1 Net investment in the lease

A lessor’s net investment in the lease would consist of the lease receivable and residual asset:

- **Lease receivable** - The lease receivable would be the total lease payments (see section 2.3 above) discounted using the rate implicit in the lease. Initial direct costs incurred as part of finance leases without recognised selling profit would be included in the lease receivable. However, initial direct costs related to finance leases with recognised selling profit would be expensed at lease commencement.

- **Residual asset** - The residual asset would be the lessor’s right to the expected value of the leased asset at the end of the lease.

At the lease commencement date, lessors would apply the key concepts described in section 2 above to determine the initial direct costs, lease term, lease payments and discount rate.

5.1.1.2 Selling profit

Lessor's would be able to recognise initial selling profit when the fair value of the underlying asset is greater than its carrying amount. Profit is often present for manufacturers and dealers who transact with customers at prices above their cost to manufacture or obtain the underlying asset.

How we see it

Although a lessor's recognition of selling profit in a finance lease would be the same as under IAS 17, a manufacturer or dealer lessor might recognise profit earlier in a finance lease than in an outright sale under IFRS 15. This could be the case when a third-party provides residual value support to the lessor. Such third party support could preclude immediate recognition of selling profit under IFRS 15, but would not under the new leases standard. The difference in timing of recognition of selling profit between the new leases standard and IFRS 15 could provide opportunities for accounting arbitrage.
Key differences between IFRS and US GAAP

The FASB's new standard would permit lessors to recognise initial selling profit only if the lessee obtains control of the underlying asset, as that would be defined in the FASB's new standard.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

5.1.2 Subsequent measurement

After lease commencement, lessors would account for a finance lease, as follows:

- Recognise interest income in profit or loss over the lease term using the rate implicit in the lease on the components of the net investment in the lease
- Reduce the net investment in the lease for lease payments received, net of interest income calculated above
- Separately recognise income from variable lease payments that are not included in the net investment in the lease (e.g., performance-or usage-based variable payments) in the period in which that income is earned

5.1.3 Reassessment

Lessors would not be required to reassess the lease term, lease payments or the discount rate after lease commencement. Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

5.1.4 Other lessor matters in finance leases

5.1.4.1 Sale of lease receivables

The new standard would require lessors to measure all lease receivables, including those an entity intends to sell, at amortised cost. We expect the Basis for Conclusions to indicate that it would be appropriate for lessors to apply the financial asset derecognition requirements in IFRS 9 when lease receivables are sold.

5.1.4.2 Impairment of net investment in the lease

In its 2013 ED, the IASB proposed requiring lessors to perform separate impairment assessments for the lease receivable (under IAS 39 Financial Instruments) and residual asset (under IAS 16). However, given the IASB's decision to leave lessor accounting essentially unchanged from IAS 17, it is not clear whether this separate assessment would be required or whether the new standard would require lessors to apply the impairment requirements in IFRS 9 to determine whether the net investment in the lease is impaired.

5.1.4.3 Classification of the underlying asset at the end of a lease

At the end of the lease term, lessors may receive the underlying asset back from the lessee. Under the new standard, lessors would reclassify the carrying amount of the residual asset to the applicable category of assets (e.g., property, plant and equipment). Thereafter, lessors would account for the underlying asset using other applicable accounting standards (e.g., IAS 16).
5.1.4.4 Income tax accounting
While the IASB agreed not to make changes to today’s lessor accounting approach, differences between the key concepts (described in section 2 above) under the new standard compared to IAS 17 could result in differences. Therefore, the new standard could affect lessors’ accounting for income taxes. Applying the new standard could change the recognition of lease-related assets (i.e., net investment in the lease), the measurement of lease-related assets and the derecognition of underlying assets for certain leases that are subject to operating leases today. The new standard also could change the timing of recognition of lease income for some leases. These changes could affect many aspects of accounting for income taxes, such as:

- Recognition and measurement of deferred tax assets and liabilities
- Assessment of the recoverability of deferred tax assets

5.2 Operating leases
Lessors would account for operating leases as they do today. That is, they would continue to recognise the underlying asset. Unlike for finance leases, at lease commencement for operating leases, lessors would not recognise a net investment in the lease (i.e., a lease receivable and residual asset) or initial profit (if any). The underlying asset would continue to be accounted for in accordance with applicable accounting standards (e.g., IAS 16).

Lessors would recognise lease payments from operating leases over the lease term on either a straight-line basis or another systematic basis if that basis better represents the pattern in which income is earned from the underlying asset. Lessors in an operating lease would recognise initial direct costs as an expense over the lease term on the same basis as lease income.

In some cases, another systematic basis of accounting might better represent the pattern in which the lessor earns income. For example, variable lease payments that are not based on an index or rate would be recognised as they are earned (i.e., when the variable payments become receivable). Likewise, ‘stepped’ rent increases that are intended to compensate a lessor for expected increases in market rental rates would be recognised based on the contractual cash flows (i.e., as the stepped payments become receivable). In both examples, revenue would be recognised on a basis other than straight line because it better reflects the pattern in which the revenue is earned.

If lease payments are uneven for reasons other than to compensate the lessor for expected increases in market rentals or changes in market conditions, the lease revenue would be recognised on a straight-line basis. For example, lease payments might be front-loaded or back-loaded or a lease might include a rent-free period. The uneven pattern of these lease payments generally would not be related to the way in which the lessor earns revenue. Therefore, they would not support revenue recognition on a basis other than straight line.
How we see it

Determining that lease payments in an operating lease should be recognised on a basis other than straight line would likely require judgement. There might not be a clear distinction between increases in scheduled lease payments that reflect the pattern in which lease income is earned (e.g., ‘stepped’ increases intended to compensate the lessor for changes in the market rentals or market conditions) and other scheduled increases that do not.

5.3 Presentation

The following table summarises how lease-related amounts and activities would be presented in lessors’ financial statements:

<table>
<thead>
<tr>
<th>Financial statement</th>
<th>Lessor presentation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
</tr>
<tr>
<td>Finance leases:</td>
<td>• Lease assets (i.e., lease receivables and residual assets) would be presented separately from other assets.</td>
</tr>
<tr>
<td></td>
<td>• Lease receivables and residual assets could be presented separately from each other, or, if presented together (i.e., the net investment in the lease), they would be separately disclosed in the notes.</td>
</tr>
<tr>
<td></td>
<td><strong>Operating leases:</strong> Underlying assets would be presented in accordance with applicable standards.</td>
</tr>
<tr>
<td><strong>Statement of profit or loss</strong></td>
<td>Both types of leases: Income arising from leases would be presented separately from other activity, or disclosed in the notes (along with the corresponding line item(s) in the statement of profit or loss).</td>
</tr>
<tr>
<td>Finance leases:</td>
<td>• Profit or loss recognised at the commencement date would be presented in accordance with IAS 1 Presentation of Financial Statements.</td>
</tr>
<tr>
<td></td>
<td>• Interest on the net investment in the lease would be presented as interest income.</td>
</tr>
<tr>
<td><strong>Statement of cash flows</strong></td>
<td>Both types of leases: Cash lease payments received would be presented within operating activities.</td>
</tr>
</tbody>
</table>

5.4 Disclosure

The disclosures that would be required for lessors are intended to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows. These disclosures would include the amounts of recognised lease-related assets and liabilities; significant judgements and assumptions about lease terms, payments, the existence of residual value guarantees and options to extend or terminate a lease. Lessors would exercise judgement to determine the level at which to aggregate, or disaggregate, the disclosures. Disclosures would need to be aggregated or disaggregated at an appropriate level so that the information is meaningful to the financial statement users and is not obscured by insignificant details or by grouping items with different characteristics.
5.4.1 General disclosure requirements

Lessors would be required to disclose information about the nature of leases, such as:

- A general description of the leases
- The basis, and terms and conditions, on which variable lease payments are determined
- The existence, and terms and conditions, of options to extend or terminate the lease
- The existence, and terms and conditions, of options for a lessee to purchase the underlying asset

As noted above, the new standard would also require lessors to disclose information about the significant judgements and assumptions made in accounting for leases. For example, a lessor might disclose information about its judgements and assumptions associated with:

- The determination of whether a contract contains a lease
- The identification of the lease and non-lease components of a contract
- The allocation of the consideration in a contract between the lease and non-lease components
- The initial measurement of the residual asset included in the net investment in the lease

Lessors would also disclose information about activities used to manage risks associated with the residual value of their leased assets. For example, a lessor might disclose:

- Its risk management strategy for residual assets
- Any other means by which the lessor reduces its residual asset risk (e.g., buyback agreements, variable lease payments for lessee use in excess of specified limits)

Lessors would also disclose lease income recognised in the reporting period, in a tabular format. The disclosure would include:

- For finance leases:
  - Profit or loss recognised at the commencement date
  - The interest income on net investments in leases (i.e., lease receivables and residual assets), either individually for each component of the net investment or in the aggregate
- For operating leases, lease income relating to lease payments
- Lease income relating to variable lease payments not included in the measurement of net investments in finance leases

5.4.2 Other quantitative and qualitative disclosures – finance leases

Under the new standard, lessors would be required to qualitatively and quantitatively explain significant changes in the balance of the net investment in their finance leases during the reporting period.
**Key differences between IFRS and US GAAP**

Under the FASB’s new standard, lessors would be required to qualitatively and quantitatively explain significant changes in residual values of assets under Type A leases. However, disclosure of significant changes in the lease receivable portion of the net investment would follow other US GAAP.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

To help financial statement users understand and evaluate liquidity risks of lease-related cash flows, lessors would be required to disclose a maturity analysis of undiscounted cash flows to be received, on an annual basis, for five years after the balance sheet date, and in total thereafter, that comprise finance lease receivables and a reconciliation to lease receivables presented on the balance sheet (or in the notes).

**5.4.3 Other quantitative disclosures – operating leases**

Lessors would be required to provide a separate maturity analysis of the undiscounted future lease payments to be received for operating leases, as of the reporting date. The maturity analysis would include undiscounted cash flows to be received, on an annual basis, for five years after the balance sheet date and in total thereafter.

For assets leased under operating leases, lessors would be required to disclose the same information that is currently required under IAS 16 for property, plant and equipment (e.g., balances by major class, accumulated depreciation, a general description of method of computing depreciation), separately from owned assets that are held and used by the lessor.
6. Other considerations

6.1 Subleases

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract remains in effect. In these arrangements, one party acts as both the lessor and lessee of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor and the ultimate lessee is often referred to as the sub-lessee.

6.1.1 Intermediate lessor accounting

An intermediate lessor would account for the head lease as described in section 4 above and the sub-lease as described in section 5 above. However, an intermediate lessor would consider the lease classification criteria with reference to the remaining right-of-use asset arising from the head lease when classifying a sublease as finance or operating.

**Key differences between IFRS and US GAAP**

Under the FASB’s new standard, intermediate lessors would consider the underlying asset when determining the sublease classification.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

An intermediate lessor generally would account for a head lease (as a lessee) and a sublease (as a lessor) as two separate lease contracts. However, when contracts are entered into at or near the same time, an intermediate lessor would be required to consider the criteria for combining contracts (i.e., whether the contracts are negotiated as a package with a single commercial objective or the consideration to be paid in one contract depends on the price or performance of the other contract) (see section 1.8 above for more information). If either criterion is met, the intermediate lessor would account for the head lease and sublease as a single combined transaction.

6.1.2 Presentation

Intermediate lessors would not be permitted to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, unless those liabilities and assets meet the requirement of IAS 32 Financial Instruments: Presentation for offsetting financial instruments. Intermediate lessors would apply the principal-agent requirements from IFRS 15.B34 - B38 to determine whether sublease revenue should be presented on a gross or net basis (i.e., reduced for head lease expenses). The IASB expects that intermediate lessors would generally present sublease revenue on a gross basis.

**How we see it**

Various aspects of the new standard (e.g., the principal-agent considerations for sublease revenue) would align with IFRS 15. Lessors should familiarise themselves with IFRS 15 because it could also influence their accounting for leases. In addition, lessors should monitor developments as the IASB considers amending IFRS 15.
6.1.3 Disclosure

In addition to the lessee and lessor disclosure requirements discussed previously, the new standard would require an intermediate lessor to disclose the following information relating to its subleases:

- A general description of the leases
- The basis, and terms and conditions, on which variable lease payments are determined
- The existence, and terms and conditions, of options to extend or terminate the lease
- The existence, and terms and conditions, of residual value guarantees provided by the sub-lessee
- The restrictions or covenants imposed by leases (e.g., those related to dividends or incurring additional financial obligations)

6.2 Business combinations

6.2.1 Classification as finance or operating

The new standard would require an acquirer to classify acquired lessor leases as either finance or operating leases using the contractual terms and conditions at the commencement date of the lease. If the contractual terms and conditions of a lease are modified as part of the business combination, the acquirer would classify the new lease based on the contractual terms and conditions of that new lease.

How we see it

- Under the new standard, no lease assets and liabilities would be recognised for acquired lessee leases that have a remaining term of 12 months or less at the acquisition date. We believe the acquirer would generally recognise lease payments on a straight-line basis over the remaining lease term following the business combination.
- It is unclear whether the acquirer’s accounting for leases with a remaining term of 12 months or less would preclude the recognition of assets and liabilities for off-market contract terms on in-place leases. Precluding the recognition of these assets and liabilities would be inconsistent with the principles in IFRS 3 Business Combinations that typically result in the recognition of assets and liabilities for the off-market terms of contracts.

6.2.2 Acquiree in a business combination is a lessee

6.2.2.1 Initial measurement of a lease

Consequential amendments to IFRS 3 would specify the initial measurement requirements for leases that are acquired in a business combination. However, subsequent measurement requirements for an acquired lease liability and right-of-use asset would be the same as the requirements for any other existing lease arrangement.

The acquirer would measure the acquired lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquiree would apply the new standard’s initial measurement provisions, using the present value of the remaining lease payments at the acquisition date. The acquirer would follow the requirements for determining the lease term, lease payments and discount rate.
The right-of-use asset would be measured at an amount equal to the recognised liability, adjusted to reflect both of the following:

- Favourable or unfavourable terms of the lease, relative to market terms
- Any other intangible asset associated with the lease, which may be evidenced by market participants’ willingness to pay for the lease even if it is at market terms (e.g., a lease of gates at an airport, a lease of retail space in a prime shopping area that provides entry to the market or other future economic benefits that qualify as an intangible asset)

Because the off-market nature of the lease would be captured in the right-of-use asset, the acquirer would not separately recognise an intangible asset or liability for favourable or unfavourable lease terms relative to market.

6.2.2.2 Subsequent measurement of a lease
The subsequent measurement of an acquired lease liability and right-of-use asset would be determined using the subsequent measurement requirements for pre-existing lease arrangements (refer to section 4 above).

6.2.3 Acquiree in a business combination is a lessor
6.2.3.1 Initial measurement of a lease when the acquiree is a finance lessor
The acquirer would measure a lease receivable as if the lease contract were a new lease at the acquisition date (i.e., measured at the present value of the remaining lease payments). The acquirer would use the key concepts described in section 2 above to determine the lease term, lease payments and discount rate. A residual asset would be initially measured as the difference between the acquisition date fair value of the underlying (acquired) asset and the initial measurement of the lease receivable. The acquirer would take into consideration the terms and conditions of the lease (e.g., off-market terms) when calculating the acquisition date fair value of the underlying asset. An acquirer would not recognise a separate intangible asset or liability for favourable or unfavourable terms, relative to market.

6.2.3.2 Initial measurement of a lease when the acquiree is an operating lessor
Underlying assets subject to operating leases would remain on the lessor’s balance sheet. Therefore, when an acquiree is a lessor, an underlying asset subject to an operating lease would be recognised on the acquirer’s balance sheet and initially measured at fair value. The acquirer would consider the terms and conditions of the lease (e.g., off-market terms) when measuring the fair value of the underlying asset (e.g., a building). No separate intangible asset or liability for favourable or unfavourable terms relative to market would be recognised.

6.2.3.3 Subsequent measurement of a lease
The subsequent measurement of the net investment in a finance lease would be determined using the subsequent measurement requirements for pre-existing lease arrangements (see section 5 above). The subsequent measurement of the underlying asset subject to an operating lease would be determined using other applicable accounting standards (e.g., IAS 16).
6.3 Sale and leaseback transactions

Because lessees would recognise most leases on the balance sheet (i.e., all leases except for leases of small assets and short-term leases depending on the lessee’s accounting policy elections), sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing.

A seller-lessee would use the definition of a sale in IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction. The seller-lessee would assess whether the buyer-lessor has gained control of the underlying asset. Control of an underlying asset refers to the ability to direct the use of the asset and obtain substantially all of the remaining benefits from the asset.

If control of an underlying asset passes to the buyer-lessor, the transaction would be accounted for as a sale and a lease by the lessee. If not, the transaction would be accounted for as a financing.

The IASB decided to retain the requirement in the 2013 ED that a buyer-lessor would account for the purchase of the underlying asset consistent with the standard that would apply to any other purchase of a non-financial asset (i.e., without the presence of the leaseback).

6.3.1 Ability to direct the use of an underlying asset

While the concepts of ‘control’ in the new standard and IFRS 15 are similar, a key difference exists. Under the new standard, the right to control the use of an underlying asset would involve the right to direct how and for what purpose the asset is used throughout the period of its use. Under IFRS 15, control is based on a broader consideration of rights with respect to the asset over its entire useful life.

The presence of a leaseback, in and of itself, would not preclude a sale. However, the IASB decided that a sale and purchase would not occur if the seller-lessee has a substantive option to repurchase the underlying asset because the buyer-lessee would not obtain control of that asset, consistent with IFRS 15. In contrast, the presence of a non-substantive repurchase option (e.g., an option that is exercisable only at the end of the underlying asset’s economic life) would not preclude sale accounting.

How we see it

In a sale and leaseback transaction, it is unclear whether options to extend a lease for the remaining economic life of the underlying asset would be evaluated in the same manner as purchase options under IFRS 15.
4.3.2 Transactions in which the buyer-lessor obtains control of the underlying asset

6.3.2.1 Accounting for the sale
When the seller-lessee transfers control of the underlying asset to the buyer-lessor in a sale and leaseback transaction, the seller-lessee would do each of the following:

- Derecognise the underlying asset
- Recognise a lease liability and right-of-use asset for the leaseback (subject to the optional exemptions for leases of small assets and short-term leases)
- Recognise a loss, if any, immediately (adjusted for off-market terms)
- Recognise a gain only on the portion related to the buyer-lessor's residual asset (i.e., the residual interest in the underlying asset transferred to the buyer-lessor)
- Recognise the remaining gain (i.e., related to the leaseback) as a reduction to the initial measurement of the seller-lessee's right-of-use asset and thus reflected as a reduction in amortisation of the right-of-use asset over the term of the leaseback

A seller-lessee would recognise a smaller immediate gain on a leaseback covering a large portion of the life of the underlying asset compared with a similar transaction with a shorter leaseback of the same asset.

Key differences between IFRS and US GAAP
Under the FASB's new standard, the seller-lessee would recognise a full gain (if any) immediately.

Refer to Appendix B for a summary of the key differences between IFRS and US GAAP.

6.3.2.2 Accounting for the leaseback
When a sale occurs, both the seller-lessee and the buyer-lessor would account for the leaseback in the same manner as any other lease (i.e., in accordance with the lessee and lessor requirements, respectively, with adjustments for any off-market terms).
6.3.2.3 Adjustment of off-market terms

The sale transaction and the lease that follows are generally interdependent and negotiated as a package. Consequently, in some cases, the transaction could be structured with a negotiated sales price above fair value and with lease payments above the then-current market rates, or vice versa. Under either scenario, the off-market terms could distort the gain on sale (or disposition) and the recognition of lease expense for the related lease. To ensure that the gain or loss on disposition and the lease-related assets and liabilities associated with such transactions are neither understated or overstated, the IASB decided to require adjustments for any off-market elements of sale and leaseback transactions.

The off-market adjustments would be determined using the fair value of the underlying asset or the market lease payments, whichever provides the more readily determinable evidence. Entities would be expected to maximise the use of observable prices and information when determining which measure is the most appropriate to use.

When the sale price is (or the total lease payments are) less than the underlying asset’s fair value (or the total market lease payments), a seller-lessee would increase the initial measurement of the right-of-use asset. This treatment would be similar to the accounting for lease prepayments under the new standard. When the sale price is (or the total lease payments are) greater than the underlying asset’s fair value (or the total market lease payments), a seller-lessee would decrease the initial measurement of the right-of-use asset.

Buyer-lessors would also be required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments would be recognised as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee.

6.3.3 Transactions in which the buyer-lessee does not obtain control of the underlying asset

When the seller-lessee does not transfer control of the underlying asset to the buyer-lessee, the seller-lessee would not derecognise the underlying asset. Instead, both parties would account for the failed sale and leaseback transaction as a financing. That is, the seller-lessee would recognise a financing liability in accordance with applicable accounting standards for financial liabilities. Similarly, the buyer-lessee would not recognise the underlying asset and would, instead, recognise the amounts paid to the seller-lessee as a receivable in accordance with other applicable accounting standards.

6.3.4 Disclosure

A seller-lessee in a sale and leaseback transaction would be required to disclose any gains or losses arising from the transaction separately from gains or losses on disposals of other assets.
7. Effective date and transition

7.1 Effective date
The IASB has not yet discussed an effective date, but plans to address it later in 2015.

7.2 Transition
Companies would adopt the new standard using either a full retrospective or a modified retrospective approach. Under the modified retrospective approach, lessees of leases previously classified as operating leases would not restate comparative figures, but, instead, would recognise the cumulative effect of initially applying the new standard as an adjustment to the opening balance of retained earnings (or some other component of equity, as appropriate) at the date of initial application. Neither lessees nor lessors would change their accounting for finance leases existing at the date of initial application of the new standard, nor would lessors of leases previously classified as operating leases (with the exception of subleases).

Entities would not be required to reassess existing contracts under the definition of a lease contained in the new standard. Instead, entities would be permitted to account for transactions that do not contain a lease under IAS 17 and IFRIC 4 as they are today (i.e., generally as services). Likewise, an entity would be permitted to account for contracts that contain a lease under IAS 17 and IFRIC 4 as containing a lease when applying the new standard. The IASB believes the cost relief to preparers outweighs any benefit to be gained from reassessment.

If an entity chooses this option, it would be applied to all contracts that are ongoing at the date of initial application (i.e., an entity would not be permitted to apply the option on a lease-by-lease basis) and that fact would be disclosed.

How we see it
Because the current accounting for operating leases and service contracts is similar, determining whether an arrangement is a lease or service contract might not have been a focus for many entities. Given the consequences of the new standard, the effects of treating an arrangement as a service instead of a lease may be material when it may not have been material in the past. This may require some entities to revisit the assessments made under current standards.

7.2.1 Leases previously classified as finance leases
An entity would not change its accounting for finance leases existing at the date of initial application of the new standard.

7.2.2 Lessees - Leases previously classified as operating leases
For leases previously classified as operating leases, lessees would be permitted to choose either a full retrospective approach or a modified retrospective approach on initial application of the new standard. The approach must be applied consistently across a lessee’s entire operating lease portfolio.

Under the modified retrospective approach, the lessee would:

- Not restate comparative figures
• Recognise the cumulative effect of initially applying the new standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application

• Measure the lease liability at the present value of the remaining lease payments, discounted using the lessee’s incremental borrowing rate at the date of initial application

• Measure the right-of-use asset on transition in one of two ways, chosen on a lease-by-lease basis:
  ▶ As if the new standard had always been applied, but using a discount rate based on the lessee’s incremental borrowing rate at the date of initial application
  ▶ At an amount equal to the lease liability, adjusted for previously recognised prepaid or accrued lease payments

• Be permitted to:
  ▶ Apply a single discount rate to a portfolio of leases with similar characteristics
  ▶ Adjust the right-of-use asset for any previously recognised onerous lease provisions
  ▶ Apply a recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application
  ▶ Exclude initial direct costs in the measurement of the right-of-use asset
  ▶ Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease

Lessees also would be required to make specific disclosures to help users understand the effect of the new standard compared to IAS 17. Instead of the requirements of paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, lessees would be required to disclose the following:

• The weighted average incremental borrowing rate at the date of initial application

• Explanation of any differences between:
  ▶ The result of discounting the operating lease commitments reported under IAS 17 at the end of the annual reporting period preceding the date of initial application; and
  ▶ Lease liabilities recognised on the balance sheet immediately after posting the cumulative catch-up adjustment on the date of initial application

First-time adopters of IFRS would also be able to use a modified retrospective approach, but with some exceptions to the approach described above.

How we see it
The additional transition reliefs for lessees with existing operating leases address many of the concerns constituents raised about the cost and complexity of applying the transition provisions contained in the 2013 ED.
7.2.3 Lessors - Leases previously classified as operating leases
With the exception of subleases described below, lessors would continue to apply their current accounting for any operating leases that are ongoing at the date of initial application.

7.2.4 Subleases
An intermediate lessor (i.e., an entity that is both the lessee and lessor of the same underlying asset) must reassess each existing operating sublease at the date of initial application to determine whether it is classified as an operating lease or a finance lease under the requirements of the new standard. This reassessment would be based on the remaining contractual terms of the head lease and the sublease with reference to the right-of-use asset associated with the head lease and not the underlying asset.

If a sublease was classified as an operating lease under IAS 17 and is a finance lease under the new standard, the intermediate lessor would account for the sublease as a new finance lease entered into on the date of initial application. Any gain or loss arising on the sublease arrangement would be included in the cumulative catch-up adjustment to retained earnings (or other component of equity, as appropriate) at the date of initial application.

7.2.5 Sale and leaseback transactions
Seller-lessees would be prohibited from reassessing historical sale and leaseback transactions to determine whether a sale occurred in accordance with IFRS 15.

Seller-lessees would not perform any retrospective adjustments to sale and leaseback transactions on transition to the new standard. Instead, the leaseback would be accounted for on transition in the same way as any other operating or finance lease ongoing at the date of initial application, subject to the following:

▶ For sale and leaseback transactions previously classified as finance leases, any gain on the sale would continue to be amortised in the same way as under IAS 17
▶ For sale and leaseback transactions previously classified as operating leases, any deferred losses or gains relating to off-market terms at the date of initial application would be adjusted against the right-of-use asset

The partial gain recognition approach discussed in section 6.3 above would only apply to new sale and leaseback transactions entered into after the date of initial application.

Key differences between IFRS and US GAAP
The IASB’s new standard would permit entities to choose either a full retrospective transition approach or a modified-retrospective approach on initial application of the new standard. The FASB would prohibit full retrospective application of its new standard.

Although the FASB would require adoption of its new standard using a modified retrospective approach and the IASB would permit such an approach, the IASB and the FASB would require the modified retrospective approach to be applied differently and would provide different types of transition relief.

Refer to appendix B for a summary of the key differences between IFRS and US GAAP.
## Appendix A: Summary of lessee and lessor reassessment requirements

<table>
<thead>
<tr>
<th></th>
<th>Lessee</th>
<th>Lessors</th>
</tr>
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</table>
| **Allocating contract consideration** | Reallocate contract consideration upon either of the following events:  
  - A contract modification that is not accounted for as a separate, new lease  
  - A reassessment of the lease term or whether the lessee is reasonably certain to exercise an option to purchase the underlying asset | Reallocate contract consideration upon a contract modification that is not accounted for as a separate, new lease. |
| **Lease term**         | Reassess upon the occurrence of significant events or changes in circumstances that are within the lessee’s control (i.e., market-based events or changes would not trigger a reassessment). | No requirement to reassess after lease commencement. |
| **Variable lease payments that depend on an index or rate**        | Reassess when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term) and upon a change in the cash flows resulting from a change in the reference index or rate (i.e., when an adjustment to the lease payments takes effect). | No requirement to reassess after lease commencement. |
| **Amounts expected to be payable under residual value guarantees** | Remeasure the lease liability and adjust the right-of-use asset if the amounts expected to be payable under residual value guarantees change during the lease term.  
  Recognise the remaining adjustment in profit or loss if the right-of-use asset is reduced to zero. | Not applicable for lessors because lease payments would generally exclude amounts receivable under residual value guarantees (from the lessee or a third party). |
| **Discount rate**      | Reassess upon a lease modification, a change to the lease term or a change to the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset. | No requirement to reassess after lease commencement. |
| **Lease classification** | Not applicable as there is no lease classification for lessees. | No reassessment after lease commencement. |
### Appendix B: Key differences between IFRS and US GAAP

<table>
<thead>
<tr>
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<th>IFRS (IASB)</th>
<th>US GAAP (FASB)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope and exclusions</strong></td>
<td>The scope of the new standard would not apply to lessors’ leases of intangible assets. However, lessees of intangible assets could apply the new standard, but would not be required to do so.</td>
<td>The scope of the new standard would not apply to leases of intangible assets.</td>
</tr>
<tr>
<td><strong>Leases of small assets</strong></td>
<td>For lessees only - recognition and measurement exemption for leases of certain low-value assets (i.e., small assets).</td>
<td>No exemption for leases of small assets.</td>
</tr>
<tr>
<td><strong>Portfolio approach</strong></td>
<td>Guidance would be included in the Application Guidance of the new standard.</td>
<td>Guidance would be included in the non-authoritative Basis for Conclusions.</td>
</tr>
<tr>
<td><strong>Variable lease payments that depend on an index or rate - lessee reassessment</strong></td>
<td>Reassess upon remeasurement of lease liability for other reasons (e.g., due to a change in the lease term) and upon a change in the cash flows resulting from a change in the reference index or rate (i.e., when an adjustment to the lease payments takes effect).</td>
<td>Reassess only when lease liability is remeasured for other reasons.</td>
</tr>
<tr>
<td><strong>Discount rate - lessees (US GAAP only)</strong></td>
<td>No accounting policy election for lessees to use the risk-free rate for initial and subsequent measurement of lease liabilities.</td>
<td>Accounting policy election for lessees that are not public business entities to use the risk-free rate to determine the present value of lease payments (for all leases).</td>
</tr>
<tr>
<td><strong>Fair value of the underlying asset</strong></td>
<td>The measurement and disclosure requirements of IFRS 13 would apply to lease transactions within the scope of the new standard.</td>
<td>Definition of fair value in ASC 820 Fair Value Measurement would not apply to fair value measurements for the purposes of lease classification and measurement (with certain exceptions).</td>
</tr>
<tr>
<td><strong>Lease classification - lessees</strong></td>
<td>Leases (with optional exemptions for leases of small assets and short-term leases) would be accounted for under a single recognition and measurement model.</td>
<td>Leases (with an optional exemption for short-term leases) would be classified as Type A or Type B, and there would be no initial measurement difference between them. Differences would result in the recognition, measurement and presentation of leases for lessees.</td>
</tr>
<tr>
<td><strong>Alternative measurement bases for right-of-use asset - lessees</strong></td>
<td>Lessees have the option to revalue right-of-use assets under IAS 16 and to measure right-of-use assets that meet the definition of investment property at fair value under IAS 40.</td>
<td>Not applicable under US GAAP.</td>
</tr>
<tr>
<td><strong>Presentation - statement of cash flows - lessees</strong></td>
<td>Cash paid for interest would be presented consistent with the entity’s policy election under IAS 7.</td>
<td>Cash paid for interest on Type A leases and lease payments for Type B leases would be presented within operating activities.</td>
</tr>
<tr>
<td><strong>Disclosure – qualitative disclosures – lessees</strong></td>
<td>IFRS (IASB)</td>
<td>US GAAP (FASB)</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>-------------</td>
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</tr>
<tr>
<td>Would not include specific qualitative disclosure requirements.</td>
<td>Would include a specific list of qualitative disclosure requirements.</td>
<td></td>
</tr>
</tbody>
</table>

**Disclosure – quantitative disclosures – lessees**

- The IASB and FASB differ on specific lessee quantitative disclosure requirements mainly because of differences in the lessee accounting models. For example, the FASB’s new standard would require disclosure of ‘Type B’ lease expense, which is not applicable under the IASB’s new standard (under which all recognised leases would be accounted for under a single model).
- The IASB would require the disclosures to be made in a tabular format unless another format is more appropriate, and all lessee disclosures to be presented in a single note or separate section of the financial statements. However, the FASB would not require a specific format for lessee quantitative disclosures.

**Determining whether to defer or recognise selling profit – lessor initial recognition of selling profit in finance leases**

- Recognise initial selling profit for all finance leases with selling profit.
- Recognise initial selling profit only if lessee obtains control of the underlying asset, as that would be defined in the new standard.

**Other quantitative and qualitative disclosures – finance leases – lessors**

- Qualitative and quantitative disclosure of significant changes in the net investment.
- Qualitative and quantitative disclosure of significant changes in the residual value component of the net investment.

**Intermediate lessor accounting – classification of a sublease**

- For purposes of lease classification, the intermediate lessor would consider its right-of-use asset as the leased asset.
- For purposes of lease classification, the intermediate lessor would consider the underlying asset as the leased asset.

**Sale and leaseback transactions – determining whether a sale has occurred**

- No sale occurs when the seller-lessee has a substantive repurchase option, with no further guidance for non-specialised assets that are readily available in the marketplace.
- Sale accounting is not prohibited for any leaseback because all recognised lessee’s leases are accounted for under a single model.
- No sale occurs when either:
  - Leaseback is a ‘Type A’ lease.
  - Seller-lessee has a substantive repurchase option.
  - Fair value (date of exercise) repurchase options for non-specialised assets that are readily available in the marketplace would not preclude a sale (i.e., option would be non-substantive).

**Sale and leaseback transactions – accounting for gains**

- Recognition of gain would be limited to the portion related to the residual asset. The remaining gain would be recognised as a reduction to the initial measurement of right-of-use asset, thus reflected as a reduction in amortisation of the right-of-use asset over term of the leaseback.
- Recognise gain in full.
The IASB’s new standard would permit entities to choose either a full retrospective transition approach or a modified-retrospective approach on initial application of the new standard. The FASB would prohibit full retrospective application of its new standard.

Although the FASB would require adoption of its new standard using a modified retrospective approach and the IASB would permit such an approach, the IASB and the FASB would require the modified retrospective approach to be applied differently and would provide different types of transition relief.
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