How the lease accounting proposal might affect your company

August 2013
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What you need to know

- The IASB and the FASB have proposed requiring lessees to recognise assets and liabilities arising from their involvement in most leases.

- Entities would still classify leases, but based on different criteria and for a different purpose. Lease classification would determine how entities recognise lease-related revenue and expense, as well as what lessors record on their balance sheets.

- Classification would be determined based primarily on the nature of the asset being leased.

- This publication builds on our earlier Applying IFRS publication, *A closer look at the revised lease accounting proposal*, and provides more detail and more examples of how entities would be affected.

- Comments are due by 13 September 2013.
1. Overview

The joint proposal by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) would significantly change the accounting for leases and could have far-reaching implications for an entity’s finances and operations.

The exposure draft (ED or proposal) features a right-of-use model that would require lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. Like IAS 17 Leases, the proposal would require lessees and lessors to classify leases by type but the criteria for classifying leases and the related accounting would be different. Under the proposal, leases would be classified into two types (Type A and Type B) and classification would be used principally for determining the method and timing for recognising lease revenue and expense. Classification would be based on the economic benefits of the underlying asset expected to be consumed by the lessee over the lease term. To apply that principle, the Boards provide criteria to consider based on whether the leased asset is property (i.e., land, building, part of a building) or an asset other than property (e.g., automobiles and machinery).

Classification would determine the method for recognising lease revenue and expense. For lessees, the recognition of lease related assets and liabilities and changes to the pattern and timing of lease expense recognition could have significant financial reporting and business implications, such as:

- Key balance sheet metrics may change
- Changes to lease revenue and expenses may affect other key metrics, such as earnings before interest, taxes, depreciation and amortisation (EBITDA)
- Debt covenants and borrowing capacity may be affected
- Decisions of whether to lease or buy significant assets may be affected

Lessors’ financial statements and business practices could also be affected. For example, lessors may be required to recognise profit for more leases at lease commencement rather than over time. This would likely occur for many current operating leases of assets other than property. Lessors also might change the way they use third-party residual value guarantees because such guarantees generally would no longer affect lease classification under the proposal.

An effective date has not yet been proposed. However, we do not expect a final leases standard to be effective before 2017. The proposal’s transition provisions would be applied at the beginning of the earliest comparative period presented in the financial statements in the year of adoption. For example, if the proposed standard were to be effective for calendar year 2017, a calendar-year entity that includes two years of information (i.e., preceding period and current period) would have an effective date of 1 January 2017 and use 1 January 2016 as its date of initial application. The Boards have proposed requiring entities to adopt the new standard using either a full retrospective or a modified retrospective approach.

Board members, however, are divided on whether it is appropriate to retain multiple lease accounting models. Two of the IASB’s 14 voting members and three of the seven FASB members voted against issuing the proposal for comment. Concerns raised include:
The complexity in the accounting model may hinder users’ ability to assess the amount, timing and uncertainty of lease-related cash flows.

The creation of two types of leases, particularly Type B leases, may make the accounting operationally difficult to apply and unnecessarily complex.

The costs may exceed the benefits of the proposal.

The diversity of views among Board members makes feedback from financial statement preparers and users critical. Comments are due by 13 September 2013.

The complete ED and instructions for submitting comment letters are available on the IASB’s website. Interested parties should also consider participating in the Boards’ planned outreach. For example, the IASB and the FASB said they will host several joint public roundtable meetings in September and October 2013 to give users, preparers and auditors an opportunity to discuss the proposals with the Boards. Interested parties can find more information about the roundtable meetings on the IASB’s leases project website.

This publication highlights how the proposal would be applied and implications for preparers. It is intended to help entities consider the potential effects of the proposal. The discussions and illustrations within this publication represent preliminary thoughts and additional issues will be identified through continued analysis of the ED and as the elements of the ED change on further deliberation by the Boards. In addition, the illustrations in this publication ignore the potential deferred tax implications of the proposal.

2. Identifying a lease

2.1 Scope exclusions

The ED would apply to leases of all assets, except for the following, which would be specifically excluded under the proposal:

- 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 proposal. This leaves open the possibility that an entity could choose, presumably as an accounting policy election, to account for leases of intangible assets under the proposed leases standard.

In a change from the 2010 ED, leases of property that meet the definition of investment property in IAS 40 Investment Property are included in the scope of the ED. In addition, the proposal would require a lessee to measure right-of-use assets arising from leased property in accordance with the fair value model of 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 accounting policy election that is available on a property-by-property basis.
Whilst the proposal would apply to arrangements involving assets other than property, plant and equipment, such arrangements often would not meet the proposed definition of a lease.

2.2 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, an arrangement would have to meet both of the following criteria:

- Fulfilment of the contract depends on the use of an identified asset
- The contract conveys the right to control the use of the identified asset

2.2.1 Identified asset

The Boards believe that being able to identify a specified asset is fundamental to the definition of a lease. Consequently, the proposal's identified asset criterion is generally consistent with the specified asset concept in IFRIC 4 Determining whether an Arrangement contains a Lease. That is, an identified asset could be either implicitly or explicitly specified in a contract. An identified asset could be a physically distinct portion of a larger asset (e.g., a floor of a building). However, a portion of an asset that is not physically distinct (e.g., 60% of a pipeline's capacity) would not qualify as an identified asset.

In some cases, however, a contract structured as a capacity agreement could, in substance include an identified asset. For example, a contract that provides a customer with the right to use substantially all of the capacity of an asset would meet the requirements of an identified asset. However, to be a lease the arrangement would also have to provide the customer with the right to control the use of the identified asset (see section 2.2.2 below).

How we see it

In some arrangements (e.g., certain supply contracts), a customer may, by design, use less than substantially all of an asset's total capacity (i.e., the potential economic benefits of the asset). We believe that if the supplier does not have a contractual and practical ability to market the remaining capacity (or other potential economic benefits of use) to unrelated customers during the contract term, the asset would qualify as an identified 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 that connects New York to 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 specific to 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 asset, as discussed in section 2.2.2 below.
Illustration 1 – Identified asset (continued)

Scenario B
Assume the same facts as in Scenario A, except that the supplier is free to use any of the 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 obligation to Customer X. That capacity portion is not physically distinct from the remaining capacity of the cable.

Illustration 2 – Implicitly identified asset

Customer Y enters into a five-year contract with a supplier for the use of a specifically designed rail car. The rail car is designed to transport materials used in Customer Y’s production process and is not suitable for use by other customers. The rail car is not specifically identified in the contract, but the supplier owns only one rail car that is suitable for such use and other rail cars of the specification required to transport such materials are not readily available from rail car suppliers. If the rail car does not operate properly, the contract requires the supplier to repair or replace the rail car. The supplier also does not have a substantive substitution right (as discussed below).

Analysis: The rail car is an implicitly identified asset. Whilst the rail car is not explicitly identified in the contract (e.g., no serial number is included in the contract), the supplier must use it to fulfil the contract. 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 2.2.2 below.

Some contracts give the supplier the right to fulfil its obligation using an alternative asset at anytime, and for any reason, throughout the contract term. If the supplier has such a substantive substitution right, the contract would not depend on the use of an identified asset. A substitution right would be substantive if both of the following conditions are met:

- The supplier can substitute an alternative asset without the customer’s consent
- There are no barriers that would prevent the supplier from substituting an alternative asset, such as:
  - Substitution costs that are so high that they create an economic disincentive to substitution
  - Operational barriers (e.g., alternative assets are not readily available nor could they be sourced within a reasonable time and cost)

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. Conversely, if the supplier has a substantive right to replace the asset, the contract does not depend on the use of an identified asset.

With the proposed requirement that substitution rights be substantive, the Boards are trying to mitigate the risk that customers and/or suppliers would structure arrangements with non-substantive substitution clauses to avoid applying the lease accounting proposal.
The assessment of whether a contract conveys the ‘right to control the use’ of the identified asset under the ED would be different from that under today’s standards.

**Illustration 3 – Substitution rights**

Scenario A

Assume that an electronic data storage provider (supplier) provides services, through a centralised data centre, that involve the use of a specified server (server No. 9) and that the supplier also has the ability to substitute another server without the customer’s consent. The supplier maintains many identical servers in a single, accessible location, and the supplier could easily substitute another server for No. 9 at a nominal cost (i.e., there are no barriers, economic or otherwise, that would prevent the substitution of the asset).

**Analysis:** Fulfilment of this contract would not depend on the use of an identified asset and the contract would not be a lease.

Scenario B

Assume the same facts as in Scenario A except that server No. 9 is customised and substitution would require the supplier to incur significant cost. For example, the server may contain the customer’s confidential information, requiring the destruction of the asset’s primary components (e.g., technological hardware and software) if substituted.

**Analysis:** Such costs may represent an economic disincentive (i.e., an economic barrier) to substitute the server. If so, the supplier’s substitution right would be non-substantive and server No. 9 would be an identified asset. 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 2.2.2 below.

### 2.2.2 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 ability to both:

- Direct the use of the identified asset
- Derive the benefits from the use of the identified asset

This concept represents a change from current lease standards. In some circumstances (e.g., when the customer obtains substantially all of the output of the underlying asset), a contract may meet today’s control criterion even if the customer does not have any rights to direct the use of the asset. However, because the proposal would focus on control (including the ability to direct the use), certain arrangements that are accounted for as leases today (e.g., some take-or-pay arrangements) would no longer be considered leases.

#### 2.2.2.1 Direct the use of the identified asset

A customer’s ability to direct the use of an identified asset would be demonstrated by its ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from the asset’s use throughout the term of the contract. Examples of such decisions would include the customer’s ability to determine or change:

- How and for what purpose the asset is employed
- How the asset is operated
- The operator of the asset (if the customer cannot or chooses not to operate the asset itself)
A customer’s ability to specify the quantity and timing of an asset’s output would not, in and of itself, indicate that the customer has the ability to make the most significant decisions. In contrast, if the supplier operates the asset according to the predetermined specific customer instructions about how the asset produces those goods, the customer would have the ability to direct the use of the asset.

**Illustration 4 – Ability to direct the use of the asset**

Assume that Entity A (customer) enters into a three-year agreement with a contract manufacturer (supplier) for the production of Entity A’s product. The contract requires the supplier to manufacture Entity A’s product using a specific factory. During the contract term, the factory will only be used to manufacture Entity A’s products.

**Scenario A**

The contract allows:

- The customer to specify the quantity of products to be manufactured and delivered each month
- The supplier to make decisions about how to operate and maintain the factory
- The supplier to determine the production schedule and which of its employees will operate the factory

**Analysis:** The contract would not contain a lease. Entity A does not have the ability to direct the use of the asset because it cannot make the decisions that most significantly affect the economic benefits to be derived from the factory during the contract term (i.e., determining how to operate and maintain the factory, determining the production schedule and deciding which employees will operate the factory are determined to be the decisions that most significantly affect the factory’s economic benefits). Instead, the supplier has the ability to make the decisions that most significantly impact the economic benefits to be derived from the use of the factory throughout the contract term.

**Scenario B**

Assume the same facts as in Scenario A, except that the contract allows the customer to determine the following:

- The design and specifications of the manufacturing equipment in the factory
- The daily production schedule (e.g., run start/stop time, speed)
- The timing of routine maintenance activities

**Analysis:** Entity A has the ability to direct the use of the asset because the entity makes the decisions that most significantly affect the economic benefits to be derived from the use of the identified asset throughout the contract term (i.e., determining the manufacturing design and specifications and determining the production and maintenance schedules are determined to be the decisions that most significantly affect the factory’s economic benefits).

The proposal does not clarify how to distinguish the decisions that most significantly affect the economic benefits to be derived from the asset during the contract term from other decisions associated with use of the asset. Nor does the proposal provide guidance on how to evaluate the most significant decision(s) when there are multiple significant decisions, including when some or all of those decisions are made at or before lease commencement (i.e., the decisions are agreed to in the contract signed by both parties).
The ED does contemplate that, in certain arrangements, a customer may have had involvement in specifying the contractual terms of the arrangement (i.e., the terms of the contract) and, therefore, the ability to influence the decisions that most significantly affect the asset’s economic benefits. As a result, the customer may have predetermined the most significant decisions about the use of the asset that affect the economic benefits of use during the term of the contract and the supplier’s ongoing decisions may, in substance, be limited to carrying out the customer’s instructions (i.e., the customer makes the most significant decisions). However, a customer’s involvement in decisions made prior to the commencement of a contract would not necessarily mean that the customer has control of the asset throughout the term of the contract, even if its involvement in such decisions is significant.

All arrangements, particularly those that establish some or all significant decisions prior to the lease commencement, would need to be scrutinised carefully, especially if the customer is deriving substantially all of the benefits from the underlying asset throughout the contract term.

2.2.2 Derive benefits from the use of the identified asset

A customer’s right to control the use of an identified asset also depends on its ability to obtain substantially all of the potential economic benefits from the use of the asset during the contract term. The customer can obtain economic benefits from use 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 relating to ownership of an asset, would not be considered potential economic benefits of use. The proposal clarifies that a customer would not have the ability to derive the benefits from the use of an asset when both of the following conditions exist:

• In some arrangements (e.g., time charter arrangements of vessels, wet leases of aircraft, co-generation power supply arrangements and oil and gas drilling contracts), both the customer and supplier often have some involvement in, or the ability to make, significant decisions and those decisions are made either before (i.e., in crafting the operating agreement that is signed by and binding on both parties) or during the contract term about how the asset is operated. The determination of which party can make the decisions that most significantly affect the economic benefits to be derived from the use of the asset throughout the contract term would require significant judgement.

• It is not clear when, or how, an entity would consider its involvement in determining the terms and conditions of the contract. For example, the ED does not specify whether this consideration would be required for all contracts or only for those in which few, if any, significant decisions are made after the commencement date. It is also unclear how entities would determine which party is responsible for individual decisions contained in a mutually agreed upon contract. We believe application guidance (e.g., how to identify and weight significant decisions) is needed to make this requirement operational.

• The ED does not provide guidance on how to consider arrangements that include significant decisions that are jointly agreed to by the customer and supplier prior to lease commencement (i.e., in the contract) whilst other significant decisions are made during the lease term.
Those benefits can be obtained only in conjunction with additional goods or services provided by the supplier and not sold separately by the supplier or others.

The asset is incidental to the delivery of services because the asset has been designed to function only with the additional goods or services provided by the supplier (e.g., a bundle of goods and services combine to deliver an overall service for which the customer has contracted).

**How we see it**

When a customer can benefit from an asset only in conjunction with additional goods or services provided by the supplier, it may be difficult for that customer to determine whether such additional goods or services are available separately from the supplier or others. It also is not clear whether after-market sales, such as those through online marketplaces, would be considered ‘available’ from other suppliers. Additional guidance may be needed to help entities apply this concept.

Customers generally obtain the economic benefits from an asset by using it for its primary purpose (e.g., van used for deliveries by a customer that is a courier). However, as described above, the economic benefits of use contemplated by the ED could be something other than the physical output of the asset, meaning economic benefits of use may also be obtained indirectly. For example, a customer could obtain economic benefits by consuming an asset directly or sub-leasing it or selling related renewable energy credits to a third party.

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

### Illustration 5 — Benefits obtained in conjunction with additional goods or services

**Scenario A**

Assume that Entity Z, a healthcare provider, enters into a three-year contract with a supplier for the use of specialised medical equipment. The equipment will be located at Entity Z’s facilities and will be operated by Entity Z’s personnel to provide healthcare services to customers. The equipment can be operated only in conjunction with a specific consumable product (the consumable). The contract requires Entity Z to purchase the consumable from the supplier, even though the consumable is readily available from other suppliers. The supplier also sells the consumable to customers that purchase the equipment (i.e., rather than leasing it).

**Analysis:** Entity Z would be able to derive benefits from use of the equipment on its own without the supplier’s consumables. Consequently, the contract would have two separate components: the right to use the equipment and the supply of the consumables. Separation of contract components is discussed in section 2.5 below.
Illustration 5 – Benefits obtained in conjunction with additional goods or services (continued)

Scenario B
Assume the same facts as in Scenario A, except the consumable is only available from the supplier and the supplier only provides such consumable in conjunction with contracts to use such specialised equipment (i.e., it does not sell the equipment and therefore the consumable is not sold separately either).

Analysis: Entity Z would not have the ability to derive benefits from the use of the equipment on its own without the supplier’s consumable. The equipment has no value to Entity Z without the consumable and, as such, the equipment is incidental to the delivery of the health services. Consequently, the contract would not be a lease.

2.3 Cancellable leases
Certain leases that are referred to as ‘cancellable’, ‘month-to-month’, ‘at will’, ‘evergreen,’ ‘perpetual’ or ‘rolling’ would be subject to the proposal if they create enforceable rights and obligations. Any non-cancellable periods in such leases would be considered part of the lease term.

For example, consider an agreement with an initial non-cancellable period of one year and an extension for an additional year upon agreement of both parties. 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 to cancel the arrangement without incurring a substantive penalty.

2.4 Short-term leases
Lessees and lessors could make an accounting policy election, by asset class, to apply a method similar to current operating lease accounting to leases with a maximum possible contractual lease term, including any options to extend, of 12 months or less. Any lease that contains a purchase option would not be a short-term lease.

The proposed short-term lease election is designed to reduce cost and complexity. All optional periods would be included in the assessment of the maximum possible lease term.

Illustration 6 – Short-term lease

Scenario A
Assume that a customer enters into a contract that meets all of the criteria to be a lease. The contract has an initial term of nine months with a single one-month renewal option. Including the renewal option the maximum possible contractual lease term is 10 months.

Analysis: The lease would qualify as a short-term lease.

Scenario B
Assume that a customer enters into a contract that meets all of the criteria to be a lease. The contract has an initial term of nine months with four one-month renewal options. The customer has no economic incentive to exercise the renewal options. In this scenario, the maximum possible contractual lease term would be 13 months.

Analysis: The lease would not qualify as a short-term lease.
An entity that makes such an election for short-term leases would not recognise lease-related assets or liabilities on the balance sheet. Lessees making the election would recognise lease expense on a straight-line basis over the lease term. Lessors making the election would recognise lease income on a straight-line basis or another systematic basis that is more representative of the pattern in which income is earned. All entities that elect to account for short-term leases under this exception would disclose that fact.

2.5 Separation of lease and non-lease components

2.5.1 Identifying and separating a lease from non-lease components of contracts

Many contracts contain a lease and the purchase of other goods or services (non-lease components). For these contracts, the non-lease components would be identified and accounted for separately from the lease. The non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to the new revenue recognition standard by lessors (suppliers). The Boards are expected to finalise the new revenue recognition standard in the third quarter of 2013 (see the project page on the IASB website for more information).

How we see it

Identifying non-lease components (e.g., services) of contracts may change practice for some lessees. Today, entities may not focus on identifying non-lease components because their accounting treatment is often the same as for an operating lease. Under the proposal, lessees may need more robust processes to identify lease and non-lease components of contracts.

2.5.2 Identifying and separating lease components

The proposal provides requirements for contracts that contain the rights to use multiple assets (e.g., a building and equipment). In such circumstances, a 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 other transactions or events)

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

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

Illustration 7 — Identifying and separating lease components

Scenario A
Assume that a lessee enters into a lease of a warehouse together with 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.
Illustration 7 — Identifying and separating lease components (continued)

Analysis: The contract contains one lease component. The lessee would be unable to benefit from the use of the warehouse without also using the surrounding parking lot. Therefore, the warehouse space is dependent upon the surrounding 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 surrounding 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 surrounding 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 surrounding parking lot on its own or together with other readily available resources.

2.5.3 Allocating contract consideration

2.5.3.1 Lessors
Lessors would be required to allocate the consideration in a contract to each lease and non-lease component in accordance with the new revenue recognition standard (i.e., on a relative standalone selling price basis). The Boards believe that lessors would be knowledgeable about their products and services and, therefore, would be able to allocate consideration between the lease and non-lease components. If a standalone price is not directly observable, lessors would develop an estimated selling price using one of the techniques described in the new revenue recognition standard, such as:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach (in limited circumstances)

If the contract contains a discount (i.e., the sum of the standalone selling prices exceeds the total contract consideration), the lessor would allocate the discount to one or more of the components (referred to as ‘performance obligations’ under the new revenue recognition standard) using a relative standalone selling price basis. If the discount relates to one or more specific components or if the contract contains contingent consideration, the lessor would apply the requirements in the new revenue recognition standard to allocate the discount entirely to that (or those) specific component(s) if both of the following criteria are met:

- The entity regularly sells or leases each good or service (or each bundle of goods or services) in the contract on a standalone basis
- The observable selling prices for those standalone sales or leases provide evidence of the performance obligation(s) to which the entire discount in the contract belongs

2.5.3.2 Lessees
Lessees would allocate consideration to each lease and non-lease component on a relative standalone-price basis if an observable standalone price for each
component exists. This would be the case if the lessee can identify a price the lessor or similar suppliers would charge separately for a similar lease, good or service component of a contract (i.e., on a standalone basis).

The Boards explain that, in some circumstances, the cost of obtaining the information required to separate lease and non-lease components that do not have observable prices, would outweigh the benefit for the lessee. When observable standalone prices are available for one or more, but not all lease and non-lease components, lessees would use a residual method to allocate contract consideration. Under the residual method, lessees would allocate the standalone observable price to each component for which an observable standalone price is available. Then, the remaining consideration in the contract would be allocated to the remaining component or components of the contract without observable standalone prices.

If one or more of the components without observable prices includes the lease component, the lessee would combine the non-lease component(s) without observable prices with that lease component and account for them as a single lease component. For example, consider an arrangement that contains three elements (lease, services and training), but only the training component has an observable standalone price. In this example, a portion of the payments would be allocated to the training and the residual would be allocated to the lease as a single unit of account.

If no observable standalone prices exist, lessees would combine all lease and non-lease components into a single lease component (i.e., lessees would not separate payments between the lease and non-lease components).

How we see it

- Identifying observable standalone prices would be critical to the accounting for contracts that contain multiple components. This would likely require judgement when observable prices are not readily apparent or when a range of observable standalone prices exists.

- It appears that the requirement for lessees to combine multiple components and account for them as a single lease component when standalone prices are not observable could result in combining multiple right-of-use assets that otherwise would be separated. That is, leases of two or more assets that are not highly interrelated and when the lessee can benefit from the use of each on its own or with other readily available resources may be combined into a single lease component. The accounting for arrangements that contain multiple unrelated lease assets as a single lease component may prove complicated and require additional guidance.

- Contractually stated prices or list prices (e.g., standard price list) might represent the standalone price for a component in a contract. However, lessees and lessors would not presume that these prices would be observable prices the lessor or other suppliers charge customers on a standalone basis. For example, typical trade discounts offered to customers would also have to be considered.

2.5.4 Embedded derivatives

IAS 39 Financial Instruments: Recognition and Measurement requires entities to evaluate whether a lease contains an embedded derivative that must be accounted for separately from the host lease contract. The proposal does not
specifically address this. However, in the basis for conclusions, the Boards explain that some variable lease payments that depend on an index or a rate could meet the definition of an embedded derivative. Because the proposal does not require variable lease payments that are derivatives to be measured at fair value, the Boards decided to retain the current accounting requirements related to embedded derivatives. Consequently, lessees and lessors would still consider IAS 39 to determine whether leases contain embedded derivatives and, if they do, account for them separately in accordance with IAS 39 (IFRS 9 Financial Instruments when it is applied).

**Illustration 8 – Separating lease and non-lease components**

Entity A (the lessee) enters into a three-year equipment lease with Entity B (the lessor). The contract requires the lessee to make fixed monthly payments of CU180 to cover the lease, maintenance and the cost of training Entity A’s employees to use the equipment. Assume that for all scenarios below, Entity A would be able to benefit from the use of the equipment without the maintenance or training.

**Entity A’s accounting (lessee)**

**Scenario A**

*Analysis:* Entity A identifies a monthly standalone observable price for each of the components of the contract and calculates the amount allocated, on a standalone basis, to each component, as follows:

<table>
<thead>
<tr>
<th>Standalone price</th>
<th>% allocation</th>
<th>Monthly payment</th>
<th>Monthly allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment lease</td>
<td>CU160</td>
<td>80%</td>
<td>CU180</td>
</tr>
<tr>
<td>Maintenance</td>
<td>30</td>
<td>15%</td>
<td>CU180</td>
</tr>
<tr>
<td>Training</td>
<td>10</td>
<td>5%</td>
<td>CU180</td>
</tr>
<tr>
<td></td>
<td><strong>CU200</strong></td>
<td><strong>100%</strong></td>
<td><strong>CU180</strong></td>
</tr>
</tbody>
</table>

For this contract, Entity A would allocate CU144 of the monthly payment to the equipment lease, CU27 to maintenance and CU9 to training. Entity A would recognise and measure the assets and liabilities related to the equipment lease using the requirements in the ED. The portions of the payment allocated to maintenance and training would be accounted for like other executory arrangements.

**Scenario B**

Assume that standalone observable prices exist for the equipment lease (CU160) and training (CU10), but not for maintenance. For instance, the lessor may offer the equipment either with or without maintenance; however, neither the lessor nor other suppliers offer maintenance separately. Training is sold separately.

*Analysis:* Entity A would use a residual method as follows:

<table>
<thead>
<tr>
<th>Monthly payment</th>
<th>CU 180</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment lease</td>
<td>(160)</td>
</tr>
<tr>
<td>Training</td>
<td>(10)</td>
</tr>
<tr>
<td>Maintenance</td>
<td>CU 10</td>
</tr>
<tr>
<td>Entity A would allocate CU160 of the monthly payment to the equipment lease and recognise and measure the assets and liabilities related to the equipment lease using the requirements in the ED. The portions of the payment allocated to maintenance (CU10) and training (CU10) would be accounted for like other executory arrangements.</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td></td>
</tr>
<tr>
<td><strong>Scenario C</strong></td>
<td></td>
</tr>
<tr>
<td>Entity A identifies an observable standalone price of CU30 for maintenance but cannot obtain observable standalone prices for the equipment lease and training.</td>
<td></td>
</tr>
<tr>
<td><strong>Analysis:</strong> Entity A would separately account for maintenance (CU30) as an executory arrangement, and CU150 of the monthly payment (the amount that cannot be specifically allocated) would be allocated to the lease component and recognised and measured using the requirements in the ED.</td>
<td></td>
</tr>
<tr>
<td><strong>Scenario D</strong></td>
<td></td>
</tr>
<tr>
<td>Assume that Entity A cannot obtain an observable price for any component.</td>
<td></td>
</tr>
<tr>
<td><strong>Analysis:</strong> All payments (i.e., the monthly payments of CU180) would be allocated to the lease component and therefore recognised and measured using the requirements in the ED.</td>
<td></td>
</tr>
<tr>
<td><strong>Entity B’s accounting (lessor)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Analysis:</strong> Entity B’s approach to separating the lease and non-lease components would be similar to Scenario A, but the standalone pricing data identified and amounts allocated could be different from those determined by Entity A (the lessee) because different pricing information may be available to each party.</td>
<td></td>
</tr>
<tr>
<td>Entity B would account for the lease payments using the requirements in the ED. The payments allocated to maintenance and training would be accounted for in accordance with the new revenue recognition standard. Note that the requirement for lessors to always separate the lease and non-lease components could result in income recognition in different periods than the lessee’s expense recognition (e.g., in situations where there are not observable standalone prices for one or more of the components).</td>
<td></td>
</tr>
</tbody>
</table>

The examples above are simplified and use fixed monthly amounts as the contractual and observable standalone prices for each component. In practice, consideration may not follow such fixed patterns (e.g., lease payments may be front or back-loaded). In such cases, other reasonable methods to allocate on a relative basis would be used.

**How we see it**

If the consideration for a contract with multiple components changes after commencement, it appears that lessors would look to the new revenue recognition standard to determine how to adjust the consideration attributable to each contract component. However, the leases proposal does not address whether, or how, lessees would adjust the consideration allocated to non-lease components after such a change in contract consideration.

**2.6 Changes to contracts**

A substantive modification to a lease’s contractual terms and conditions would create a new contract when the modification becomes effective. Such a modification would require an assessment of whether the new contract is, or contains, a lease. Examples of substantive modifications include changes to the contractual lease term or the amount of contractual payments that
were not part of the original terms and conditions of the lease. For example, the exercise of a renewal option included in the original contract would not be a substantive contract modification. However, a substantive renewal provision negotiated and inserted into the contract after lease inception would be a substantive change to the contract.

Upon a substantive modification, the previous lease-related assets and liabilities would be derecognised and the assets and liabilities related to the new lease, if any, would be recognised. The differences between the carrying amounts of the lease-related assets and liabilities under any new lease and those of the previous lease would be recognised in profit or loss.

**How we see it**

It appears that changes in circumstances (other than substantive contractual changes) would not require a reassessment of whether a contract is or contains a lease. For example, if a supplier's substantive substitution right becomes non-substantive, there would be no reassessment of whether the arrangement is or is not a lease because there was no change to the contract itself.

**3. Key concepts**

Certain key concepts would be used by both lessees and lessors to identify, classify, recognise and measure lease contracts. Lessees and lessors would generally apply these concepts consistently.

**3.1 Lease commencement and inception date**

The commencement date would be the date on which a lessor makes an underlying asset available for use by a lessee. Lessees and lessors would initially recognise and measure lease-related assets and liabilities (when applicable) on the commencement date. Generally, a lessee would not have an obligation to make lease payments and a lessor would not have a right to receive lease payments before an asset is made available for the lessee's use.

However, it is possible that some lease agreements could create significant rights or obligations between the lease inception date (the date on which the principal terms are agreed to) and the commencement date. The accounting and disclosure considerations for such rights and obligations are discussed later in this publication (see section 5 below).

**3.2 Significant economic incentive**

When evaluating a lease term and lease payments (see sections 3.3 and 3.4 below), the proposal would require lessors and lessees to consider economic incentives associated with exercising purchase options, lease renewal options and options to terminate a lease. The threshold against which these considerations would be evaluated is similar to IAS 17, which focuses on 'reasonable certainty'. For example, the Boards explain that the expected exercise of an option to extend (or not terminate) a lease, in and of itself, would not be sufficient to conclude that a significant economic incentive exists to do so. Instead, the Boards believe an evaluation that focuses on the existence of significant economic incentives could be applied more easily because it is more objective than a threshold based solely on management's estimates and intent.

The proposal would require entities to evaluate any incentives associated with lease renewal, termination or purchase options embedded in a lease.
arrangement. The initial evaluation of whether a significant economic incentive exists would consider all contract, asset, entity and market-based factors, including:

- The existence of a purchase option or lease renewal option and the related 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., the head lease has a non-cancellable term of five years with a two-year renewal option, and the sublease term is for seven years)

The application of the significant economic incentive concept is addressed with illustrations in sections 3.3 and 3.4 below.

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

- The periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option
- The periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option

The periods covered by lease renewal options would be included in the lease term when a significant economic incentive to exercise the option exists. As discussed above, the evaluation of whether a significant economic incentive exists involves judgement. However, the proposed principle is fairly straightforward: if a lessee has a significant economic incentive to exercise a renewal option, the substance of the arrangement dictates that the lease term should include the additional periods contemplated in the renewal provision.

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

Purchase options would be assessed in the same way as options to extend the lease term. The Boards reasoned that purchasing an underlying asset is economically similar to extending the lease term for the remaining economic life of the underlying asset. When a lease contains a purchase option and the lessee has a significant economic incentive to exercise that option, the lease would be classified as Type A. Lease classification as Type A or Type B is discussed below.
Entities would be required to reassess the lease term upon changes in certain factors or events (see sections 5.3 and 6.2 below).

### Illustration 9 – Determining the lease term

<table>
<thead>
<tr>
<th>Scenario A</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assume that Entity P enters into a lease for equipment that includes a non-cancellable term of four years and a two-year renewal option. There are no termination penalties or other factors indicating that Entity P has a significant economic incentive to exercise the renewal option.</strong></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Scenario B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assume that Entity Q enters into a lease for a building that provides a non-cancellable term of four years and a two-year renewal option. Before it takes possession of the building, Entity Q pays for significant 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.</strong></td>
</tr>
</tbody>
</table>

**Analysis:** At lease commencement, Entity Q determines that a significant economic incentive to exercise the renewal option exists (i.e., 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.

<table>
<thead>
<tr>
<th>Scenario C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity Y enters into a six-year lease for retail space with annual lease payments of CU120,000 (market rate). The retail space is not customised and Entity Y’s operations can be readily relocated in the market area. The lease contract also permits Entity Y to terminate the lease at the end of the third year after paying a CU250,000 termination fee to the lessor. At the commencement date, Entity Y determines that the CU250,000 termination payment is sufficiently large to create a significant economic incentive to not terminate the lease at the end of the third year.</strong></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Scenario D</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assume the same facts as in Scenario C, but now assume that Entity Y has recently entered this geographic market on a test basis. Also assume that the contract allows Entity Y to terminate the lease at the end of the third year by paying CU20,000 to the lessor. Entity Y determines that the CU20,000 termination payment is not sufficiently large to create a significant economic incentive to not terminate the lease at the end of year three.</strong></td>
</tr>
</tbody>
</table>

**Analysis:** At lease commencement, the lease term would be three years.
3.4 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 would be recognised as a lease liability by lessees or as part of the lease receivable by lessors of Type A leases, as discussed below. Lease payments would include the aggregate of:

- 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 has a significant economic incentive 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 do not include payments allocated to non-lease components of a contract, except when the lessee is required to combine lease and non-lease components as a single lease component (as described in section 2.5 above).

3.4.1 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 recognition). The Boards 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.

The ED proposes using the prevailing rate as of the end of the reporting period for the purpose of measuring index or rate-based variable lease payments. Forward rates and forecasting techniques would not be considered because the Boards believe that the incremental costs and complexity involved in using forecasts or forward curves would outweigh the benefits of the additional information that would be obtained.

Lessees and lessors would be required to reassess index or rate-based variable lease payments when the underlying rate or index changes. The reassessment process and related accounting is discussed in sections 5.3 and 6.2 below.
### Illustration 10 – Index-based lease payments

Entity L enters into a four-year lease. The lease payment is CU1,000 in the first year and the annual rent would increase each year based on the change in the Consumer Price Index (CPI).

**Analysis:** Entity L would initially include CU4,000 as the lease payments. Entity L would not assume or forecast future changes in the CPI. Rather in this circumstance, the lease payments would be reassessed in each reporting period in which the index changes (as discussed in section 5.3 below).

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### 3.4.2 In-substance fixed lease 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. As a reminder, if such payments are not in-substance fixed lease payments they may be derivatives in the scope of IAS 39 (see section 2.5.4 above).

### Illustration 11 – In-substance fixed payments

Entity W enters into a five-year lease with annual payments of CU10,000. The lease calls for the payments to increase each year by 10 times the annual increase in the CPI, limited by an annual adjustment of 1% (effectively a cap). Assume there is no deflation in the relevant economy.

**Analysis:** The combination of the multiplier and cap is specifically designed to virtually assure that the cap is reached in each period. Therefore, the increases to the lease payments are in-substance fixed payments. That is because the contract terms are designed to virtually assure that the 1% cap is always met (i.e., an annual increase of 1% is fixed). Entity W would include the 1% escalation when calculating the annual lease payments, at lease commencement, as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CU10,000</td>
</tr>
<tr>
<td>2</td>
<td>CU10,100</td>
</tr>
<tr>
<td>3</td>
<td>CU10,201</td>
</tr>
<tr>
<td>4</td>
<td>CU10,303</td>
</tr>
<tr>
<td>5</td>
<td>CU10,406</td>
</tr>
</tbody>
</table>

---

### 3.4.3 Purchase options

Entities would consider asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options. That is, if the lessee has a significant economic incentive to exercise a purchase option, the exercise price would be included as a lease payment.
### Illustration 12 – Purchase options

#### Scenario A
Entity F (lessee) enters into a five-year lease for equipment that includes a purchase option under which the lessee can purchase the equipment for CU1,000 at the end of the lease. The equipment has a seven-year economic life, and the expected fair value of the equipment at the end of five years is CU10,000. At lease commencement, Entity F has a significant economic incentive to exercise the purchase option because Entity F can obtain the equipment at a price that is significantly less than the expected fair value at the time of exercise.

**Analysis:** The present value of the CU1,000 purchase option payment would be included as a lease payment.

#### Scenario B
Assume the same facts as in Scenario A except that Entity F can purchase the equipment at the end of the contract for CU10,000. In this scenario, at lease commencement the pricing of the purchase option does not create a significant economic incentive for Entity F to exercise the purchase option. Assume no other factors create a significant economic incentive to exercise the option.

**Analysis:** The purchase option exercise price would be excluded from the lease payments.

### How we see it
The Boards’ believe the proposal would apply to any contract that conveys the right to use an underlying asset for a period of time. The basis for conclusions notes that, “The proposals apply to any contract that conveys the right to use an underlying asset for a period of time. They do not apply to transactions for which control of the underlying asset is transferred to the lessee - such transactions are sales within the scope of other IFRSs or US GAAP (for example, the requirements for property, plant and equipment and revenue recognition).”

However, the ED’s scope does not specifically exclude transactions that automatically transfer title of the underlying asset to the customer at the end of the lease term. Nor does it provide guidance on whether or when such transactions would transfer control of the underlying asset to the customer. Therefore, it is not clear whether such transactions are or are not in the proposal’s scope. In addition, it is not clear if the Boards’ believe such transactions are substantively different from a lease with a bargain purchase option (e.g., CU1 purchase option).

### 3.4.4 Lease termination penalties
The determination of whether to include lease termination penalties as lease payments would be similar to the evaluation of lease renewal options. If a lessee has a significant economic incentive to 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 early termination penalty would be included as a lease payment.
Illustration 13 – Lease termination penalties
Entity M (lessee) enters into a lease with a five-year term and an option to terminate the lease after two years upon making a termination payment (penalty) of CU75,000 to the lessor.

Scenario A
At lease commencement, Entity M considers all contract, market, asset, and entity-based factors and determines that the penalty does not create a significant economic incentive to not exercise its termination option.

Analysis: The lease term would be two years and the CU75,000 termination penalty would be a lease payment.

Scenario B
At lease commencement, Entity M considers all contract, market, asset and entity-based factors and determines that the penalty creates a significant economic incentive to not exercise its option to terminate the lease.

Analysis: The lease term would be five years and the CU75,000 termination penalty would not be a lease payment.

3.4.5 Residual value guarantees – lessees
A lessee may guarantee 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. Consequently, the Boards believe that any uncertainty related to a lessee’s guarantee of a lessor’s residual value relates to measurement of the obligation rather than the existence of an obligation.

The proposal would require lessees to include the amounts they expect to pay to the lessor under residual value guarantees as lease payments.

Illustration 14 – Residual value guarantee included in lease payments
Entity P (lessee) enters into a lease and guarantees that 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 P expects to pay the lessor CU6,000 under the residual value guarantee and would include that amount as a lease payment.

Lessees would be required to reassess lease payments and the lease liability if the amounts expected to be payable under residual value guarantees change during the lease term (see section 5.3 below).

How we see it
Under the proposal, lease payments related to residual value guarantees would differ from the maximum guarantee amounts used in today’s accounting. Lessees would need to develop processes to monitor and estimate the amounts expected to be payable under residual value guarantees.

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

For example, in some contracts, a lessor not only obtains a residual value guarantee from the lessee, but the contract also 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 an amount specified in the contract. In this circumstance, the counterparty is exposed to all (or substantially all depending on how the loss guarantee is structured) of the upside and downside in changes in the value of the asset and the lessor would receive a fixed amount (i.e., the amount 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, the Boards believe such amounts should be included as lease payments.

The introduction of payments from a party other than the lessee, such as an in-substance fixed lease payment structured as a residual value guarantee that is due from a third party, creates complexity. The ED does not provide guidance for how lessors would account for premiums paid to a third party that provides an in-substance fixed lease payment structured as a residual value guarantee (e.g., whether premiums should be treated as a reduction of lease payments) or whether a lessor obtaining a third party guarantee subsequent to the lease commencement date would require reassessment of the lease payments.

How we see it

It is unclear which existing lease arrangements the Boards attempted to address with the proposed requirements for fixed lease payments structured as residual value guarantees - one possibility is synthetic leases. Further, it is not clear whether a partial residual value guarantee (e.g., a guarantee in which the lessee assumes the first CU85 of the loss when the selling price is less than the specified price of CU100 with the lessee receiving any appreciation above CU100) would be considered a lease payment structured as a residual value guarantee.

When residual value guarantees are not in-substance fixed payments, the lessor would not include any amounts as lease payments. The Boards believe the inclusion of guarantees that are not in-substance fixed payments would prematurely permit the recognition of profit related to the residual asset. However, the existence of a residual value guarantee would be factored into any subsequent impairment evaluation of the residual asset (see section 5.4.1 below).

3.4.7 Variable lease payments not based on an index or rate

Variable payments not based on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage (e.g., the number of miles flown and the number of units produced) of the underlying asset, would not be included as lease payments. These payments would be recognised in the statement of profit or loss when they are incurred (lessee) or earned (lessor), 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 payments is created.
As a reminder, if such payments are not in-substance fixed lease payments they may be derivatives in the scope of IAS 39 (see section 2.5.4 above).

**Illustration 15 — Variable lease payments not based on an index or rate**

Entity N (lessee) enters into a four-year lease for production equipment. The lease calls for fixed lease payments of CU50,000 per year and a variable payment of CU1 per unit produced using the equipment.

**Analysis:** Entity N would include the fixed lease payments of CU50,000 per year in the lease payments when initially measuring the lease liability and right-of-use asset. The remaining payments that vary based upon the number of units produced with the equipment would be excluded. Entity N would recognise expense for the usage-based variable payments in the period in which the obligation to make the payments is incurred (i.e., the period during which the units are produced).

3.5 **Discount rate**

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

3.5.1 **Lessees**

Lessees would use the rate the lessor charges the lessee if that rate can be readily determined. In practice, lessees may not know the rate the lessor charges the lessee. When the rate is not known, the lessee would use its own incremental borrowing rate.

The rate that the lessor charges the lessee (e.g., the rate implicit in the lease and the property yield) would reflect the nature and specific terms of the lease. 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, with similar payment terms (i.e., lease term) and security (i.e., collateral) in a similar economic environment. The incremental borrowing rate definition in the ED is generally consistent with the definition in current standards.

**How we see it**

The rate the lessor charges the lessee could be influenced by certain information such as applicable taxes, cash selling prices or residual value estimates and this data may not be available to the lessee. In addition, the rate the lessor charges the lessee would not necessarily be the rate stated in the contract. Therefore, lessees may find it difficult to determine the rate charged by the lessor.

3.5.2 **Lessors**

Lessors would use the rate the lessor charges the lessee, which could be the rate implicit in the lease. The rate implicit in the lease would be the rate that causes the sum of the present value of payments made by the lessee for the right to use the underlying asset and the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease to equal the fair value of the underlying asset. If the rate implicit in the lease is not available for leased property, the lessor would be permitted to use another rate, such as the property yield.

Lessors might expect to receive variable payments that are not based on an index or a rate during the lease term. If such payments (which are otherwise
excluded from lease payments) are included in a lessor’s determination of the rate it charges the lessee, the lessor would also need to give consideration to such amounts in the initial and subsequent measurement of the residual asset (see section 6.1 below).

3.6 Initial direct costs
The Boards believe capitalising initial direct costs as part of lease arrangements should be consistent with how such costs are considered when a lessee acquires any other non-financial asset (e.g., property, plant, equipment and intangible assets) or when a lessor acquires similar financial assets (e.g., receivables). Consequently, under the proposal, initial direct costs would be capitalised as part of the right-of-use asset (lessee) or the lease receivable (lessor). Initial direct costs would be the costs directly attributable to negotiating and arranging a lease. That is, these costs would not have been incurred without entering into the lease. Initial direct costs for a lessee or lessor may include the following, for example:

- Commissions
- Legal fees
- Costs of evaluating and recording guarantees, collateral or other security contracts
- Costs of negotiating lease terms and preparing and processing lease documents
- Costs of evaluating the prospective lessee’s financial condition
- Payments made to existing tenants to obtain the lease

Costs related to general overhead (e.g., depreciation, occupancy and equipment costs, unsuccessful origination efforts and idle time) and costs related to certain activities performed by the lessor (i.e., advertising, soliciting potential lessees, servicing existing leases or other ancillary activities) are examples of items that would not be directly attributable to negotiating and arranging the specific lease and thus would not be initial direct costs.

3.7 Property
The proposal would establish a principle to classify leases based on the portion of the underlying asset that the lessee is expected to consume during the lease term. The application of the principle would focus on whether the underlying asset is property or an asset other than property. Property would be defined as land or a building, or part of a building (i.e., a physically distinct portion of a building) or both.

A combination of assets in a single arrangement may exist. In those cases, entities would determine whether the contract contains two lease components or a single lease component made up of the combination of assets. If there is a single lease component, classification would be based on the nature of the primary asset within that lease component (which could be an asset other than property). See section 2.5.2 above for a discussion of identifying and separating lease components.
3.8 Underlying asset
The ED defines an underlying asset as an asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. An underlying asset could be a physically distinct portion of a single asset (e.g., a floor of a building).

3.9 Economic life
The Boards have proposed defining 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
- The number of production or similar units expected to be obtained from the asset by one or more users

This definition is the same as in IAS 17.

4. Lease classification
The Boards determined that the underlying economics of leases vary and that these differences are best reflected by two types of leases. The Boards decided that the principle to be used to distinguish between the two types of leases should be based on the portion of the economic benefits of the underlying asset expected to be consumed by the lessee over the lease term.

To reduce complexity in the application of this principle, the ED would require entities to classify leases primarily based on the nature of the underlying asset. Under the proposal, leases would be classified at the lease commencement date, as follows:

- Leases of assets other than property (e.g., equipment and vehicles) would be classified as Type A leases, unless one of the following two criteria is met:
  - The lease term is for an insignificant part of the total economic life of the underlying asset
  - The present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date
- Leases of property (i.e., land, a building or part of a building) would be classified as Type B leases, unless one of the following two criteria is met:
  - The lease term is for the major part of the remaining economic life of the underlying asset
  - The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date

If one of the two exception criteria above is met for a lease of an asset other than property, the lease would be classified as Type B. If one of the two exception criteria above is met for a lease of a property asset, the lease would be classified as Type A. Notwithstanding the classification requirements above, a lease would be classified as Type A when it contains an option to purchase the underlying asset and the lessee has a significant economic incentive to exercise that option.
The application of the lease classification principle would be based on the premise that property assets generally have long economic lives. The Boards believe that a property lessee generally would not be expected to consume more than an insignificant portion of the economic benefits of the underlying asset during the lease term. Conversely, assets other than property are generally depreciating assets with shorter economic lives. Therefore, for such leases the lessee generally would be expected to consume more than an insignificant portion of the economic benefits of the underlying asset.

Using these presumptions, the Boards have indicated that leases of property would generally be classified as Type B and leases of assets other than property would generally be classified as Type A. That is, the exception criteria noted above are expected to be met for a relatively small population of leases.

Comparing the lease term of leases of assets other than property to the ‘total’ economic life of the underlying asset (rather than the ‘remaining’ economic life) may result in leases of certain older non-property assets being classified as Type B leases. For example, a two-year lease of a railcar would likely be insignificant to the total economic life of the railcar. Therefore, regardless of the age of the railcar at the lease commencement date (i.e., even very late in the economic life of the asset), such a lease would be classified as Type B. However, a two year lease of a building near the end of its economic life may result in the lease being classified as Type A because the lease term would be compared to the remaining economic life of the building.

How we see it

Many leases of non-property assets (e.g., vehicles and office equipment) that are classified as operating leases today would likely be classified as Type A leases under the proposal. As discussed in section 5.2.1 below, classification as a Type A lease would generally result in accelerated expense recognition.

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

Lease classification would not be reassessed after lease commencement unless there is a substantive modification to the contract provisions. If a substantive modification occurs, the arrangement would be evaluated as if it were a new contract (i.e., the arrangement would be evaluated to determine whether it is or contains a lease and, if so, the lease classification).

If a lessee chooses to measure the right-of-use asset in accordance with the fair value model in IAS 40 or using the revaluation model in IAS 16 Property, Plant and Equipment (see section 5.2.3 below), the lessee would not classify the lease as Type A or Type B. However, such a lease would be treated as Type A for presentation and disclosure purposes (see sections 5.5 and 5.6 below).
How we see it
The proposal does not define ‘insignificant’ for purposes of assessing the exception criteria for classifying leases of assets other than property. Therefore, evaluating whether a non-property lease meets either of the exception criteria would likely be subjective and require careful judgement. It is unclear whether the Boards might consider ‘insignificant’ in the context of ‘minor’ (i.e., 10%) in today’s US lease standard or whether other rules of thumb, such as the inverse of the bright-line tests used in the economic life and fair value tests under the current US lease standard might be considered.

<table>
<thead>
<tr>
<th>Illustration 16 – Lease classification – property asset</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario A</strong></td>
</tr>
<tr>
<td>Entity D leases 10 floors of a new 20-storey office building for 10 years. There are no optional renewal periods or purchase options. The economic life of the building is 40 years. The lease term represents 25% of the remaining economic life of the building. The present value of the lease payments represents 33% of the fair value of the building at the lease commencement date.</td>
</tr>
</tbody>
</table>

**Analysis:** Entity D would conclude that the lease term does not represent the major part of the remaining economic life of the building (i.e., 25% is not the major part of the underlying asset’s remaining economic life) and that the present value of the lease payments does not represent substantially all of the fair value of the floors of the building being leased. Because the underlying asset is property and neither of the two exception criteria specific to leases of property assets is met, the lease would be classified as Type B.

<table>
<thead>
<tr>
<th><strong>Scenario B</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assume the same facts as in Scenario A, except that the building is 29 years old at lease commencement. The property’s remaining economic life is 11 years and the lease term represents 91% of the remaining economic life of the building.</td>
</tr>
</tbody>
</table>

**Analysis:** Entity D would conclude that the lease term represents the major part of the remaining economic life of the building. Because the asset is property and at least one of the two exception criteria specific to leases of property assets is met, the lease would be classified as Type A.

<table>
<thead>
<tr>
<th><strong>Scenario C</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity E leases a plot of land for 99 years. There are no optional renewal periods or purchase options. The present value of the lease payments represents 95% of the fair value of the land at the lease commencement date.</td>
</tr>
</tbody>
</table>

**Analysis:** Entity E would conclude that the arrangement meets one of the two exception criteria specific to leases of property assets (i.e., the present value of the lease payments represents substantially all of the fair value of the land). Therefore, because the underlying asset is property and at least one of the two exception criteria specific to leases of property assets is met, the lease would be classified as Type A.
Illustration 17 — Lease classification — non-property asset

Scenario A
Assume that Entity F leases a newly constructed vessel for 20 years. There are no optional renewal periods and no termination or purchase options. The total economic life of the vessel is 50 years. The lease term represents 40% of the total economic life of the vessel. The present value of the lease payments represents 45% of the fair value of the vessel at the lease commencement date.

Analysis: Entity F would conclude that the lease term represents more than an insignificant part of the total economic life of the vessel. Entity F also would conclude that the present value of the lease payments is more than insignificant when compared with the fair value of the vessel. Because the underlying asset is not property and neither of the two exception criteria specific to assets other than property is met, the lease would be classified as Type A.

Scenario B
Assume the same facts as in Scenario A except that Entity F leases the same vessel for two years and the present value of the lease payments represents 5% of the fair value of the vessel at the lease commencement date. In this fact pattern, the lease term represents 4% of the total economic life of the vessel.

Analysis: Entity F would conclude that the lease term represents an insignificant part of the total economic life of the vessel. Because the underlying asset is not property and one of the two exception criteria specific to leases of assets other than property is met, the lease would be classified as Type B.

Scenario C
Assume the same facts as in Scenario B, except that the vessel is 45 years old at lease commencement. Because the vessel's total economic life is 50 years, the lease term represents 4% of the total economic life of the vessel.

Analysis: Entity F would conclude that the lease term represents an insignificant part of the total economic life of the vessel. Because the asset is not property and one of the two exception criteria specific to leases of assets other than property is met (i.e., the lease term is for an insignificant part of the total economic life of the vessel), the lease would be classified as Type B. Unlike Illustration 16, the remaining economic life of the underlying asset is not relevant when evaluating assets that are not property.

How we see it
Similar to today’s accounting, lessees would need to gather information about the remaining economic lives of leased property assets for the purpose of classifying leases as either Type A or Type B.
Illustration 18 – Lease classification - lease of an asset with purchase option

Entity T leases a relatively new building for two years. There are no optional renewal periods, but Entity T may purchase the building at the end of the lease for CU200,000. The economic life of the building is 20 years and it is expected to have a fair value of CU1,000,000 at the end of the lease. Entity T concludes that it has a significant economic incentive to exercise the purchase option.

Analysis: The existence of the lessee’s significant economic incentive to exercise its rights under the purchase option makes the lease Type A.

As described above, some leases may convey the right to use more than one asset (see section 2.5.2 above).

If a lease component contains the right to use more than one interrelated asset, the primary asset within the lease 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.

The Boards believe that the determination of the primary asset would often be straightforward. Difficulty determining which asset is the primary asset may indicate there are additional lease components in the contract that should be identified for separate accounting.

The proposal provides specific guidance for classifying a single lease component that contains both land and a building. In those instances, entities would refer to the remaining economic life of the building when classifying the lease, which could result in a different classification than if the lease of land was assessed separately. For example, a 40-year lease of land would not be the major part of the land’s remaining (indefinite) economic life. As a result, the land lease would be a Type B lease. However, a 40-year lease of a building with the underlying land would likely be the major part of the building’s remaining economic life. As a result, if the building were considered the primary asset both the land and building would likely be classified as a Type A lease. Because the lease component would not be subdivided into the land and building elements, entities would not allocate the lease payments between the land and building.

How we see it

Additional guidance on the definition of property is needed. For example, it is not clear whether the Boards intended for certain structures that are attached to land, or buried under land, to be considered property assets or non-property assets under the proposal. The distinction could affect the classification of leases for such assets.
Illustration 19 – Lease classification – multiple property elements

Scenario A
Entity P enters into a 10-year lease of an office building that includes the underlying land.

Analysis: Although the lease incorporates the land on which the building is situated (i.e., an additional property element), Entity P cannot benefit from the use of the building without also using the underlying land. Additionally, the land and building assets are dependent upon each other. Therefore, Entity P concludes that the contract contains one lease component.

Entity P would classify the lease (i.e., the single lease component) using the criteria for leases of property assets. Entity P would use the remaining economic life of the building to determine whether the lease term is for the major part of the remaining economic life of the underlying asset.

Scenario B
Entity J, a trucking company, enters into a 20-year lease for a warehouse location with the surrounding land necessary for truck parking. Because the lease is for a warehouse, a trucking company would not lease the warehouse without space for truck parking.

Analysis: Although the lease includes the land surrounding the warehouse, the company cannot benefit from the use of the warehouse without also using the surrounding land for truck parking. Therefore, Entity J concludes that the contract contains a single lease component.

Entity J would classify the lease (i.e., the single lease component) using the criteria for leases of property assets. The entity would use the remaining economic life of the warehouse to determine whether the lease term is for the major part of the economic life of the underlying asset.

How we see it
Judgement would be required to determine when an arrangement includes multiple assets. For example, a lease of a warehouse with the underlying land and an adjacent plot of land would contain multiple lease components if the lessee could benefit from the adjacent plot either on its own or with other readily available resources. In other circumstances, the lessee may not be able to benefit from the adjacent plot of land on its own or with other readily available resources (e.g., zoning ordinance may forbid future development) and, therefore, the lease would include a single lease component.
### Scenario A
Entity L enters into a 10-year lease for a specified floor in an office building (i.e., a property asset). The lease also includes heating and air conditioning from a system (i.e., an asset other than property) dedicated to the floor.

**Analysis:** Entity L concludes that the contract contains one lease component. The entity cannot benefit from the use of the heating and air conditioning system on its own or together with other readily available resources. Additionally, Entity L’s use of the heating and air conditioning system depends on its use of the floor of the building.

Entity L determines that the primary asset in the lease is the floor of office space because the office space is the primary purpose for entering into the lease. Entity L would classify the lease (i.e., the single lease component) using the criteria for leases of property assets because the primary asset is part of a building. The entity would use the economic life of the building to determine whether the lease term is for the major part of the remaining economic life of the underlying asset.

### Scenario B
Entity M enters into a 15-year lease for the exclusive use of an above-ground pipeline, which is determined to be an identified asset. The lease incorporates the land on which the pipeline is situated, but Entity M does not have any rights to use the land surrounding the pipeline.

**Analysis:** Entity M concludes that the contract contains one lease component because it cannot benefit from using the above-ground pipeline (i.e., an asset other than property, presuming an above-ground pipeline is an asset other than property) or the land on which the pipeline is situated, either on its own or in combination with other readily available resources.

Entity M determines that the primary asset in the lease is the pipeline. Entity M would classify the lease (i.e., the single lease component) using the criteria for leases of assets other than property because the primary asset is the pipeline. The entity would use the total economic life of the pipeline to determine whether the lease term is insignificant to the life of the underlying asset.
Scenario C
Entity V enters into a 12-year lease of a turbine plant, which consists of a turbine housed in a building, along with the land on which the building and turbine are located. The building was specifically designed to house the turbine and the life of the building is directly tied to the life of the turbine. When the turbine can no longer be used, the turbine and the building will both be dismantled.

Analysis: Entity V concludes that the contract contains one lease component. The building and the land on which the turbine and building are located are highly interrelated with the turbine. That is, Entity V cannot benefit from the use of the building or the land without also using the turbine. Similarly, Entity V cannot benefit from the use of the turbine without the building in which it is housed or the underlying land.

Entity V determines that the primary asset is the turbine because its use was the primary purpose for entering into the lease. Entity V would classify the lease (i.e., the single lease component) using the criteria for leases of assets other than property because the primary asset is the turbine. Entity V would use the total economic life of the turbine to determine whether the lease term is insignificant to the life of the underlying asset.

How we see it
The determination of the primary asset in a lease that includes the rights to use both a property asset and a non-property property asset (i.e., the lease component contains the right to use more than one interrelated asset) might be challenging when the property asset and the non-property asset are dependent upon each other (i.e., the lessee cannot benefit from either asset without the other). Additional guidance may be needed to help entities apply this concept because the determination of the primary asset would affect the classification of the lease as well as the related accounting.

5. Lessee accounting
The ED would require lessees to recognise all leases on the balance sheet (except short-term leases when the policy election is made). At the commencement date of a lease, a lessee would recognise a liability to make lease payments (the lease liability) and an asset representing the right to use the underlying asset during the lease term (the right-of-use asset). Lessees would measure lease liabilities and right-of-use assets on a cost basis. The Boards concluded that a cost measurement basis would provide financial statement users with the most useful information, whilst minimising costs for preparers.

The initial recognition of the right-of-use asset and the lease liability would be the same for Type A and Type B leases, as would the subsequent measurement of the lease liability. However, subsequent measurement of the right-of-use asset for Type A and Type B leases would differ.
5.1 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 key concepts described previously to identify the lease components, determine the lease term, lease payments and discount rate as of the commencement date of the lease. Variable payments not based on an index or rate (e.g., performance or usage-based payments) would be excluded from the lease liability and would be recognised in the statement of profit or loss as incurred.

The initial measurement of the lease liability would consist of the present value of the following payments, related to the use of the underlying asset during the lease term, that are not yet paid:

- Fixed lease payments, less any lease incentives receivable from the lessor
- Variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date
- Variable lease payments that are in-substance fixed payments
- Amounts expected to be payable under residual value guarantees
- The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option
- Payments for penalties for terminating the lease, if the lease term (determined consistently with the key concepts in section 3 above) reflects the lessee exercising an option to terminate 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 5.4.2 below)
- Any initial direct costs incurred by the lessee

It is possible that some lease agreements could create significant rights or obligations between the inception date (i.e., the date on which the principal terms are agreed to) and the lease commencement date. The proposal would require lessees to disclose in the notes information about such leases, but it does not address the accounting for the resulting rights or obligations. The Boards indicate in the basis for conclusions that entities would apply existing accounting standards (i.e., IAS 37, Provisions, Contingent Liabilities and Contingent Assets) for significant rights or obligations that arise prior to lease commencement.
5.2 Subsequent measurement

The Boards believe 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 for Type A and Type B leases would be accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the effective interest method). Lease payments would reduce the lease liability when paid. However, Type A and Type B leases would achieve different expense recognition patterns through the subsequent measurement of the right-of-use asset.

5.2.1 Right-of-use asset - Type A leases

Amortisation on the right-of-use asset would be recognised in a manner consistent with existing IFRS 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 has a significant economic incentive to exercise a purchase option.

Lessees also would 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 5.2.3 below).

**Illustration 21 - Lessee accounting for a Type A lease**

Entity H (lessee) enters into a three-year lease of equipment and concludes that the agreement is a Type A lease. The entity 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) or payments to the lessor before the lease commencement date. 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 4.24%). Entity H uses its incremental borrowing rate because the rate the lessor charges the lessee 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>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 33,000</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 33,000</td>
<td></td>
</tr>
<tr>
<td><strong>To initially recognise the lease-related asset and liability</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>CU 1,398</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 1,398</td>
<td></td>
</tr>
<tr>
<td><strong>To record interest expense and accrete the lease liability using the effective interest method (CU33,000 x 4.24%)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>CU11,000</td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 11,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record amortisation expense on the right-of-use asset (CU33,000 ÷ 3 years)</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Illustration 21 — Lessee accounting for a Type A lease (continued)

<table>
<thead>
<tr>
<th>Initial</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>
</tbody>
</table>

The total periodic expense (i.e., the sum of interest and amortisation expense) of a Type A lease would generally be higher in the early periods and lower in the later periods. 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 straight-line amortisation of the right-of-use asset, would result in the recognition of more total periodic expense in the early periods of a Type A lease than in later periods.

The separate recognition of interest and amortisation expense for Type A leases is consistent with the concept of the lessee paying to finance the acquisition of the portion of the underlying asset that will be consumed during the lease term. The expense recognition pattern for Type A leases is also generally consistent with the treatment of finance leases under current standards.

5.2.1.1 Purchase options

If a lessee has a significant economic incentive to exercise a purchase option, the exercise price would be included in the lease payments (as described in section 3.4 above) and the lessee's right-of-use asset would be amortised over the useful life of the underlying asset rather than the shorter of the lease term or the useful life of the right-of-use asset.
Illustration 22 − Purchase options − subsequent measurement of the right-of-use asset

Scenario A
A lessee enters into a five-year lease for equipment. The lease includes a purchase option that allows the lessee to purchase the equipment for CU1,000 at the end of the lease. The equipment has a seven-year useful life, and the expected fair value of the equipment at the end of five years is CU10,000. The lessee has a significant economic incentive to exercise the purchase option because the lessee can obtain the equipment at a price that is significantly less than the equipment’s expected fair value at the time the option is exercised. The lessee includes the present value of the CU1,000 purchase option payment as a lease payment.

Analysis: The amortisation period used to determine periodic amortisation expense of the right-of-use asset would be seven years (i.e., the useful life of the equipment).

Scenario B
Assume the same facts as in Scenario A except that the lease contract specifies that the lessee can purchase the equipment at the end of the lease for CU10,000. In this scenario, the option price alone does not create a significant economic incentive to exercise the purchase option. Assume no other factors create a significant economic incentive. The lessee does not include the present value of the CU1,000 purchase option payment as a lease payment.

Analysis: The lessee would amortise the right-of-use asset over five years (i.e., the lease term).

5.2.2 Right-of-use asset – Type B leases
Lessees would recognise periodic lease expense for Type B leases on more of a straight-line basis versus the front-loaded pattern for Type A leases, which is in some ways similar to today’s accounting for operating leases. Throughout the lease term, the lessee would recognise periodic lease expense as the greater of the following:

• The remaining cost of the lease (calculated at the beginning of each period) allocated over the remaining lease term on a straight-line basis
• The periodic interest expense taken on the lease liability (using the effective interest method)

At each reporting period, the remaining cost of the lease would be calculated as:

• Lease payments (determined at the lease commence date)
  Plus
• Initial direct costs (determined at the lease commencement date)
  Minus
• The periodic lease cost recognised in prior periods
  Minus
• Any impairment of the right-of-use asset recognised in prior periods
  Plus or minus
• Any adjustments to reflect changes that arise from the remeasurement of the lease liability not recognised in profit or loss at the date of remeasurement (e.g., the present value of the additional lease payments a lessee is obligated to pay if it exercises a renewal option that it originally did not have a significant economic incentive to exercise)
When the remaining cost of the lease allocated over the remaining lease term is higher than the periodic interest taken on the lease liability, the change in the right-of-use asset would be calculated as the difference between the periodic straight-line cost amount and the accretion of the lease liability. If the periodic interest expense is higher, there would be no adjustment to the right-of-use asset. This may be the case after a significant impairment of the right-to-use asset, which would reduce the remaining cost of the lease.

**Illustration 23 – Lessee accounting for a Type B lease**

Entity L (lessee) enters into a three-year lease of office space and concludes that the agreement is a Type B lease. The entity agrees to pay 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) or payments to the lessor before the lease commencement date. The initial measurement of the right-of-use asset and lease liability is CU33,000 using a discount rate of approximately 4.235%. Entity L uses its incremental borrowing rate because the rate the lessor charges the lessee cannot be readily determined. Entity L calculates that the annual straight-line lease cost is CU12,000 per year \([(CU10,000 + CU12,000 + CU14,000) \div 3\].

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

<table>
<thead>
<tr>
<th>Account</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>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense</td>
<td>CU 12,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 1,398</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 10,602</td>
</tr>
</tbody>
</table>

*To record lease expense, accrete the lease liability and adjust the right-of-use asset (change in right-of-use asset = CU12,000 annual straight-line lease cost less CU1,398 accretion of liability using the effective interest method)*

<table>
<thead>
<tr>
<th>Account</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*
Illustration 23 – Lessee accounting for a Type B lease (continued)

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

<table>
<thead>
<tr>
<th></th>
<th>Initial</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 2,000</td>
<td>CU 14,000</td>
<td></td>
</tr>
<tr>
<td>Periodic lease cost</td>
<td>CU 12,000</td>
<td>CU 12,000</td>
<td>CU 12,000</td>
<td></td>
</tr>
<tr>
<td>Less: Accretion of lease liability</td>
<td>(1,398)</td>
<td>(1,033)</td>
<td>(569)</td>
<td></td>
</tr>
<tr>
<td>Change in right-of-use asset</td>
<td>CU 10,602</td>
<td>CU 10,967</td>
<td>CU 11,431</td>
<td></td>
</tr>
</tbody>
</table>

**Balance sheet**

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 33,000</td>
<td>CU 22,398</td>
<td>CU 11,431</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(33,000)</td>
<td>CU(24,398)</td>
<td>CU(13,431)</td>
<td></td>
</tr>
</tbody>
</table>

1. Calculated using the effective interest method on the lease liability (same calculation as for Type A lease).
2. Calculated as the difference between the straight-line periodic lease cost to be recognised (i.e., CU12,000) and the accretion of the lease liability.

Lease-related expenses would be presented together as lease or rent expense. This presentation is consistent with the concept of the lessee paying to use the asset during the lease term, rather than paying to finance the acquisition of a portion of the underlying asset in a Type A lease.

Illustration 24 – Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the two types of leases discussed in Illustrations 21 and 23:

<table>
<thead>
<tr>
<th></th>
<th>Both lease types</th>
<th>Type A lease</th>
<th>Type B lease</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lease liability</td>
<td>Interest expense</td>
<td>Amortisation expense</td>
</tr>
<tr>
<td>Initial</td>
<td>CU33,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 1</td>
<td>CU24,398</td>
<td>CU1,398</td>
<td>CU11,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>CU13,431</td>
<td>1,033</td>
<td>11,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>CU</td>
<td></td>
<td>569</td>
</tr>
<tr>
<td></td>
<td>CU3,000</td>
<td>CU33,000</td>
<td>CU36,000</td>
</tr>
</tbody>
</table>

The initial measurement of the right-of-use asset and the lease liability, as well as the subsequent measurement of the lease liability, is the same for both types of leases. Over the life of the arrangement, the same total lease expense would be recognised for each type of lease. A lessee would generally recognise higher total lease expense and higher amortisation on the right-of-use asset in the earlier periods of a Type A lease than it would for a Type B lease.

**How we see it**

Whilst Type B leases might result in expense recognition patterns similar to today’s operating leases, the recordkeeping burden for lessees could increase significantly. Lessees may have to develop systems capable of tracking the right-of-use asset and would have to perform additional calculations to account for the change in the right-of-use asset in each period.
5.2.3 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 if the lessee revalues all assets within that class of property, plant and equipment.

5.3 Reassessment

After lease commencement, lessees would monitor leases for changes that could trigger a reassessment of the lease term or the lease payments. Upon reassessment, lessees would remeasure the lease liability, using revised inputs at the reassessment date to reflect any changes to the lease payments that result from changes in:

- Relevant factors that result in a change to the lease term, including changes when the lessee has or no longer has a significant economic incentive to do either of the following:
  - Exercise an existing option to extend the lease or purchase the underlying asset
  - Not exercise an existing option to terminate the lease
- Amounts expected to be payable under residual value guarantees
- An index or a rate used to determine lease payments

Relevant factors to consider when evaluating whether the lease term has changed include asset, contract and entity-based factors. Market-based factors would also be considered but would not, in isolation, be determinative when evaluating whether the lease term has changed.

A lessee would also reassess the lease term if the lessee elects to exercise an option to renew a lease even though the lessee had previously determined that it did not have a significant economic incentive to do so. Similarly, the lessee would reassess the lease term if it does not exercise a lease termination option when the lease term previously contemplated that the lessee would exercise that option.

Upon reassessment, lessees would determine the revised lease payments based on the new lease term. When remeasuring the lease liability, lessees would reassess the discount rate only when there is a change to any of the following (and the possibility of the change was not contemplated in developing the previous discount rate):

- The lease term
- Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise a purchase option
- A reference interest rate if variable payments are determined using that rate

Lessees would record a remeasurement of the lease liability as an adjustment to 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

Lessees would also remeasure the lease liability in accordance with IAS 21 The Effects of Changes in Foreign Exchange Rates for foreign currency exchange differences when a lease liability is denominated in a foreign currency.

How we see it
• A change in market-based factors such as market prices, in isolation, would not trigger a reassessment of the lease term. However, a change in market-based factors would often be indicative of changes in other factors (e.g., contract, asset and entity-based) that would be considered to determine whether a reassessment is required. As a result, the intended relief related to market-based factors may be limited.

• Lessees would need to implement processes and controls to monitor their leases to identify events that could trigger a reassessment of a lease liability.

5.3.1 Change in the lease term

Lessees would be required to consider all relevant factors (e.g., contractual, asset, entity, and market-based) when determining whether the lease term has changed. However, a change in market-based factors (e.g., market rates), in isolation, would not trigger reassessment of the lease term. The Boards were concerned that frequent reassessments of the lease liability based solely on changes in market-based factors would add complexity and cost to the reassessment process.

Upon a change in the lease term, lessees would reassess the lease payments using the revised lease term. The lease liability would then be remeasured as the present value of the new remaining lease payments. Lessees would use a revised discount rate, which would be determined at the reassessment date, based on the rate that the lessor would charge the lessee. If the rate the lessor would charge the lessee at the remeasurement date is not readily determinable, the lessee would use its incremental borrowing rate, as of the remeasurement date, as the revised discount rate. The remeasurement of the lease liability would be recognised as an adjustment to the right-of-use asset. If the carrying amount of the right-of-use asset is reduced to zero, any remaining remeasurement amount would be recognised in profit or loss.

How we see it
When remeasuring the lease liability for a change in the lease term, it is not clear how lessees would determine the revised discount rate based on the rate the lessor would charge the lessee. It appears that the determination of such a revised discount rate could require the lessee to assess whether there has been a change to the value of the residual asset.
**Illustration 25 – Reassessment of the lease term – Type A lease**

Entity L leased production equipment for an initial three-year term with an option to extend for an additional two years. Lease payments were CU14,000 per year during the initial three-year term, payable at the end of each year. Lease payments in the optional term would be CU10,000 per year, payable at the end of each year. Entity L concluded that the agreement is a Type A lease.

The equipment would be used to manufacture a new product, Product X. At the commencement date, the entity determined that it does not have a significant economic incentive to exercise the option to extend the lease. For simplicity, also assume there are no variable payments, amounts expected to be payable under a residual value guarantee or purchase or termination options. At lease commencement, the entity concluded the lease term was three years. Also, Entity L could not determine the rate charged by the lessor. However, Entity L’s incremental borrowing rate was approximately 8.12%, which reflected the rate at which it could have borrowed a similar amount for a similar duration (i.e., three years) and with similar collateral.

At lease commencement, Entity L recognised the lease-related asset and liability, as follows:

| Right-of-use asset | CU 36,000 |
| Lease liability    | CU 36,000 |

To initially recognise the lease-related asset and liability (CU14,000 x 3 years, discounted at 8.12%)

A summary of the lease contract’s accounting for the first two years is, as follows:

<table>
<thead>
<tr>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 14,000</td>
<td>CU 14,000</td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 2,923</td>
<td>CU 2,024</td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>12,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Total expense</td>
<td>CU 14,923</td>
<td>CU 14,024</td>
</tr>
</tbody>
</table>

Balance sheet

| Right-of-use asset | CU 36,000 | CU 24,000 | CU 12,000 |
| Lease liability    | CU(36,000) | CU(24,923) | CU(12,947) |

At the end of the second year of the lease, Entity L developed an additional product, Product Y, to replace Product X. Entity L can use the leased production equipment to manufacture Product Y more efficiently than it could procure and install new production equipment for Product Y (i.e., the time and cost to install such new equipment would be significant). As a result, Entity L concludes that the development of Product Y, which can be produced using the leased equipment, and the need to introduce the product to the market quickly, has created a significant economic incentive to exercise the option to extend the lease.
Illustration 25 – Reassessment of the lease term – Type A lease (continued)

Analysis: The lease term has changed due to the presence of a significant economic incentive to exercise the option to extend the lease, which did not previously exist. Therefore, Entity L reassesses the lease term and lease payments. At the end of year two, Entity L applies the concepts above and determines that its current incremental borrowing rate (assuming the rate the lessor would charge the lessee is not readily determinable), for a similar asset and duration with similar collateral, is approximately 6.96%, taking into consideration the remaining lease term of three years.

At the end of year two, prior to the reassessment of the lease term, the lease liability was CU12,948 (the present value of the remaining payment discounted at approximately 8.12%) and the right-of-use asset was CU12,000. Entity L remeasures the lease liability based on the lease payments to be made over the revised lease term (three years). The remaining payments (one payment of CU14,000 and two payments of CU10,000) are discounted using the updated discount rate of approximately 6.96% to arrive at the remeasured lease liability of CU30,000.

Entity L records an entry to increase the lease liability to the remeasured amount with an adjustment to the right-of-use asset (which will be amortised prospectively based on the adjusted balance):

Right-of-use asset  CU 17,052
Lease liability     CU 17,052

To adjust the lease-related asset and liability upon reassessment (CU30,000 - CU12,948)

A summary of the lease contract’s accounting for the remaining three years of the lease term (subsequent to the reassessment) is, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 14,000</td>
<td>CU10,000</td>
<td>CU10,000</td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 2,090</td>
<td>CU 1,259</td>
<td>CU 651</td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>9,684</td>
<td>9,684</td>
<td>9,684</td>
</tr>
<tr>
<td>Total expense</td>
<td>CU 11,774</td>
<td>CU10,943</td>
<td>CU10,335</td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 29,052</td>
<td>CU 19,368</td>
<td>CU 9,684</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(30,000)</td>
<td>CU(18,090)</td>
<td>CU(9,349)</td>
</tr>
</tbody>
</table>

Illustration 26 – Reassessment of the lease term - Type B lease

Entity H, a retailer, entered into a three-year lease of property with an option to extend for an additional two years. Lease payments were CU15,000 per year during the initial three-year term, payable at the end of each year. Lease payments in the optional term would be CU20,000 per year, payable at the end of each year. Entity H concluded that the agreement is a Type B lease.
At the commencement date, the entity determined that it did not have a significant economic incentive to exercise the option to extend the lease. Therefore, it concluded the lease term was three years. Also, entity H could not determine the rate charged by the lessor. However, its incremental borrowing rate was approximately 3.53%, which reflected the rate at which it could have borrowed a similar amount for a similar duration (i.e., three years) and with similar collateral.

Entity H initially measured the right-of-use asset and lease liability at CU42,000 using a discount rate of approximately 3.53%. At lease commencement, it recognised the lease-related asset and liability:

| Right-of-use asset | CU 42,000 |
| Lease liability | CU 42,000 |

To initially recognise the lease-related asset and liability

A summary of the lease contract’s accounting for the first two years is, as follows:

<table>
<thead>
<tr>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 15,000</td>
<td>CU 15,000</td>
</tr>
<tr>
<td>Periodic lease cost</td>
<td>CU 15,000</td>
<td>CU 15,000</td>
</tr>
<tr>
<td>Less: Accretion of lease liability</td>
<td>(1,483)</td>
<td>(1,005)</td>
</tr>
<tr>
<td>Change in right-of-use asset</td>
<td>CU 13,517</td>
<td>CU 13,995</td>
</tr>
</tbody>
</table>

Balance sheet

<table>
<thead>
<tr>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 42,000</td>
<td>CU 28,483</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(42,000)</td>
<td>CU(28,483)</td>
</tr>
</tbody>
</table>

At the end of the second year of the lease, Entity H made significant leasehold improvements to the location. Due to the significant cost associated with the leasehold improvements, Entity H determines that it now has a significant economic incentive to exercise the option to extend the lease.

The presence of a significant economic incentive to exercise the option to extend the lease, which did not previously exist, results in a change that requires Entity H to reassess the lease term and payments. At the end of year two, Entity H determines its current incremental borrowing rate is approximately 4.70%, taking into consideration the remaining lease term of three years (assume the rate the lessor charges the lessee is not readily determinable).

At the end of year two (prior to reassessment), the lease liability was CU14,488 (present value of the remaining payment discounted at approximately 3.53%). The right-of-use asset was also CU14,488.

**Analysis:** Entity H remeasures the lease liability based on the lease payments to be made over the revised three-year lease term. The remaining payments (one payment of CU15,000 and two payments of CU20,000) are discounted using the updated discount rate of approximately 4.70% to arrive at the remeasured lease liability of CU50,000.
A change in the amount expected to be payable under a residual value guarantee would trigger remeasurement of the lease liability.

5.3.2 Change in relevant factors related to a significant economic incentive to exercise a purchase option

Remeasurement of the lease liability would be required when the lease payments change because a change in relevant factors (e.g., contract, asset, entity and market-based) results in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset. However, a change in market-based factors (e.g., market rates), in isolation, would not trigger such a reassessment. Consistent with reassessments of lease terms, described in section 5.3.1. above, the Boards were concerned that frequent changes in market-based factors would add complexity and cost to the reassessment process.

Lessees would determine the revised lease payments based on whether a significant economic incentive exists to exercise a purchase option. If, upon reassessment, a significant economic incentive is found to exist (or no longer exists), the Boards believe the lessee has acquired more (or less) of the right to use the underlying asset. Lessees would reassess the lease payments using the revised lease term. The lease liability would then be remeasured as the present value of the new lease payments. Lessees would use a revised discount rate, which would be determined based on the rate that the lessor would charge the lessee. If the rate the lessor would charge the lessee is not determinable, the lessee would use its incremental borrowing rate.
The lease liability remeasurement would be recognised as an adjustment to the right-of-use asset. If the carrying amount of the right-of-use asset is reduced to zero, any remaining remeasurement amount would be recognised in profit or loss.

**Illustration 27 — Reassessment of the lease payments – purchase**

Entity H entered into a three-year lease of production equipment with an option to purchase the equipment for CU47,800 at the end of three years. The equipment, which is only manufactured by the lessor, has a total economic life of six years and is expected to have a value of CU45,000 at the end of the lease term. Lease payments are CU15,000 per year, payable at the end of each year. Entity H concluded that the agreement is a Type A lease.

At the commencement date, the entity determined that it did not have a significant economic incentive to exercise the option to purchase the equipment. Therefore, it concluded the lease term was three years and the exercise price of the purchase option was excluded from the lease payments. Also, Entity H could not determine the rate charged by the lessor. However, its incremental borrowing rate was approximately 3.53% which reflected the rate at which it could have borrowed a similar amount for a similar duration (i.e., three years) and with similar collateral.

Entity H initially measured the right-of-use asset and lease liability at CU42,000 using a discount rate of approximately 3.53%. At lease commencement, it recognised the lease-related asset and liability:

<table>
<thead>
<tr>
<th>Right-of-use asset</th>
<th>CU 42,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>CU 42,000</td>
</tr>
</tbody>
</table>

To initially recognise the lease-related asset and liability

A summary of the lease contract’s accounting for the first two years is, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 15,000</td>
<td>CU 15,000</td>
<td></td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 1,483</td>
<td>CU 1,005</td>
<td></td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>14,000</td>
<td>14,000</td>
<td></td>
</tr>
<tr>
<td>Total expense</td>
<td>CU 15,483</td>
<td>CU 15,005</td>
<td></td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 42,000</td>
<td>CU 28,000</td>
<td>CU 14,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(42,000)</td>
<td>CU(28,483)</td>
<td>CU(14,488)</td>
</tr>
</tbody>
</table>

At the end of the second year of the lease, the lessor announces that it will no longer produce the leased equipment. Entity H concludes that it now has a significant economic incentive to purchase the equipment because it will no longer be able to replace the equipment from the lessor at the end of the lease term (e.g., entering into a new lease for replacement equipment).
The presence of a significant economic incentive to exercise the purchase option, which did not previously exist, results in a change that requires Entity H to reassess the lease payments. At the end of year two, Entity H determines its current incremental borrowing rate is approximately 4.67% (assume the rate the lessor charges the lessee is not readily determinable), taking into consideration the remaining lease term of one year and the exercise of the purchase option.

At the end of year two (prior to reassessment), the lease liability was CU14,488 (present value of the remaining payment discounted at approximately 3.53%). The carrying amount of the right-of-use asset was CU14,000.

Analysis: Entity H would remeasure the lease liability based on the revised lease payments to be made over the lease term. The remaining payments (one payment of CU15,000 and the exercise price of the purchase option of CU47,800) are discounted using the updated discount rate of approximately 4.67% to arrive at the remeasured lease liability of CU60,000.

Entity H records an entry to increase the lease liability to the remeasured amount with an adjustment to the right-of-use asset:

| Right-of-use asset | CU 45,512 |
| Lease liability    | CU 45,512 |

To adjust the lease liability (CU60,000 - CU14,488) and the right-of-use asset upon reassessment

Because it has a significant economic incentive to exercise the purchase option, Entity H would amortise the adjusted carrying amount of the right-of-use asset (CU59,512) on a straight-line basis over the remaining useful life of the equipment (four years), or CU14,878 per year.

A summary of the accounting by Entity H for the remaining year of the lease term (subsequent to the reassessment) is, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Reassessment</th>
<th>Year 3</th>
<th>Purchase option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash payments</td>
<td>CU 15,000</td>
<td></td>
<td>CU47,800</td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 2,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortisation expense</td>
<td></td>
<td>14,878</td>
<td></td>
</tr>
<tr>
<td>Total expense</td>
<td>CU 17,678</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 59,512</td>
<td>CU 44,634¹</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(60,000)</td>
<td>CU(47,800)</td>
<td>CU —</td>
</tr>
</tbody>
</table>

¹ Upon exercising the purchase option, Entity H would reclassify the carrying amount of the right-of-use asset to property, plant and equipment.

5.3.3 Change to the amounts expected to be payable under residual value guarantees

Remeasurement of the lease liability would be required when the lease payments change due to a change in the amount expected to be payable under a residual value guarantee. Lessees would include the reassessed
amounts expected to be payable under a residual value guarantee in the reassessed lease payments.

Lessees would then remeasure the lease liability as the present value of the revised lease payments using the previously determined discount rate (i.e., the discount rate would not be revised). The adjustment to the lease liability would be offset against the right-of-use asset. That is, to the extent there is an increase in the expected amount payable under a residual value guarantee there would be a corresponding increase to the right-of-use asset (alternatively there would be a corresponding decrease to the right-of-use asset if there is a decrease to the expected amount payable under the residual value guarantee). If the carrying amount of the right-of-use asset is reduced to zero, any remaining remeasurement amount would be recognised in profit or loss. The Boards believe that changes in the amount expected to be payable under a residual guarantee is most closely associated with the right-of-use asset rather than an element of current profit or loss.

**Illustration 28 – Reassessment of residual value guarantee**

Entity Q entered into a three-year lease for equipment with no options to purchase, terminate or extend beyond the initial term. Lease payments were CU50,000 per year and Entity Q provided the lessor with a guarantee that it will realise CU45,000 from selling the asset to another party at the end of the lease.

At lease commencement, Entity Q estimated that the equipment will have a value of CU36,000 at the end of the lease. Because Entity Q expected to pay the lessor CU9,000 under the residual value guarantee at the end of the lease, that amount was included as a lease payment. Entity Q determined that the lease is a Type A lease. Entity Q could not determine the rate the lessor charges the lessee. Its incremental borrowing rate was approximately 7.22%.

Entity Q initially measured the right-of-use asset and lease liability at CU138,000 using a discount rate of approximately 7.22%. At lease commencement, it recognised the lease-related asset and liability:

| Right-of-use asset | CU 138,000 |
| Lease liability    | CU 138,000 |

*To initially recognise the lease-related asset and liability (CU50,000 per year and CU9,000 at the end of the lease, discounted at 7.22%)*

A summary of the lease contract’s accounting for the first two years is, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 50,000</td>
<td>CU 50,000</td>
<td></td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 9,963</td>
<td>CU 7,073</td>
<td></td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>46,000</td>
<td>46,000</td>
<td></td>
</tr>
<tr>
<td>Total expense</td>
<td>CU 55,963</td>
<td>CU 53,073</td>
<td></td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 138,000</td>
<td>CU 92,000</td>
<td>CU 46,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(138,000)</td>
<td>CU(97,963)</td>
<td>CU(55,036)</td>
</tr>
</tbody>
</table>
Illustration 28 – Reassessment of residual value guarantee (continued)

At the end of the second year of the lease, Entity Q determines that the estimated residual value of the equipment has decreased from the initial estimate of CU36,000 to a revised estimate of CU15,000. As a result, Entity Q now estimates that it will pay CU30,000 under the residual value guarantee.

Analysis: At the end of year two (prior to reassessing the amount expected to be payable under the residual value guarantee), the lease liability was CU55,036 and the right-of-use asset was CU46,000. Entity Q remeasures the lease liability by including the revised lease payments (i.e., CU50,000 per remaining year for three years, plus the reassessed amount expected to be payable under the residual value guarantee of CU30,000). The entity applies the previously used 7.22% discount rate to arrive at the remeasured lease liability of CU74,613 at the end of year two.

Entity Q would record an entry to increase the lease liability with an offsetting adjustment to the right-of-use asset:

```
Right-of-use asset  CU19,577
Lease liability     CU 19,577
To adjust the lease-related asset and liability upon reassessment (CU74,613 - CU55,036)
```

The entry to record an adjustment to the lease liability, upon reassessment of a residual value guarantee, would be the same for a Type B lease. However, the lessee would subsequently recalculate a new periodic straight-line lease cost amount for the Type B lease.

How we see it

An increase in the right-of-use asset caused by an increase in the amount expected to payable under a residual value guarantee might result in a higher risk of impairment for the right-of-use asset. That is, the right-of-use asset would have a higher carrying amount because the increase to the amount expected to be payable under the residual value guarantee would be included in the asset’s measurement.

However, because the increase in the amount expected to be paid under the residual value guarantee is indicative of a decline in value, albeit at a point in time in the future, in many cases, it will also be indicative of a potential impairment when the lease payments are revised.

5.3.4 Change to an index or rate used to determine lease payments

For leases with index or rate-based variable payments, the lease payments would be reassessed at the end of each reporting period in which there is a change to the relevant index or rate (i.e., when a change occurs during the reporting period).

When the applicable index or rate changes, lessees would determine the revised lease payments using the prevailing index or rate at the end of that reporting period. If the lease payments vary based on a reference interest rate, lessees would also determine a revised discount rate at the remeasurement date by applying the key concepts (see section 3 above). If lease payments vary based on something other than a reference interest rate, the discount rate would not be revised. Instead, the lease liability would
be remeasured using the discount rate that was previously used to measure the lease liability. The lease liability would be adjusted to the remeasured amount. The amount of the remeasurement that is attributable to the current period would be recorded in profit or loss. Other remeasurement amounts would be recorded to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, any remaining remeasurement amount would be recognised in profit or loss.

5.3.5 Changes in foreign currency exchange rates
Lessees would apply IAS 21 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.

5.4 Other lessee matters
5.4.1 Impairment
Lessees’ right-of-use assets, for both types of leases, 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
• Whilst lessees would apply existing impairment requirements in the same manner they currently use for assets held under finance leases, the analysis would be new for current operating leases. 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.
For Type B leases, lessees would recognise an amount of periodic lease expense equal to the greater of the straight-line periodic amount or the periodic accretion of the lease liability (see section 5.2.2 above). Lessees would have to consider this requirement if the right-of-use asset for a Type B lease becomes impaired. For example, consider a right-of-use asset for a Type B lease that becomes impaired early in the lease term. An impairment of the right-of-use asset would affect the pattern of the subsequent recognition of the remaining cost of the lease. If the periodic accretion of the lease liability exceeds the periodic straight-line cost amount determined in a period subsequent to the impairment event, the lease expense would be an amount equal to the accretion of the liability.

Illustration 29 – Type B lease accounting subsequent to impairment

Entity Z enters into a three-year lease for a building and concludes that the agreement is a Type B lease. Entity Z agrees to make the following annual payments at the end of each year: CU30,000 in year one, CU35,000 in year two and CU40,000 in year three. The initial measurement of the right-of-use asset and lease liability is CU89,000 using a discount rate of approximately 8.32%. The company calculates that the annual straight-line lease expense is CU35,000 per year [(CU30,000+CU35,000+CU40,000)÷3]. At lease commencement, Entity Z would recognise the right-of-use asset and lease liability.

For simplicity, assume there are no initial direct costs, no events that give rise to a remeasurement of the lease liability, and that Entity Z reports only on an annual basis.

Analysis: A summary of the lease contract’s initial accounting is, as follows:

<table>
<thead>
<tr>
<th>Initial</th>
<th>Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 30,000</td>
</tr>
<tr>
<td>Lease cost recognised</td>
<td>CU 35,000</td>
</tr>
<tr>
<td>Less: Accretion of lease liability</td>
<td>(7,404)</td>
</tr>
<tr>
<td>Change in right-of-use asset</td>
<td>CU 27,596</td>
</tr>
</tbody>
</table>

Balance sheet

| Right-of-use asset | CU 89,000 | CU 61,404 |
| Lease liability | (89,000) | (66,404) |

At the end of the first year, Entity Z identifies indicators of impairment and completes an impairment analysis in accordance with IAS 36. Entity Z determines that the right-of-use asset is impaired and records a loss of CU60,404 to reduce the right-of-use asset to its recoverable amount of CU1,000. Entity Z recalculates the remaining cost of the lease to be CU9,596, based on the lease payments determined at commencement (CU105,000), less:

- The periodic lease cost recognised in prior periods (CU35,000)
- The impairment recognised on the right-of-use asset (CU60,404)

Entity Z then recalculates the periodic straight line cost amount to be CU4,798 (CU9,596 ÷ 2 years).
Because the scheduled accretion to the liability in year two (CU5,526) exceeds the revised periodic straight-line cost amount (CU4,798), Entity Z recognises lease expense at the amount of the accretion to the liability in year two. The remaining scheduled accretion to the liability (CU3,070) and change to the right-of-use asset (CU1,000) would be expensed in year three. A summary of the accounting, subsequent to the impairment follows:

<table>
<thead>
<tr>
<th>Reassessed</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 35,000</td>
<td>CU40,000</td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td>CU 5,526</td>
<td>CU 4,070</td>
</tr>
<tr>
<td>Less: Accretion of lease liability</td>
<td>(5,526)</td>
<td>(3,070)</td>
</tr>
<tr>
<td>Change in right-of-use asset</td>
<td>CU —</td>
<td>CU 1,000</td>
</tr>
</tbody>
</table>

**Balance sheet**

| Right-of-use asset¹ | CU 1,000 | CU 1,000 | CU —  |
| Lease liability     | CU(66,404) | CU(36,930) | CU —  |

¹Right-of use asset balance of CU1,000 represents adjusted carrying amount subsequent to recognition of impairment loss of CU60,404.

How we see it

The periodic change in the right-of-use asset for Type B leases would be the difference between the periodic straight-line amount and the accretion of the lease liability. Because the accretion of the lease liability typically declines over the lease term (i.e., as the lease liability is reduced for lease payments made), the carrying amount of right-of-use assets would typically decrease more slowly for Type B leases than for similar assets recognised for Type A leases. As a result, Type B right-of-use assets may be more likely to become impaired than Type A right-of-use assets.

5.4.2 Lease incentives paid or receivable at lease commencement

Lessees often receive incentives (e.g., an upfront cash payment for leasehold improvements) for entering into a new lease. SIC 15 *Operating Leases – Incentives* requires lessees to recognise lease incentives over the lease term as a reduction of lease expense.

Under the proposal, lease incentives that are receivable from the lessor at the commencement date would be deducted from the fixed lease payments. 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 what happens under current operating lease accounting, lease incentives would reduce lease expense over the lease term.
Illustration 30 – Lease incentive paid at lease commencement

Entity N enters into a three-year lease of equipment and concludes that the agreement is a Type A lease. Entity N agrees to pay the following annual payments at the end of each year: CU25,000 in year one, CU30,000 in year two and CU35,000 in year three. At commencement, Entity N also receives a cash payment of CU10,000 from the lessor to help cover the costs incurred to remove Entity N’s existing equipment, which will be replaced by the leased equipment. The initial measurement of the liability to make lease payments is CU80,000 (annual lease payments of CU25,000, CU30,000 and CU35,000 discounted using the incremental borrowing rate of approximately 5.79%). Entity N actually incurs CU15,000 of removal costs.

Analysis: Entity N records the following entries at the commencement date:

Right-of-use asset  CU 80,000
Lease liability     CU 80,000
To initially recognise the lease-related asset and liability

Cash  CU 10,000
Right-of-use asset    CU 10,000
To recognise the receipt of lease incentive payment

Removal expense  CU 15,000
Cash    CU 15,000
To recognise removal costs incurred and paid

The lease incentive is recorded as a reduction to the right-of-use asset because it was received at (or before) lease commencement. The reduction in the right-of-use asset will result in decreased amortisation expense in the amount of approximately CU3,333 per year. Additionally, the receipt of the lease incentive does not affect Entity N’s recognition of the full amount of the equipment removal costs when they are incurred.

The summary of the accounting including the lease incentive (assuming no changes due to reassessment) is, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash payments</td>
<td>CU 25,000</td>
<td>CU 30,000</td>
<td>CU 35,000</td>
<td></td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 4,632</td>
<td>CU 3,453</td>
<td>CU 1,915</td>
<td></td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>23,333</td>
<td>23,333</td>
<td>23,334</td>
<td></td>
</tr>
<tr>
<td>Total expense</td>
<td>CU 27,965</td>
<td>CU 26,786</td>
<td>CU 25,249</td>
<td></td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 70,000</td>
<td>CU 46,667</td>
<td>CU 23,334</td>
<td>CU —</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(80,000)</td>
<td>CU(59,632)</td>
<td>CU(33,085)</td>
<td>CU —</td>
</tr>
</tbody>
</table>
**Illustration 31 – Lease incentive receivable at lease commencement**

Assume the same facts as in Illustration 30, except that the lease incentive payment is receivable at lease commencement. However, payment will not be made (by the lessor to the lessee) until the end of the first year. The initial measurement of the liability to make lease payments is CU70,547 using a discount rate (incremental borrowing rate) of approximately 5.79%.

**Analysis:** Entity N records the following entries at the commencement date:

- **Right-of-use asset**
  
  \[ \text{CU } 70,547 \]

- **Lease liability**
  
  \[ \text{CU } 70,547 \]

  _To initially recognise the lease-related asset and liability (present value of lease payments, CU90,000 less the CU10,000 receivable from the lessor at the end of year one, discounted at 5.79%)_

- **Removal expense**
  
  \[ \text{CU } 15,000 \]

- **Cash**
  
  \[ \text{CU } 15,000 \]

  _To recognise removal costs incurred and paid_

The lease incentive receivable reduces the lease payments measured at the commencement date (i.e., lease payments in year one are lower because of the CU10,000 cash to be received), and therefore the initial measurement of the lease liability. The lease incentive does not affect Entity N’s recognition of the full amount of the equipment removal costs when they are incurred. When the equipment is removed, Entity N records the following entry to recognise the receipt of the cash lease incentive:

- **Cash**
  
  \[ \text{CU } 10,000 \]

- **Lease liability**
  
  \[ \text{CU } 10,000 \]

  _To recognise a receivable for the lease incentive_

The accretion of the lease liability over the lease term would need to consider the timing of the receipt of the lease incentive (i.e., the lease liability increases upon receipt of the cash incentive) because the initial measurement of the lease liability was reduced for the lease incentive receivable.

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

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash payments</td>
<td>CU 25,000</td>
<td>CU 30,000</td>
<td>CU 35,000</td>
<td></td>
</tr>
<tr>
<td>Cash incentive received</td>
<td>CU 10,000</td>
<td>CU —</td>
<td>CU —</td>
<td></td>
</tr>
<tr>
<td><strong>Lease expense recognised</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU 4,085</td>
<td>CU 3,453</td>
<td>CU 1,915</td>
<td></td>
</tr>
<tr>
<td>Amortisation expense</td>
<td>23,516</td>
<td>23,516</td>
<td>23,515</td>
<td></td>
</tr>
<tr>
<td><strong>Total expense</strong></td>
<td>CU 27,601</td>
<td>CU 26,969</td>
<td>CU 25,430</td>
<td></td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 70,547</td>
<td>CU 47,031</td>
<td>CU 23,515</td>
<td>CU —</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU(70,547)</td>
<td>CU(59,632)</td>
<td>CU(33,085)</td>
<td>CU —</td>
</tr>
</tbody>
</table>

**5.4.3 Lease incentives not received or receivable at lease commencement**

The ED does 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). For example, reimbursements for moving costs or leasehold...
improvements that become receivable by the lessee when the lessee incurs such costs would be contingently receivable at commencement.

5.4.4 Income tax accounting

The proposal could also affect lessees’ accounting for income taxes. For lessees, application of the ED’s provisions could result in changes to 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 different expense recognition patterns. These changes could affect many aspects of accounting for income taxes, such as the following:

- Recognition and measurement of deferred tax assets
- Recognition and measurement of deferred tax liabilities
- Assessment of the recoverability of deferred tax assets (i.e., the need for, and the measurement of, valuation allowances)

5.5 Presentation

Whilst the proposal would change lessee financial statement presentation, the statement of profit or loss and statement of cash flows presentation requirements for Type A leases and Type B leases would be similar to the current requirements for finance and operating leases, respectively.

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

<table>
<thead>
<tr>
<th>Financial statement</th>
<th>Lessee presentation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td>Both types of leases:</td>
</tr>
<tr>
<td></td>
<td>• Right-of-use assets and lease liabilities for each type of lease (Type A and Type B) would be presented separately from other assets and liabilities, or disclosed separately for each type of lease in the notes, with disclosure of the balance sheet line items that include right-of-use assets and lease liabilities.</td>
</tr>
<tr>
<td></td>
<td>• If right-of-use assets are presented together with other non-lease assets, right-of-use assets would be presented within the same line item as if the underlying assets were owned.</td>
</tr>
<tr>
<td><strong>Statement of profit or loss</strong></td>
<td>Type A leases: Lease-related amortisation and interest expenses would be presented separately (i.e., lease-related amortisation and interest expenses could not be combined).</td>
</tr>
<tr>
<td></td>
<td>Type B leases: Lease-related expenses would be presented as a single line of lease or rent expense.</td>
</tr>
<tr>
<td><strong>Statement of cash flows</strong></td>
<td>Type A leases: 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 in accordance with IAS 7 Statement of Cash Flows.</td>
</tr>
<tr>
<td></td>
<td>Type B leases: Cash payments for lease payments would be presented within operating activities.</td>
</tr>
<tr>
<td></td>
<td>Both types of leases:</td>
</tr>
<tr>
<td></td>
<td>• Short-term lease and variable lease payments (not included in the lease liability) would be presented within operating activities.</td>
</tr>
</tbody>
</table>
|                     | • Non-cash activity (e.g., initial recognition of the lease at commencement) would be disclosed as a supplemental non-cash item.
How we see it

For entities that currently have a significant amount of non-property asset (e.g., equipment) operating leases, EBITDA would likely increase under the Type A lease model because today’s rent expense would be presented as amortisation and interest expenses under the proposal. Operating cash flow would also increase because cash payments for the principal portion of a Type A lease would be classified as financing activities. Entities would have to consider the effects of these changes when developing key performance metrics and communicating them to stakeholders.

5.5.1 Balance sheet

In the basis for conclusions, the Boards note that owned and leased assets are often used in similar ways. Therefore, the Boards believe that presenting right-of-use assets as if they are owned assets would provide financial statement users with useful information about the function of the underlying assets. However, the Boards also acknowledge that some users believe right-of-use assets have risk profiles that differ from those of owned assets (e.g., different residual value risk and the need to renew a right-of-use at the end of the lease term). To accommodate the multiple views, entities may elect to present the right-of-use assets in either of the following ways:

- Separately from other similar assets on the face of the balance sheet
- Together with other similar assets on the balance sheet, but disclosed separately in the notes to the financial statements

If leased assets are disclosed separately in the notes, such disclosure would include a reference to the balance sheet line items that include the right-of-use assets.

Similarly, the Boards generally believe that lease liabilities have unique characteristics because of their relationship to the right-of-use asset and their many possible features (e.g., options, residual value guarantees, variable payments), which are not present with other types of liabilities. The Boards also believe that the separate presentation of lease liabilities (either on the face of the balance sheet or in the notes) would provide financial statement users with useful information about the extent to which entities use lease arrangements and the relationship between the lease liability and the right-of-use asset.

5.5.2 Statements of profit or loss and cash flows

The differences in the statement of profit or loss and statement of cash flows presentation requirements for Type A and Type B leases are intended to be consistent with the underlying principle of lease classification. The Type A lease presentation requirements are intended to reflect arrangements in which a lessee is expected to finance the acquisition and consumption of a portion of the underlying asset during the lease term. Alternatively, the Type B lease presentation requirements are intended to reflect arrangements in which a lessee is expected to pay for the use of an asset during the lease term.

5.6 Disclosure

The proposal would require new disclosures to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows, including the amount of lease-related assets and liabilities recognised, significant judgements and assumptions about leases, the existence of residual value guarantees and options to extend or terminate the lease and
restrictions or covenants imposed by leases. Lessees would exercise judgement to determine an appropriate level at which to aggregate, or disaggregate, the disclosures such that information meaningful to the financial statement users is not obscured by insignificant details or by the grouping of items with different characteristics.

5.6.1 General disclosure requirements

Lessees would be required to disclose information about the nature of their 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 (including descriptions of the options that are recognised as part of the right-of-use asset and lease liability, and those that are not)
- The existence, and terms and conditions, of residual value guarantees provided by the lessee
- The restrictions or covenants imposed by leases (e.g., those related to dividends or incurring additional financial obligations)

Lessees would also be required to specifically identify the information related to sublease arrangements included in the disclosures above.

The proposal would also require lessees to disclose information about the significant judgements and assumptions made in accounting for leases. For example, a lessee might disclose information about its judgements and significant 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 contract consideration between the lease and non-lease components
- The determination of the discount rate
- The determination of the primary asset when a lease contains the right to use multiple assets
- The estimation of amounts expected to be payable under residual value guarantees

Lessees would be required to provide information about leases that create significant rights or obligations for the lessee when such leases have not yet commenced as of the balance sheet date.

5.6.2 Other quantitative disclosures

Lessees would provide separate reconciliations of the opening and closing balances of Type A and Type B lease liabilities. These reconciliations would include information that would help financial statement users understand the change in the carrying amounts of lease liabilities. The information in the reconciliations would include:

- Liabilities created due to leases commencing or being extended
Liabilities extinguished due to leases being terminated
- Remeasurements relating to a change in an index or a rate used to determine the lease payments
- Accretion of lease liabilities
- Cash paid
- Foreign currency transaction gains and losses
- Effects of business combinations

A lessee also would be required to provide a quantitative reconciliation of opening and closing balances of right-of-use assets by class of underlying asset separating Type A leases, Type B leases and right-of-use assets measured at revalued amounts. The information in the reconciliations would include, but would not necessarily be limited to:

- Additions due to leases commencing or being extended
- Reclassifications when a lessee exercises a purchase option
- Reductions due to leases being terminated
- Remeasurements relating to a change in an index or a rate used to determine lease payments
- Amortisation
- Effects of business combinations
- Impairment

Lessees that measure right-of-use assets arising from leased investment property in accordance with the fair value model in IAS 40 may elect not to provide the reconciliation of right-of-use assets described above.

Lessees that measure right-of-use assets at revalued amounts would disclose:

- The effective date of the revaluation
- The amount of the revaluation surplus that relates to right-of-use assets at the start and end of the reporting period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders

Lessees would be required to disclose costs that are recognised in the period relating to variable lease payments not included in the lease liability (e.g., payments based on performance or usage of the underlying asset). As discussed previously, these obligations would be excluded from the lease liability and, instead, would be recognised as incurred.

To help financial statement users understand and evaluate the extent of liquidity risks of lease-related cash flows, lessees would be required to disclose a maturity analysis of the lease liability balance at each reporting date. The maturity analysis would include undiscounted cash flows, on an annual basis, for a minimum of each of the five years after the balance sheet date and a total of the amounts for the remaining years (i.e., the total undiscounted cash flows beyond the fifth year). This analysis would also
include a reconciliation of the undiscounted cash flows to the lease liability recognised in the balance sheet.

6. Lessor accounting

Lessors would account for Type A leases using an approach that is similar to today’s accounting for finance leases. Type B leases would be accounted for using a method similar to current operating lease accounting.

6.1 Type A leases

6.1.1 Initial recognition and measurement

Upon commencement of a Type A lease, lessors would:

- Derecognise the carrying amount of the underlying asset
- Recognise a lease receivable and a residual asset
- Recognise in net income any profit or loss on the lease

Lessors would recognise a lease receivable for the right to receive lease payments during the lease term. They would derecognise the carrying amount of the underlying asset and allocate that amount between the portion related to the right to use granted to the lessee (i.e., the cost of sales) and the portion that is retained (i.e., the residual asset). The profit, if any, related to the right of use granted to the lessee would be recognised in profit or loss at lease commencement.

6.1.1.1 Lease receivable

The lease receivable would be measured as the present value of the lease payments to be received during the lease term plus any initial direct costs incurred by the lessor. At the lease commencement date, lessors would apply the key concepts described in section 3 above to determine the initial direct costs, lease term, lease payments and discount rate.

At the commencement date, the lease payments included in the lease receivable would consist of the following payments relating to the use of the underlying asset during the lease term:

- Fixed payments, less any lease incentives payable to the lessee
- Variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date
- Variable lease payments that are in-substance fixed payments
- Fixed payments structured as residual value guarantees
- The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option
- Payments for penalties for terminating the lease, if the lease term (determined using the key concepts described in section 3 above) reflects the lessee exercising an option to terminate the lease

Variable payments that are not based on an index or rate (e.g., variable lease payments based on usage or performance) would be recognised separately in profit or loss as they are earned (see section 3.4.2 above).

Additionally, residual value guarantees would be excluded from the lease receivable. However, the lease receivable would include in-substance fixed
lease payments that are structured as residual value guarantees (see Illustration 32 below). If the residual value guarantee is not an in-substance fixed lease payment, payments received under the residual value guarantee would be recognised when realised (e.g., at the end of the lease).

Illustration 32 - Fixed lease payments structured as a residual value guarantee

Entity G (lessor) leases production equipment to a lessee. The lease calls for the lessee to guarantee a residual value of CU10,000. The contract requires the lessee to pay Entity G any shortfall if the equipment is sold at the end of the lease for less than the residual value guarantee amount (CU10,000). If the equipment is sold for more than that amount, the contract allows the lessee to retain the excess.

Analysis: The residual value guarantee is an in-substance fixed payment to Entity G because Entity G will receive CU10,000 regardless of the actual selling price for the equipment. Entity G would include the CU10,000 in-substance fixed payment in the lease payments. If the residual value guarantee is not an in-substance fixed payment it would be recognised when realised.

6.1.1.2 Profit

A lessor would have a profit at the commencement date of the lease if the fair value of the underlying asset is greater than its carrying amount immediately before commencement of the lease. In such cases, the profit at the commencement date of the lease would be the product of multiplying the total profit (i.e., underlying asset fair value less its carrying amount at lease commencement) by the ratio of the present value of the lease payments to the fair value of the underlying asset.

\[
\text{Profit at lease commencement} = \left( \frac{\text{Fair value of underlying asset} - \text{Carrying amount of underlying asset}}{\text{Fair value of underlying asset}} \right) \times \frac{\text{Present value of lease payments}}{\text{Fair value of underlying asset}}
\]

Alternatively, profit recognised at lease commencement could be calculated as the difference between the present value of the lease payments and cost derecognised. The cost derecognised would be the portion of the underlying asset leased, as discussed in section 6.1.1.3 below.

Illustration 33 – Profit recognised at lease commencement

Entity X leases an asset to a lessee under a Type A lease. Assume that the present value of the lease payments is CU42,000, the fair value of the underlying asset is CU60,000, the carrying amount of the underlying asset is CU50,000. Therefore, the portion of the underlying asset conveyed to the lessee is 70% (CU42,000 ÷ CU60,000).

Analysis: Total profit would be CU10,000 (CU60,000 – CU50,000). Entity X would recognise CU7,000 of profit (70% of CU10,000) upon commencement of the lease.

Alternatively, the profit recognised at commencement (CU7,000) could be calculated as the difference between the present value of the lease payments (CU42,000) and cost derecognised (70% x CU50,000 = CU35,000).
6.1.1.3 Residual asset

The carrying amount of the derecognised underlying asset would be allocated between the portion leased and the newly recognised residual asset. The ED describes the initial measurement of the residual asset as:

- A + B − C, where:
  - A is the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term, discounted using the rate the lessor charges the lessee (gross residual asset)
  - B is the present value of variable lease payments that the lessor expects to receive and that have been reflected in the rate the lessor charges the lessee, but which are not included in the lease receivable (e.g., variable lease payments linked to performance)
  - C is any unearned profit (see below)

How we see it

It appears that the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term (‘A’ above) would be determined using entity-specific assumptions rather than using fair value principles (i.e., market participant assumptions) described by IFRS13 Fair Value Measurement.

Another way to calculate the initially recognised residual value would be to start with the portion of the derecognised underlying asset leased (or cost derecognised). As noted at the bottom of Illustration 33, that portion could also be calculated as the ratio of the present value of the lease payments to the fair value of the underlying asset multiplied by its previous carrying amount.

\[
\frac{\text{Carrying amount of underlying asset} \times \text{Present value of lease payments}}{\text{Fair value of underlying asset}}
\]

Consequently, the initially recognised residual asset would be the remaining portion of the previous carrying amount or:

\[
\text{Carrying amount of underlying asset} - \left( \frac{\text{Carrying amount of underlying asset} \times \text{Present value of lease payments}}{\text{Fair value of underlying asset}} \right)
\]

The unearned profit is the portion of the total profit inherent in the underlying asset (i.e., the difference between the underlying leased asset’s fair value and carrying amount) not allocated to profit associated with the lessee’s right to use the underlying asset. The unearned profit would be deferred until that asset is either sold or re-leased at the end of the lease term (refer section 6.1.2 below).

As noted in section 6.1.1.2 above, the portion of the profit allocated to the lessee’s right to use the underlying asset can be calculated as:

\[
\frac{\text{Fair value of underlying asset} - \text{Carrying amount of underlying asset}}{\text{Fair value of underlying asset}} \times \text{Present value of lease payments}
\]
The Boards considered whether the initial measurement of the residual asset should be based solely on the present value of the estimated residual value at the end of the lease (i.e., a current measurement basis) or based on an allocation of the cost of the underlying asset (i.e., a cost basis). The former is more akin to the method used in current finance lease accounting. However, they concluded that the current measurement basis was not appropriate because it would result in the recognition of the total profit at lease commencement, which would include the lessor’s profit associated with the residual asset that is not expected to be consumed by the lessee. The Boards believe that approach might imply that a lease is equivalent to a sale of the underlying asset.

**Illustration 34 — Allocation of the carrying amount of the underlying asset to the residual asset**

Entity X leases an asset to a lessee under a Type A lease. Assume that the present value of the lease payments is CU42,000, the fair value of the underlying asset is CU60,000 and the carrying amount of the underlying asset is CU50,000 (the ratio of the present value of the lease payments to the fair value of the underlying asset is 70%). The present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term is CU18,000. In this example, there are no variable lease payments that are not included in the lease receivable.

**Analysis:**

(A) CU18,000 gross residual asset

(B) CU0 present value of variable lease payments, which are expected to be collected, but not included in the lease receivable (not applicable because there are no variable lease payments)

(C) CU3,000 unearned profit, calculated using the allocation method described above where the present value of the lease payments is 70% of the fair value of the underlying asset (70% = CU42,000 ÷ CU60,000):

CU10,000 (CU60,000 - CU50,000) total profit

Less

CU7,000 (CU10,000 x 70%) profit allocated to lessee’s right-of-use asset

The residual asset would be initially measured at CU15,000 (A+B-C) and the remaining CU35,000 (CU50,000 - CU15,000) of the derecognised underlying asset would be recognised in profit or loss (e.g., as cost of sales).

**6.1.1.4 Residual asset in a lease with variable lease payments not based on an index or rate**

If a lessor expects to receive variable lease payments that are not included in the lease receivable (e.g., variable lease payments linked to performance) and reflected that expectation in the rate the lessor charges the lessee (i.e., the lessor’s discount rate), the present value of those variable payments would be included in the initial measurement of the residual asset.

Expected variable lease payments that are not based on an index or a rate would be excluded from the lease receivable but could be included in the determination of the lessor’s discount rate. When included, the initially measured residual asset would also reflect those expected variable lease payments.
Entity W is a lessor of production equipment. Entity W enters into a three-year lease of equipment in return for fixed annual payments of CU2,400 plus additional payments of CU1 per production unit (i.e., a usage-based variable payment). Entity W expects to collect an additional CU1,200 in variable lease payments in each annual period. These amounts have been included in the calculation of the 7.87% rate the lessor charges the lessee. That is, in this circumstance, Entity W included the fixed lease payments plus the amounts expected to be received from variable lease payments in the calculation of the rate implicit in the lease (i.e., the rate the lessor charges the lessee).

Entity W expects to sell the production equipment at the end of the lease term for CU2,400. The fair value of the asset at lease commencement was CU11,200 and its carrying amount was CU8,000.

Entity W determines that the rate the lessor charges the lessee is the rate implicit in the lease, or 7.87%. That is, the rate that causes the sum of the fixed lease payments (present value of three annual payments of CU2,400 is CU6,200), the expected variable lease payments (present value of CU1,200 in expected annual variable lease payments is CU3,100) and the amount expected to be derived from the equipment at the end of the lease (present value of CU2,400 is CU1,900) to equal the fair value of the underlying asset (approximately CU11,200).

Entity W records a lease receivable of CU6,200 based on the present value of the lease payments (excluding the variable usage-based payments).

**Analysis:** As described above, Entity W would determine that the present value of lease payments is approximately 55.4% of the fair value of the underlying asset (55.4% = CU6,200 ÷ CU11,200) at lease commencement. Using the alternative method described above, Entity W would derecognise the carrying amount of the underlying asset (CU8,000) and record CU4,428 (55.4% x CU8,000) as cost of sales and CU3,572 (44.6% x CU8,000)\(^1\) as the residual asset at lease commencement.

\(^1\) Alternatively, the residual asset could be calculated as \(A + B - C\) where:

- \(A\) is the gross residual asset of CU1,900 (present value of the CU2,400 that the lessor expects to derive from the underlying asset following the lease)
- \(B\) is CU3,100 (the present value of three annual variable lease payments of CU1,200 expected to be collected)
- \(C\) is the unearned profit of CU1,428 (total profit of CU3,200 \([11,200 - 8,000]\), less profit allocated to the lessee’s right of use of approximately CU1,772 \([3,200 x (6,200 ÷ 11,200)]\)\)

The subsequent accounting for variable lease payments and the residual asset is discussed in section 6.1.2.2 and 6.1.2.3 below.
6.1.2 Subsequent measurement

After lease commencement, lessors would:

- Recognise interest income on the accretion of the lease receivable using the effective interest method
- Reduce the lease receivable for lease payments received
- Recognise interest income on the accretion of the gross residual asset
- Separately, recognise income from variable lease payments that are not included in the lease receivable (e.g., performance or usage-based variable payments) in the period in which that income is earned and derecognise the corresponding portion of the residual asset associated with such variable lease payments

The interest income on the accretion of the lease receivable and the gross residual asset would be recognised in profit or loss.

6.1.2.1 Lease receivable

Subsequent to lease commencement, lessors would increase the carrying amount of the lease receivable for the accretion of interest, using a rate that produces a constant periodic discount rate on the remaining balance of the receivable. Lease payments received would reduce the receivable balance.

If the lease receivable contains initial direct costs (see section 6.1.1.1 above), the effective interest rate used to accrete the lease receivable would be lower than the rate the lessor charges the lessee. This is because the rate the lessor charges the lessee (i.e., the rate used to discount the lease payments when initially measuring the lease receivable) would not consider the effects of initial direct costs.

Illustration 36 — Subsequent measurement of lease receivable – no initial direct costs

Entity L enters into a contract to lease production equipment to a lessee for a three-year term. The lessee does not have any options to extend or terminate the lease and there are no options for the lessee to purchase the underlying asset. Lease payments are CU10,000 per year, payable at the end of each year. Entity L concludes the lease is a Type A lease.

Analysis: At the lease commencement date, Entity L determines that the rate the lessor charges the lessee is 5.46% and the initial measurement of the lease receivable is CU27,000 (i.e., present value of the lease payments).

A summary of Entity L’s accounting for the lease receivable is, as follows (assuming no changes due to reassessment):

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income (rate of 5.46%)</td>
<td>CU 1,473</td>
<td>CU 1,009</td>
<td>CU 518</td>
<td></td>
</tr>
<tr>
<td>Cash lease payments received</td>
<td>CU(10,000)</td>
<td>CU(10,000)</td>
<td>CU(10,000)</td>
<td></td>
</tr>
<tr>
<td>Lease receivable</td>
<td>CU27,000</td>
<td>CU 18,473</td>
<td>CU 9,482</td>
<td>—</td>
</tr>
</tbody>
</table>
Assume the same facts as in Illustration 36, except that Entity L also incurs CU1,000 of initial direct costs in the form of legal fees and commissions to enter into the lease.

Analysis: At the lease commencement date, Entity L determines that the rate the lessor charges the lessee is 5.46% and the present value of the lease payments is CU27,000. Entity L records a lease receivable in the amount of CU28,000 based on the present value of the lease payments (CU27,000) and its initial direct costs (CU1,000).

Because the lease receivable includes initial direct costs, Entity L determines the discount rate that will reduce the balance of the lease receivable to zero at the end of the lease term. The discount rate of 3.53% is used to determine the interest income on the lease receivable in each annual period.

A summary of Entity L’s accounting for the lease receivable is, as follows (assuming no changes due to reassessment):

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income (rate of 3.53%)</td>
<td>CU 989</td>
<td>CU 670</td>
<td>CU 341</td>
<td></td>
</tr>
<tr>
<td>Cash lease payments received</td>
<td>CU (10,000)</td>
<td>CU (10,000)</td>
<td>(10,000)</td>
<td></td>
</tr>
<tr>
<td>Lease receivable</td>
<td>CU28,000</td>
<td>CU 18,989</td>
<td>CU 9,659</td>
<td>—</td>
</tr>
</tbody>
</table>

6.1.2.2 Residual asset

Subsequent to the lease commencement, the recognised residual asset would be accreted up to the expected value (undiscounted) of the residual asset at the end of the lease term, less the unearned profit on the residual asset that was deferred at lease commencement, using the rate the lessor charges the lessee.

How we see it

Whilst referred to as unearned profit, ultimately the profit that will be recognised will depend on the fair value of the underlying asset and the terms of a subsequent transaction involving the underlying asset (e.g., its subsequent sale).

Because residual assets would be accreted over the lease term, the measurement basis of residual assets would differ from the way most other non-financial assets are measured. In the basis for conclusions, the Boards address the accretion of the residual asset by explaining that, in Type A leases, lessors derive economic benefits from the entire underlying asset and they are unable to access any other economic benefits from the underlying asset until the end of the lease term. Therefore, in pricing a lease, a lessor charges the lessee for both of the following:

- The lessee’s use of the entire underlying asset over the lease term
- The lessor’s return on its investment in the portion of the underlying asset that the lessee is expected to consume
The Boards view the interest income from accreting the residual asset as the lessor’s return on the residual portion of the underlying asset whilst that asset is subject to a lease (i.e., whilst the lessor cannot otherwise generate economic benefits from the leased asset). Although the gross residual asset would be accreted during the lease term, the unearned profit on the residual asset would not be adjusted. Instead, the unearned profit (which is a component in calculating the recognised residual asset) would only be recognised upon the sale or re-lease of the underlying asset at the end of the lease term and then the profit would be based on its fair value at that time and the terms of such transaction.

**Illustration 38 — Lessor accounting for a Type A lease with profit at lease commencement**

Assume Entity Z manufactures a machine for CU75,000 and enters into a three-year lease of the machine with a lessee. There are no options for the lessee to purchase the machine or to extend or terminate the lease. The lease is classified as a Type A lease. Entity Z incurs no initial direct costs to execute the lease. At lease commencement, the machine has a fair value of CU100,000. The annual rent is CU24,000, due at the end of each year. The amount that Entity Z expects to derive from the machine following the end of the lease term is CU47,700. The present value of the lease payments discounted at the interest rate implicit in the lease (approximately 7.87%) is CU62,000. The present value of the amount that Entity Z expects to derive from the underlying asset following the end of the lease term, discounted at the interest rate implicit in the lease (7.87%), is CU38,000. Entity Z presents lease-related statement of profit or loss activity on a gross basis.

**Analysis:** Upon lease commencement, Entity Z records the following:

- **Lease receivable**
  - CU 62,000

- **Revenue**
  - CU 62,000

  *To initially recognise the revenue and related lease receivable at the present value of the lease payments*

- **Cost of sales**
  - [CU75,000 x (CU62,000 ÷ CU100,000)]
  - CU 46,500

- **Residual asset**
  - (CU75,000 – CU46,500)
  - CU 28,500

  *To derecognise the underlying asset and to recognise a residual asset and cost of sales for the portion of the underlying asset leased*
The following table illustrates the amounts recognised throughout the lease (assuming no changes due to reassessment):

<table>
<thead>
<tr>
<th>Period</th>
<th>Lease receivable</th>
<th>Gross residual</th>
<th>Unearned profit</th>
<th>Residual asset</th>
<th>Profit recognised</th>
<th>Cash received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>CU62,000</td>
<td>CU38,000 (^1)</td>
<td>CU9,500</td>
<td>CU28,500 (^3)</td>
<td>CU15,500</td>
<td>CU —</td>
</tr>
<tr>
<td>Year 1</td>
<td>CU42,880</td>
<td>CU40,990</td>
<td>CU9,500</td>
<td>CU31,490</td>
<td>7,870</td>
<td>24,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>CU22,250</td>
<td>CU44,220</td>
<td>CU9,500</td>
<td>CU34,720</td>
<td>6,600</td>
<td>24,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>CU —</td>
<td>CU47,700</td>
<td>CU9,500</td>
<td>CU38,200</td>
<td>5,230</td>
<td>24,000</td>
</tr>
<tr>
<td>Total</td>
<td>CU35,200</td>
<td>CU72,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. The present value of the expected value of the underlying asset at the end of the lease term, CU47,700 discounted at 7.87%.
2. Unearned profit is the difference between the gross residual asset and the recognised residual asset (e.g., CU38,000 – CU28,500).
3. The residual asset is initially measured based on the formula described in section 6.1.1.3 above [CU75,000 – CU75,000 x (CU62,000 ÷ CU100,000)]. The residual asset could also be calculated as A + B – C where A is CU38,000, B is CU0 (i.e., none are assumed in this example), and C is CU9,500.
4. Represents profit on the right of use transferred, interest income on the gross residual asset and interest income on the lease receivable. See calculation of profit recognised below.

Profit recognised is comprised of the following:

<table>
<thead>
<tr>
<th>Period</th>
<th>Interest on receivable (^1)</th>
<th>Interest on residual (^2)</th>
<th>Profit on right of use transferred</th>
<th>Profit recognised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>CU —</td>
<td>CU —</td>
<td>CU15,500 (^3)</td>
<td>CU15,500 (^3)</td>
</tr>
<tr>
<td>Year 1</td>
<td>4,880</td>
<td>2,990</td>
<td>—</td>
<td>7,870</td>
</tr>
<tr>
<td>Year 2</td>
<td>3,370</td>
<td>3,230</td>
<td>—</td>
<td>6,600</td>
</tr>
<tr>
<td>Year 3</td>
<td>1,750</td>
<td>3,480</td>
<td>—</td>
<td>5,230</td>
</tr>
<tr>
<td>Total</td>
<td>CU10,000</td>
<td>CU 9,700</td>
<td>CU15,500</td>
<td>CU35,200</td>
</tr>
</tbody>
</table>

1. Interest income on the lease receivable recognised over the lease term is calculated using the effective interest method. For example, year one interest is calculated as CU4,880 (CU62,000 x 7.87%).
2. Interest income on the gross residual asset recognised over the lease term is calculated as the gross residual multiplied by the rate the lessor charges the lessee (i.e., in this case the rate implicit in the lease). For example, year one accrual is calculated as CU2,990 (CU38,000 x 7.87%).
3. At commencement, profit is recognised for the difference between the revenue recognised from the present value of the lease payments (CU62,000) and the portion of the carrying amount of the underlying asset derecognised through the statement of profit or loss (underlying asset of CU75,000 less residual asset of CU28,500, or CU46,500).

If at the end of the lease, Entity Z sells the machine for CU47,700, as originally estimated, it would derecognise the CU38,200 residual asset and recognise CU9,500 of profit.

---

**Illustration 39 – Lessor accounting for a Type A lease without profit at lease commencement**

Entity B, a financing entity, acquires equipment for CU100,000 and enters into a three-year lease of the equipment with a lessee. The annual rent is CU24,000, due at the end of each year. There are no options for the lessee to extend or terminate the lease. For simplicity, we have ignored initial direct costs. The lease is determined to be a Type A lease.
Illustration 39 – Lessor accounting for a Type A lease without profit at lease commencement (continued)

At lease commencement, the equipment has a fair value of CU100,000 (i.e., the commencement date fair value is equal to Entity B’s cost to acquire the equipment). The present value of the lease payments discounted at the interest rate implicit in the lease (approximately 7.87%) is CU62,000.

Entity B estimates that the equipment’s expected value at the end of the lease term will be CU47,700. The expected value of the underlying asset at the end of the lease discounted at the interest rate implicit in the lease (7.87%) is CU38,000 (gross residual).

Analysis: Upon lease commencement, Entity B records the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>CU 62,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>CU 62,000</td>
</tr>
</tbody>
</table>

To initially recognise the revenue and related lease receivable at the present value of the lease payments

<table>
<thead>
<tr>
<th>Description</th>
<th>Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>CU 62,000</td>
</tr>
<tr>
<td>[CU100,000 x (CU62,000 ÷ CU100,000)]</td>
<td></td>
</tr>
<tr>
<td>Residual asset (CU100,000 – CU62,000)</td>
<td>CU 38,000</td>
</tr>
<tr>
<td>Underlying asset</td>
<td>CU 100,000</td>
</tr>
</tbody>
</table>

To derecognise the underlying asset and to recognise a residual asset and cost of sales for the portion of the underlying asset leased

Entity B would likely present the commencement date profit or loss activity on a net basis on the statement of profit or loss because Entity B enters into leases to provide finance.

The following table illustrates the amounts recognised throughout the lease (assuming no changes due to reassessment):

<table>
<thead>
<tr>
<th>Period</th>
<th>Lease receivable</th>
<th>Gross residual</th>
<th>Unearned profit</th>
<th>Residual asset</th>
<th>Profit recognised</th>
<th>Cash received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>CU 62,000</td>
<td>CU38,000</td>
<td>-</td>
<td>CU38,000</td>
<td>CU –</td>
<td>CU –</td>
</tr>
<tr>
<td>Year 1</td>
<td>CU 42,880</td>
<td>CU40,990</td>
<td>CU –</td>
<td>CU40,990</td>
<td>7,870</td>
<td>24,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>CU 22,250</td>
<td>CU44,220</td>
<td>CU –</td>
<td>CU44,220</td>
<td>6,600</td>
<td>24,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>CU –</td>
<td>CU47,700</td>
<td>CU –</td>
<td>CU47,700</td>
<td>5,230</td>
<td>24,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CU19,700</td>
<td>CU72,000</td>
</tr>
</tbody>
</table>

1 The present value of the expected value of the underlying asset at the end of the lease term, CU47,700, discounted at 7.87%.

2 Unearned profit is nil, because Entity B’s cost of acquiring the equipment (CU100,000) was equal to its fair value at lease commencement.

3 The residual asset is initially measured based on the formula described in section 6.1.1.3 above (CU100,000 – (CU100,000 x (CU62,000 ÷ CU100,000))).

4 Represents subsequent profit from the interest income on the gross residual asset and interest income on the lease receivable. There is no profit on the right of use transferred because the fair value of the asset was equal to Entity B’s cost at the lease commencement date. See calculation of profit recognised in the following table.
**Illustration 39 — Lessor accounting for a Type A lease without profit at lease commencement (continued)**

Profit recognised is comprised of the following:

<table>
<thead>
<tr>
<th>Period</th>
<th>Interest on receivable(^1)</th>
<th>Interest on residual(^2)</th>
<th>Profit on right of use transferred</th>
<th>Profit recognised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>CU —</td>
<td>CU —</td>
<td>CU (^{-3})</td>
<td>CU (^{-3})</td>
</tr>
<tr>
<td>Year 1</td>
<td>4,880</td>
<td>2,990</td>
<td>—</td>
<td>7,870</td>
</tr>
<tr>
<td>Year 2</td>
<td>3,370</td>
<td>3,230</td>
<td>—</td>
<td>6,600</td>
</tr>
<tr>
<td>Year 3</td>
<td>1,750</td>
<td>3,480</td>
<td>—</td>
<td>5,230</td>
</tr>
</tbody>
</table>

\(^{1}\) Interest income on the lease receivable recognised over the lease term calculated using the effective interest method. For example, year one interest is calculated as CU4,880 (CU62,000 x 7.87%).

\(^{2}\) Interest income on the gross residual asset recognised over the lease term calculated as the gross residual multiplied by the rate the lessor charges the lessee. For example, in year one the accretion is calculated as CU2,990 (CU38,000 x 7.87%).

\(^{3}\) At commencement, profit is CU0 because there is no difference between the fair value of the underlying asset and the carrying amount of the underlying asset immediately before the commencement date.

If at the end of the lease, Entity B sells the machine for CU47,700, as originally estimated, there would be no additional profit to be recognised (i.e., the carrying amount of residual asset at the end of the lease would be CU47,700).

### 6.1.2.3 Residual asset in a lease with variable lease payments not based on an index or rate

As described above, if lessors reflect an expectation of variable payments that are not based on an index or rate in determining the rate the lessor charges the lessee, the present value of those expected amounts (discounted using the rate the lessor charges the lessee) would be included in the initial measurement of the residual asset. At the lease commencement date, the lessor would also calculate a portion of the residual asset to derecognise in each period on the basis of the expected variable lease payments. In each subsequent reporting period, lessors would derecognise the calculated portion of the residual asset and recognise a corresponding expense in profit or loss. The periodic adjustments to the residual asset would be calculated using the following formula and inputs:

\[
\left(\frac{A}{B}\right) \times C \times \left(\frac{D}{E}\right)
\]

- \(A\) — The amount of variable lease payments expected to be earned in the current period reflected when determining the rate the lessor charges the lessee
- \(B\) — The amount of total variable lease payments expected to be earned during the lease term reflected in determining the rate the lessor charges the lessee
- \(C\) — The amount of the initial measurement of the residual asset relating to variable lease payments (i.e., the present value of variable lease payments expected to be earned during the lease term, discounted using the rate the lessor charges the lessee)
• D – The carrying amount of the underlying asset immediately before the commencement date

• E – The fair value of the underlying asset at the commencement date

Subsequent changes in estimates relating to future variable lease payments do not affect the amounts to be derecognised by the lessor in each period. Instead, any differences between the actual variable lease payments and the expected variable lease payments (on which the periodic derecognition amounts are based) would be recognised in profit or loss in the periods in which they occur.

6.2 Reassessment

After lease commencement, lessors would monitor leases for changes that could trigger a reassessment of the lease term or lease payments.

Upon reassessment, the lessor would remeasure its lease receivable using revised inputs at the reassessment date to reflect any changes to the lease payments that result from changes in:

• Relevant factors that result in a change to the lease term, including changes when the lessee has, or no longer has, a significant economic incentive to do either of the following:
  • Exercise an existing option to extend the lease or purchase the underlying asset
  • Not exercise an existing option to terminate the lease

• An index or a rate used to determine lease payments

Relevant factors to consider when evaluating whether the lease term has changed include asset, contract and entity-based factors. Market-based factors (e.g., a change in market rents compared with a fixed price renewal option) would also be considered, but would not, in isolation, be determinative when evaluating whether the lease term has changed.

Lessors would also reassess the lease term if the lessee elects to exercise an option to renew a lease even though the lessor had previously determined that the lessee did not have a significant economic incentive to do so. Similarly, lessors would reassess the lease term if the lessee does not exercise a lease termination option when the lease term previously contemplated that the lessee would exercise that option.

Lease classification would not be reassessed after lease commencement unless there is a modification to the contract provisions. The exercise of an existing option to renew or terminate a lease would not trigger a reassessment of the lease classification as it would not be a change in the contractual terms.

Upon reassessment, lessors would determine the remaining lease payments based on the new lease term. When remeasuring the lease receivable, lessors would use an updated discount rate (to discount the revised lease payments) only when there is a change to any of the following (and the possibility of the change was not contemplated in developing the previous discount rate):

• The lease term (as discussed in section 6.2.1 below)

• Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise a purchase option
A reference interest rate used to determine variable lease payments (as discussed in section 6.2.2 below)

Upon remeasuring the lease receivable, lessors would:

- Adjust the carrying amount of the residual asset to reflect the amount that the lessor expects to derive from the underlying asset following the end of the lease term if there is a change in the lease term or the assessment of whether the lessee has, or no longer has, a significant economic incentive to exercise a purchase option

- Recognise any difference between carrying amounts of the lease receivable and residual asset before and after the remeasurement in profit or loss

Lessors would also remeasure the lease receivable for foreign currency exchange differences when a lease receivable is denominated in a foreign currency and recognise any resulting changes in profit or loss.

**How we see it**

- It is not clear how the measurement of the unearned profit would change upon remeasurement of the residual asset. The proposal indicates that the carrying amount of the residual asset should be adjusted to reflect the amount that the lessor expects to derive from the underlying asset following the end of the lease. That might imply the initially measured unearned profit, which is included in the previous carrying amount of the residual asset, is immediately recognised. However, we believe the Boards intended that the remeasured residual asset would continue to reflect unearned profit adjusted for the change in the portion of the underlying asset that has been leased.

- Lessors would need to establish processes to identify certain changes (e.g., changes in lease term, relevant factors, indexes or rates on which variable lease payments are based) that could trigger a reassessment of the lease receivable.

**6.2.1 Subsequent change to the lease term**

Lessors would be required to consider all relevant factors (e.g., contract, asset, entity and market-based) when determining whether the lease term has changed. However, a change in market-based factors (e.g., market rates), in isolation, would not trigger reassessment of the lease term. The Boards were concerned that frequent reassessments of the lease receivable arising solely from changes in market-based factors would add complexity and cost to the reassessment process.

Upon a change in the lease term, lessors would reassess the lease payments using the revised lease term. The lease receivable would then be remeasured as the present value of the revised lease payments as described above. Lessors would use a revised discount rate, which would be determined at the reassessment date, based on the rate that the lessor would charge the lessee.

In the basis for conclusions, the Boards explain that a change in the lease term indicates that the lessee has acquired more, or less, of the right to use the underlying asset than was previously determined (e.g., at lease commencement). The Boards proposed that lessors remeasure the lease receivable and residual asset amounts to reflect the relative value of the right
of use transferred (the lease receivable) and the retained interest in the underlying asset (the residual asset) based on current economic conditions. For example, consider a lease with a lease term that increases upon the determination that the lessee has a significant economic incentive to exercise an option to extend the lease when that incentive did not previously exist. Also assume that the revised lease term (including the optional period) represents almost all of the economic life of the underlying asset. Upon remeasurement, the lessor would increase the carrying amount of the lease receivable to include the lease payments in the optional period and would simultaneously reduce the residual asset to reflect the expectation that the carrying amount of the residual asset (i.e., the underlying asset at the end of the new lease term) is expected to be smaller.

How we see it

The reassessment aspects of the lessor accounting model are complex and the ED is unclear on how lessors would consider two of the key inputs upon reassessment, the rate the lessor would charge the lessee and the unearned profit. It is not clear whether lessors would consider whether the value of the residual asset has changed when determining the revised rate the lessor would charge the lessee. Additionally, the ED does not address how a lessor would adjust the unearned profit (i.e., the difference between the gross residual asset and the recognised residual asset) upon reassessment. We believe that if a change in the lease term results in an adjustment to the residual asset then the unearned profit would also need to be adjusted because the lessor’s interest in the underlying asset at the end of the lease would be different from the amount that the lessor had previously estimated.

6.2.2 Subsequent change to lease payments that depend on an index or rate

For leases with variable payments based on an index or rate, the lease payments would be reassessed at the end of each reporting period in which there is a change to the relevant index or rate. For example, a lessor that reports quarterly may have a lease arrangement in which the lease payments change based on changes to a monthly interest rate index. The lease payments would be updated at each reporting date using the interest rate at the end of the reporting period.

A change in index or rate-based variable payments represents a change in the total consideration that a lessor expects to receive for transferring the right to use the underlying asset. Therefore, lessors would remeasure the lease receivable and recognise any difference between the carrying amount of the lease receivable before and after the remeasurement in profit or loss. The Boards explain in the basis for conclusions that the recognition of such changes in profit or loss is appropriate because they do not represent a change in the lessor’s remaining rights to the underlying asset (i.e., the residual asset). Instead, changes in index or rate-based variable payments relate to the right-of-use asset already transferred to the lessee.

The discount rate used to remeasure the lease receivable would be updated upon changes to lease payments that depend on a reference interest rate. All other changes in variable lease payments do not impact the discount rate.

6.2.3 Change to foreign currency exchange rates

Lessors would apply IAS 21 to leases denominated in a foreign currency. Lessors would remeasure the lease receivable using the exchange rate at...
each reporting date and any resulting changes would be recognised in profit or loss. Because the residual asset is a non-monetary asset, it would not be affected by changes in the exchange rate.

6.3 Other lessor matters in Type A leases
6.3.1 Sale of lease receivables
Lessors would measure all lease receivables, including those held for sale, at amortised cost.

The Boards considered whether specific accounting guidance was needed for the derecognition of lease receivables that are sold. However, the IASB concluded that it would be appropriate for lessors to apply the existing financial asset derecognition requirements in IAS 39 or IFRS 9 when lease receivables are sold. The Boards explain in the basis for conclusions that they believe lease receivables do not contain any features that would cause the application of IAS 39 (or IFRS 9 when it is applied) to be inappropriate.

6.3.2 Impairment of lease receivables
Lessors would apply the impairment requirements in IAS 39 to determine whether lease receivables are impaired. The IASB is separately developing new impairment requirements for financial assets, including lease receivables. The Financial Instruments: Expected Credit Losses exposure draft can be found on the IASB website.

6.3.3 Impairment of residual assets
Lessors’ residual assets would be subject to the impairment requirements in IAS 36 and would consider residual value guarantees, if any, relating to the underlying asset when assessing residual assets for impairment.

The Boards believe the value of a residual asset would be closely linked to the value of the underlying asset. Therefore, they reason that an impairment to the residual asset would generally be caused by a decline in the value of the underlying asset (i.e., a non-financial asset) so the impairment model in IAS 36 for non-financial assets would apply.

The requirements of IAS 36 are summarised in section 5.4.1 above.

The IASB decided not to permit revaluation of the residual asset because it would be inconsistent with the decision to prohibit measuring the residual asset on a current measurement basis (and thereby recognising profit relating to the residual asset) at the commencement date. It would also be inconsistent with the decision to require a lessor to recognise the unwinding of the discount embedded in the measurement of the residual asset over the lease term as interest income. The IASB also questioned whether a lessor would ever choose to measure the residual asset at fair value, with changes in fair value being recognised as part of other comprehensive income. Such an approach would result in part of the income earned from a lease never being recognised in profit or loss.

Whilst the IASB’s decision could be viewed as being inconsistent with the requirements of IAS 16 and IAS 38 Intangible Assets, as noted above, in the IASB’s view, the nature of the residual asset is different from that of other non-financial assets.
How we see it

More application guidance on impairment of residual assets may be needed. For example, it is not clear how lessors would reflect a decline in the expected fair value of the underlying asset at the end of a lease when applying the impairment requirements for residual assets. Would lessors refer to the original expected value at the end of the lease or the current carrying amount of the residual asset?

6.3.4 Measurement of the underlying asset at the end of a lease

At the end of the lease term, lessors receive the underlying asset back from the lessee. 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).

6.3.5 Measurement of the underlying asset and the lease receivable upon lease termination

In certain circumstances, a lease agreement may be terminated before the lease term is completed. For example, a contract could be terminated due to a lessee’s bankruptcy or the lessee may exercise its option to terminate the lease even though it had a significant economic incentive not to.

Upon a lease termination, lessors would:

- Test the lease receivable for impairment in accordance with IAS 39 (or IFRS 9 when that standard is applied) and recognise any impairment loss identified

- Reclassify the aggregate of the carrying amounts of the lease receivable (less any amounts still expected to be collected by the lessor) and the residual asset to the appropriate category of the recovered underlying asset

- Account for the asset that was the subject of the lease in accordance with other applicable standards

If the lessor expects to continue to collect amounts from the lessee, those amounts would remain classified as receivables (i.e., the amounts would not be reclassified to another asset category as part of the underlying asset). If the underlying asset subsequently becomes the subject of another lease, the lessor would account for that new lease contract in accordance with the proposal.
Assume Entity J manufactured a machine for CU75,000 and entered into a three-year lease of the machine with a lessee. There are no options for the lessee to extend or terminate the lease. Entity J incurred no initial direct costs to execute the lease. The annual rent is CU24,000, due at the end of each year. The present value of the lease payments, discounted at the interest rate implicit in the lease (approximately 7.87%), was CU62,000.

At lease commencement, the machine had a fair value of CU100,000. Entity J estimated that the machine’s expected value at the end of the lease term would be CU47,700. The expected value of the underlying asset at the end of the lease term, discounted at the interest rate implicit in the lease (7.87%), was CU38,000.

The following table illustrates Entity J’s accounting for years one and two of the lease:

<table>
<thead>
<tr>
<th>Period</th>
<th>Lease receivable</th>
<th>Gross residual</th>
<th>Unearned profit</th>
<th>Residual asset</th>
<th>Profit recognised</th>
<th>Cash received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>CU62,000</td>
<td>CU38,000</td>
<td>CU(9,500)</td>
<td>CU28,500</td>
<td>CU15,500</td>
<td>CU —</td>
</tr>
<tr>
<td>Year 1</td>
<td>CU42,880</td>
<td>CU40,990</td>
<td>CU(9,500)</td>
<td>CU31,490</td>
<td>7,870</td>
<td>24,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>CU22,250</td>
<td>CU44,220</td>
<td>CU(9,500)</td>
<td>CU34,720</td>
<td>6,600</td>
<td>24,000</td>
</tr>
</tbody>
</table>

Profit recognition for years one and two of the lease were comprised of the following:

<table>
<thead>
<tr>
<th>Period</th>
<th>Interest on receivable</th>
<th>Interest on residual</th>
<th>Profit on right of use transferred</th>
<th>Profit recognised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>CU —</td>
<td>CU —</td>
<td>CU15,500</td>
<td>CU15,500</td>
</tr>
<tr>
<td>Year 1</td>
<td>CU4,880</td>
<td>CU2,990</td>
<td>—</td>
<td>CU 7,870</td>
</tr>
<tr>
<td>Year 2</td>
<td>CU3,370</td>
<td>CU3,230</td>
<td>—</td>
<td>CU 6,600</td>
</tr>
</tbody>
</table>

At the end of the second year, the lessee stops operating the business line that employed the leased machine. The lessee returns the machine to Entity J, pays the CU24,000 rental charge for year two and remains committed, and able, to pay the last rental payment in year three. Upon lease termination, Entity J has a remaining lease receivable balance of CU22,250, which it expects to collect from the lessee. The residual asset’s carrying amount is CU34,720 when the underlying asset is returned.

Analysis: Entity J tests the lease receivable for impairment in accordance with IAS 39 (discussed in section 6.3.2 above) and concludes that the receivable is not impaired. Because Entity J expects to collect the remaining lease receivable (and the related interest under the lease agreement), the CU22,250 balance remains classified as a receivable. Entity J reclassifies the residual asset to inventory (determined by Entity J to be the appropriate category of asset), as follows:

<table>
<thead>
<tr>
<th></th>
<th>CU 34,720</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>CU 34,720</td>
</tr>
<tr>
<td>Residual asset</td>
<td>CU 34,720</td>
</tr>
</tbody>
</table>

To reclassify the residual asset to inventory upon return by the lessee

Until the machine is sold or re-leased, Entity J would account for it in a manner similar to other inventory (i.e., using relevant accounting standards).
6.3.6 Income tax accounting

The proposal could also affect lessors' accounting for income taxes. For lessors, application of the ED’s provisions could result in changes to the measurement of lease-related assets as well as the recognition of lease-related assets (i.e., lease receivables and residual assets) and the derecognition of underlying assets for certain leases that are subject to operating leases today. In addition, the proposal would change the timing of the lease income recognised for some leases. These changes could affect many aspects of accounting for income taxes, such as the following:

- Recognition and measurement of deferred tax assets
- Recognition and measurement of deferred tax liabilities
- Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of valuation allowances)

6.4 Type B leases

Lessors would account for Type B leases in a manner similar to today's operating leases. That is, they would continue to recognise the underlying asset and, at lease commencement, would not recognise a lease receivable (or residual asset) on the balance sheet or initial profit in profit or loss. 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 Type B leases over the lease term on either a straight-line basis or another systematic basis, if that better represents the pattern in which income is earned from the underlying asset. Circumstances where the lease income is recognised on a systematic basis other than straight-line could represent a significant change for lessors. Lessors in a Type B lease would recognise initial direct costs as an expense over the lease term, proportionate to the lease income.

The Boards believe a lessor’s continued recognition of the underlying asset is consistent with their view that in a Type B lease the lessee makes lease payments for the ability to use the asset during the lease term (rather than to acquire a portion of the underlying asset as in a Type A lease).

The lease payments made by the lessee represent amounts paid to provide the lessor with a return on its investment in the underlying asset (i.e., a charge for the use of the asset by the lessee). That return would often be earned on a straight-line basis over the lease term. However, the Boards acknowledged that, in some circumstances, 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**

- Today, when rental payments for an operating lease are not made on a straight-line basis, IAS 17 requires lessors to recognise lease income on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property (in which case that basis should be used). This requirement often results in lessors recognising operating lease income on a straight-line basis.

As described above, the ED would require lessors to recognise lease payments from Type B 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. It is unclear what the Boards intended 'earned' to mean, as it relates to other systematic bases of lease income recognition for Type B leases.

In the basis for conclusions, the Boards indicate that in the case of stepped rent increases when those stepped rents are expected to compensate the lessor for increases in market rentals, recognising lease income as lease payments are received would better reflect the pattern in which income is earned from the underlying asset.

It is not clear whether a lessor receiving straight-line rent payments for the lease of an asset for which it expects market rentals to increase over the lease term could, by analogy, recognise lease income in a pattern reflecting higher periodic income in later periods (as it would also better reflect the pattern in which income is earned from the underlying asset). Similarly, it is not clear whether a lessor that expects market rentals to decrease over the lease term, could recognise lease income in a pattern reflecting higher income in earlier periods as a better reflection of the pattern in which income is earned from the underlying asset.

- Determining that lease payments in a Type B lease should be recognised on a basis other than straight-line would likely require judgement. There may 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.

- Whilst the ED provides detailed requirements for the reassessment of the lease term and the lease payments (i.e., upon the occurrence of certain changes) for lessors in Type A leases, it does not provide guidance as to whether lessors in Type B leases would reassess the lease term or the lease payments. Additional guidance may be needed.
Scenario A
A lessor enters into a three-year lease for an office suite. There are no initial direct costs. The annual lease payments are CU5,000 in year one, CU20,000 in year two and CU20,000 in year three. The rent for year one was reduced to induce the lessee to enter into the agreement. The lessor concludes the lease is a Type B lease.

Analysis: The uneven lease payments are not related to the pattern in which the lessor earns income from the underlying asset (i.e., the office suite). Therefore, the lessor would recognise lease income on a straight-line basis in an amount of CU15,000 per year (CU15,000 = (CU5,000 + CU20,000 + CU20,000) ÷ 3).

Scenario B
A lessor enters into a three-year lease of a retail store. There are no initial direct costs. The annual lease payments are CU0 in year one, CU30,000 in year two and CU30,000 in year three. The rent-free period in year one was included to induce the lessee to enter into the agreement. The lessor concludes the lease is a Type B lease.

Analysis: The uneven lease payments (i.e., the rent holiday) are not related to the pattern in which the lessor earns income from the underlying asset (i.e., the store). Therefore, the lessor would recognise lease income on a straight-line basis in an amount of CU20,000 per year (CU20,000 = (CU0 + CU30,000 + CU30,000) ÷ 3).

Scenario C
A lessor enters into a three-year lease of a building. There are no initial direct costs. The annual lease payments are CU30,000 in year one, CU30,600 in year two and CU31,212 in year three. The rent increases each year to reflect expected increases in market rentals that result from increases in the property value. The lessor concludes the lease is a Type B lease.

Analysis: The uneven lease payments are related to the pattern in which the lessor earns income from the underlying asset. That is, the increases in the lease payments are intended to compensate the lessor for expected changes in the market rentals that result from increases in the underlying asset’s value. Therefore, the lessor would recognise lease income as the payments become receivable (a basis other than straight-line): CU30,000 in year one, CU30,600 in year two and CU31,212 in year three.

Scenario D
A lessor enters into a three-year lease of property. There are no initial direct costs. The annual fixed lease payments are CU35,000 for each year of the lease. The agreement also calls for the lessee to make a variable payment of 0.5% of annual sales in each year. Further assume that the lessee has sales of CU1 million in year one, CU3 million in year two and CU5 million in year three. The lessor concludes the lease is a Type B lease.
Illustration 41 – Recognition of lease income in Type B leases (continued)

Analysis: The lessor would recognise lease income from the fixed annual lease payments on a straight-line basis in an amount of CU35,000 per year.

The variable lease payments would be recognised in the period they are earned (i.e., when they become receivable). The lessor would recognise additional lease income of CU5,000 in year one, CU15,000 in year two and CU25,000 in year three.

The lessor would recognise total lease income of CU40,000 (CU35,000 fixed payment + CU5,000 variable payment) in year one, CU50,000 (CU35,000 fixed payment + CU15,000 variable payment) in year two and CU60,000 (CU35,000 fixed payment + CU25,000 variable payment) in year three.

Illustration 42 – Recognition of lease income in Type B leases with initial direct costs

Scenario A
A lessor enters into a three-year lease of office space and incurs initial direct costs of CU3,000. The annual lease payments are CU5,000 in year one, CU20,000 in year two and CU20,000 in year three. The rent for year one was reduced to induce the lessee to enter into the agreement.

Analysis: The uneven lease payments are not related to the pattern in which the lessor earns income from the underlying asset (i.e., the office space). Therefore, the lessor would recognise lease income on a straight-line basis in an amount of CU15,000 per year [CU15,000 = (CU5,000 + CU20,000 + CU20,000) ÷ 3]. The lessor would recognise the initial direct costs on the same straight-line basis as lease revenue. The lessor would recognise CU1,000 of the initial direct costs (to expense) in each year (CU1,000 = CU3,000 initial direct costs ÷ 3 years).

Scenario B
A lessor enters into a three-year lease of office space and incurs initial direct costs of CU1,000. The annual lease payments are CU30,000 in year one, CU30,600 in year two and CU31,212 in year three. The rents increase in each year to reflect expected increases in the market rentals as a result of increases in the property value.

Analysis: The uneven lease payments are related to the pattern in which the lessor earns income from the underlying asset (i.e., office space). That is, the increases in the lease payments are intended to compensate the lessor for expected changes in the market rentals that result from increases in the underlying asset’s value.

Therefore, the lessor would recognise lease income as the payments become receivable (a basis other than straight-line): CU30,000 in year one, CU30,600 in year two and CU31,212 in year three. The lessor would recognise initial direct costs on the same basis as lease revenue: CU327 in year one [CU327 = CU1,000 x (CU30,000 ÷ CU91,812)], CU333 in year two [CU333 = CU1,000 x (CU30,600 ÷ CU91,812)], and CU340 in year three [CU340 = CU1,000 x (CU31,212 ÷ CU91,812)].
6.5 Presentation

Lessors would have to change the way they present leases in their financial statements, except for short-term leases and current operating leases that would be classified as Type B leases under the proposal. The following table summarises how lease-related amounts and activity 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>▶ Type A leases:</td>
</tr>
<tr>
<td></td>
<td>1. Lease assets (i.e., the sum of the carrying amount of lease receivables and residual assets) would be presented separately from other assets.</td>
</tr>
<tr>
<td></td>
<td>2. Lease receivables and residual assets could be presented separately from each other, or if presented together, separately disclosed in the notes.</td>
</tr>
<tr>
<td></td>
<td>▶ Type B leases: 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></td>
<td>▶ Type A leases:</td>
</tr>
<tr>
<td></td>
<td>1. Profit or loss recognised at the commencement date would be presented on either a gross or net basis, based on the lessor’s business model.</td>
</tr>
<tr>
<td></td>
<td>2. Lessors that use leasing as an alternative means of realising value from goods they would otherwise sell would present lease revenue and cost of goods sold gross (i.e., revenue and costs in separate line items).</td>
</tr>
<tr>
<td></td>
<td>3. Lessors that use leases for the purpose of providing finance would present the gain or loss on a net basis (i.e., in a single line item).</td>
</tr>
<tr>
<td></td>
<td>4. Interest on the lease receivable and the accretion of the gross residual asset 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>

The proposal would require lessors to present the sum of Type A lease receivables and residual assets (collectively, lease assets) separately from other assets on the balance sheet. Lessors would also present Type A lease receivables and residual assets separately, either on the balance sheet or in the notes. The Boards believe that there is value in presenting the sum of lessors’ lease assets because the lease receivable and the residual asset relate to the same underlying asset. However, the Boards also believe that the separate disclosure of lease receivables and residual assets provides important information to financial statement users. The Boards explain that separate disclosure of these amounts would provide more transparent information to financial statement users about the inherent differences in the nature, risks and liquidities of lease receivables and residual assets (e.g., credit risk for lease receivables and asset risk for residual assets).

The statement of profit or loss presentation of lease income would be determined based on a lessor’s business model. The Boards believe this approach would result in presentation that is consistent with how the lessor generates its income. For example, a manufacturer might use leasing as an alternative way to realise value from the goods it also sells. Current accounting standards generally require the manufacturer to use a gross
presentation for the revenue and expenses it generates from the goods it sells. The manufacturer would also present lease-related statement of profit or loss activity on a gross basis (i.e., consistent with the presentation of the similar goods that are sold). Conversely, the ED would require entities (e.g., a financial institution) that enter into leases to provide finance to present lease-related statement of profit or loss activity on a net basis.

6.6 Disclosure

The proposal would require disclosures for lessors to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows, including the amount of lease-related assets and liabilities recognised, significant judgements and assumptions about lease terms, payments, 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 disaggregated or aggregated 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.

6.6.1 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 proposal 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

Lessors would also disclose information about activities used to manage risks associated with residual assets. Such disclosures would include:

- The lessor’s risk management strategy for residual assets
- The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor)
- 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 Type A leases:
  - Profit or loss recognised at the commencement date (presented gross or net, consistently with the lessor’s business model)
  - The interest income on the lease receivables
  - The interest income on the gross residual assets
- For Type B leases, lease income relating to lease payments
- Lease income relating to variable lease payments not included in the measurement of the Type A lease receivable
- Short-term lease income

6.6.2 Other quantitative disclosures - Type A leases

Lessors would also make quantitative disclosures about lease-related assets and income specific to Type A leases. Lessors would provide separate reconciliations of the opening and closing balances of lease receivables and residual assets (i.e., the recognised residual asset). These reconciliations would present activity that would help financial statement users understand the change in the assets.

The activity in the lease receivable reconciliation could include:

- Additions due to leases commencing or being extended
- Receivables derecognised due to leases being terminated
- Accretion of interest on the lease receivable
- Cash lease payments received
- Foreign currency transaction gains and losses
- Effects of business combinations
- Changes to the loss allowance

To help financial statement users understand and evaluate liquidity risks of lease-related cash flows, lessors would be required to disclose the information relating to risks arising from leases in accordance with IFRS 7 Financial Instruments: Disclosures. However, in place of the maturity analyses required by IFRS 7, lessors would be required to disclose a maturity analysis of the lease receivable at each reporting date that would include undiscounted cash flows, on an annual basis, for a minimum of each of the five years after the balance sheet date and a total of the amounts for the remaining years (i.e., the total undiscounted cash flows beyond the fifth year). This analysis would also include a reconciliation of the undiscounted cash flows to the lease receivable recognised on the balance sheet.
The activity in the reconciliation of the residual asset could include:

- Additions due to leases commencing
- Reductions due to leases being extended
- Reclassifications at expiration or termination of a lease
- Accretion of interest on the gross residual asset
- Effects of business combinations
- Effects of an impairment

6.6.3 Other quantitative disclosures – Type B leases

Lessors would be required to provide a maturity analysis of the undiscounted future lease payments for Type B leases, as of the reporting date. The maturity analysis would include undiscounted cash flows to be received, on an annual basis, for a minimum of each of the five years after the balance sheet date and for a total for the amounts in the remaining years (i.e., the total undiscounted cash flows for years beyond the fifth year). This maturity analysis would be presented separately from the lease receivable maturity analysis for Type A leases.

7. Other considerations

7.1 Subleases

Lessees often enter into arrangements to sublease an underlying leased asset to a third party whilst 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’.

7.1.1 Intermediate lessor accounting

To classify a sublease, the intermediate lessor would consider the same principles as any lessor and would assess whether the sub-lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset (i.e., the asset subject to the original lease, not the original lessee’s right-of-use asset) over the lease term. The intermediate lessor would assess sublease classification independently of the classification assessment that it makes as the lessee of the same asset. Said another way, the intermediate lessor would apply the classification requirements as if it were the legal owner of the underlying asset.

7.1.2 Sub-lessee accounting

A sub-lessee often would not know the terms of the head lease. Therefore, the Boards believe it would be easier for a sub-lessee to classify the sublease by referring to the underlying asset rather than by referring to the right-of-use asset arising from the head lease.

The Boards believe that referring to the underlying asset, rather than the right-of-use asset, when classifying subleases would prevent a lessor from accounting for similar leases in a different manner. For example, consider a lessor that leases two similar properties for five-year lease terms. One property is owned and has an economic life of 20 years and the other is subject to a five-year head lease. If sublease classification were to be determined by reference to the intermediate lessor’s right-of-use asset, the
sublease would be a Type A lease and the lease of the owned property would a Type B lease, even though the economics of the leases would be similar.

### Illustration 43 - Sublease classification

#### Scenario A

Entity L enters into a four-year lease, as a lessee, for equipment. The economic life of the equipment is eight years. The lease term represents 50% of the economic life of the equipment. The present value of the lease payments represents 55% of the fair value of the equipment at the lease commencement date.

Entity L concurrently subleases the equipment to Entity W for four years. The sublease term represents 50% of the economic life of the equipment. The present value of the sublease payments represents 65% of the fair value of the equipment at the sublease commencement date.

**Analysis:** Entity L would classify the head lease (i.e., the contract in which it is the lessee) as a Type A lease because the underlying asset is not property and because neither of the two exception criteria specific to leases of assets other than property is met.

Entity L would then perform a separate analysis to determine the classification of the sublease. The sublease would also be a Type A lease because the underlying asset is not property and neither of the two exception criteria specific to leases of assets other than property is met.

When assessing whether the sublease term or the fair value of the sublease payments are insignificant to the economic life or fair value of the underlying asset, respectively, Entity L would refer to the underlying asset (i.e., the equipment) rather than the right-of-use asset in the head lease.

Entity L would derecognise the carrying amount of the head lease’s right-of-use asset. Entity L would also recognise a lease receivable (no residual asset would be recognised in this example because the head lease and sublease have the same lease term) and any profit at sublease commencement.

#### Scenario B

Entity M enters into a 38-year lease, as a lessee, for a ship. The economic life of the ship is 50 years. The lease term represents 76% of the economic life of the ship. The present value of the lease payments represents 80% of the fair value of the ship at the lease commencement date.

Entity M concurrently subleases the ship to Entity X for two years. The sublease term represents 4% of the economic life of the ship. The present value of the sublease payments represents 4% of the fair value of the ship at the sublease commencement date.

**Analysis:** Entity M would classify the head lease (i.e., the contract in which Entity M is the lessee) as a Type A lease because the underlying asset is not property and because neither of the two exception criteria specific to leases of assets other than property is met.

Entity M would then perform a separate analysis to determine the classification of the sublease. When assessing whether the sublease term or the fair value of the sublease payments are insignificant to the economic life or fair value of the underlying asset, respectively, Entity M would refer to the actual underlying asset (i.e., the ship) rather than the right-of-use asset in the head lease.
Illustration 43 – Sublease classification (continued)

Entity M concludes that the sublease term is insignificant to the total economic life of the underlying asset and the present value of the sublease payments is insignificant to the fair value of the underlying asset. Therefore, the sublease is a Type B lease because at least one of the two exception criteria specific to leases of assets other than property is met.

Because the sublease is a Type B lease, the accounting for the sublease would be similar to today’s operating lease accounting. Entity M would retain the head-lease right-of-use asset on its balance sheet and amortise it over the head-lease term. Entity M would recognise sublease income on a straight-line basis over the sublease term (or another systematic basis of recognition that better represents the pattern in which income is earned from the ship).

7.1.3 Disclosure

In addition to the lessee and lessor disclosure requirements discussed previously, the proposal requires the intermediate lessor to identify in its disclosures, 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 (including descriptions of options that are recognised as part of the right-of-use asset and lease liability, and those that are not)
- 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)

7.2 Business combinations

7.2.1 Classification as Type A or Type B

An acquirer would classify acquired leases (as Type A or Type B) using the contractual terms and conditions at the commencement date of the lease. Consistent with the consideration of changes to any lease contract, if the contractual terms and conditions of a lease arrangement are modified as part of the business combination (i.e., the modified lease becomes a new contract), the acquirer would classify the new lease based on the contractual terms and conditions of the new lease.
How we see it

• Although the proposal does not provide guidance for the subsequent measurement of leases acquired in a business combination, for leases that have a remaining maximum possible term under the contract of 12 months or less (and, thus, lease assets and liabilities are not recognised), we believe the acquirer would generally recognise lease payments on a straight-line basis over the lease term.

• It is unclear whether the acquirer accounting treatment of leases with a remaining maximum possible term under the contract of 12 months or less would preclude the recognition of assets and liabilities for off-market contract terms on such leases. Such an accounting approach would appear to 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.

7.2.2 Acquiree in a business combination is a lessee

Consequential amendments proposed to IFRS 3 would specify 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 lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquiree would apply the proposed lessee initial recognition provisions, using the present value of the remaining lease payments at the acquisition date. The acquirer would use the key concepts described in section 3 above to determine 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 a price for the lease even if it is at market terms (e.g., a lease of gates at an airport and 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 a contract 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). The classification of the lease (as Type A or Type B) would not affect the initial measurement of the lease liability or the right-of-use asset.

7.2.3 Acquiree in a business combination is a lessor

7.2.3.1 Initial measurement of a lease when the acquiree is a Type A 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 3 above to determine the lease term, lease payments and discount rate. A residual asset would be initially recognised as the difference between the acquisition date fair value of the underlying (acquired) asset and the initial measurement of the lease receivable. The
The lease accounting proposal 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. As in situations when the acquirer is a lessee, no separate intangible asset or liability (for favourable or unfavourable terms, relative to market) would be recognised.

**How we see it**

The Boards considered whether lease receivables and residual assets for acquired lessor contracts should each be initially measured at their acquisition date fair values. The Boards concluded that such an approach would not be cost-beneficial. However, the proposed approach to initially measure such assets would still require the acquirer to determine the acquisition date fair value of the underlying asset (i.e., in order to determine the discount rate and initial measurement of the residual asset).

### 7.2.3.2 Initial measurement of a lease when the acquiree is a Type B lessor

Underlying assets subject to Type B leases would remain on the lessor's balance sheet under the ED. Therefore, when an acquiree is a lessor, an underlying asset subject to a Type B 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.

### 7.3 Sale and leaseback transactions

As lessees would recognise most leases on the balance sheet (i.e., all leases except for certain short-term leases), sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing. The determination of whether a sale and leaseback transaction is accounted for as a sale and a lease or a financing transaction would generally be based on the control criteria in the new revenue recognition standard. The Boards believe that referring to the control criteria in the new revenue recognition standard will increase comparability between sales entered into as part of sale and leaseback transactions and all other sales.

If control of the underlying asset passes to the buyer-lessee, the transaction would be accounted for as a sale/purchase and a lease. If control of the underlying asset is retained by the seller-lessee, the transaction would be accounted for as a financing.

**How we see it**

The Boards' decision to use revenue recognition concepts for sale and leaseback transactions represents a change from existing IFRS for sale and leaseback transactions. IAS 17 focuses on whether the leaseback is an operating lease or a finance lease, and does not explicitly require the seller-lessee to determine whether the sale and leaseback transaction meets the condition for the sale of the asset. However, it is not clear how the seller-lessee retaining the right to use the asset or features in the lease (e.g., purchase options) would affect the sale evaluation.

### 7.3.1 Right to control the use of an underlying asset

Whilst the concepts of 'control' in the Boards' proposal and the new revenue recognition standard are generally similar, a key difference exists. Under the leases proposal, the right to control the use of an
underlying asset involves making the decisions that most significantly affect the economic benefits to be derived from the leased asset's use throughout the contract term. Under the new revenue recognition standard, control would be based on a broader consideration of the asset over its entire useful life. The decisions made under each evaluation would not necessarily be the same.

The leases proposal clarifies that the existence of a leaseback does not, by itself, prevent a transaction from being accounted for as a sale. The lease contract may simply transfer the right to control the use of the underlying asset during the lease term.

However, the Boards also clarified that the buyer-lesser would not obtain control of the asset when the lease provides the seller-lessee the ability to direct the use of and obtain substantially all of the remaining benefits (i.e., the economic benefits to be derived over the remaining useful life of the asset) from the underlying asset. This would be the case if either of the following conditions is met:

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

Meeting either of these conditions would indicate that (through the lease) the seller-lessee, and not the buyer-lesser, is expected to consume substantially all of the remaining economic benefits of the underlying asset. That is, because the seller-lessee, has in effect, transferred the underlying asset but retained control of such asset, no sale has occurred.

Whilst the conditions are similar to the two exception criteria specific to the classification of leases of property assets, they would apply to leases of all assets (i.e., property and non-property) when determining which party has control of an underlying asset in a sale and leaseback transaction. The Boards did not provide any ‘bright-line’ guidance for these criteria. Therefore, the evaluation of these criteria might require careful judgement.

It is expected that the new revenue recognition standard will provide guidance on the consideration of a repurchase option in a sale and leaseback transaction. The existence of a repurchase option may cause that transaction to be accounted for as a financing.

7.3.1.1 Transactions when the transferee obtains control of the underlying asset

If the buyer-lesser obtains control of the underlying asset, based on the requirements in the new revenue recognition standard and the additional criteria described above, the seller-lessee would recognise the sale in accordance with the new revenue recognition standard and the ensuing lease would be accounted for under the leases ED. The buyer-lesser would account for the purchase of the asset under applicable standards for asset purchases and the ensuing lease under the leases ED.
How we see it

The requirement for the buyer-lessee to consider the requirements in both the new revenue recognition standard and the ED to determine if the buyer-lessee has acquired an asset may be a significant change for buyer-lessees in sale and leaseback transactions. In addition, it appears to be inconsistent with the scope of the new revenue recognition standard in that the new revenue recognition standard would not apply to purchasers of goods (i.e., the buyer would not apply the control concepts of the new revenue recognition standard in accounting for purchases).

The sale transaction and the ensuing lease 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 for the ensuing lease 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 ensuing lease. To ensure that the gain or loss on disposition and the lease-related assets and liabilities associated with such transactions are not understated or overstated, the proposal would require the following adjustments for any off-market elements of sale and leaseback transactions:

- The transferor (i.e., the seller-lessee) would measure the right-of-use asset and the gain or loss on disposal of the underlying asset to reflect current market rates for lease payments for that asset.
- The transferee (i.e., the buyer-lessee) with a Type A lease would measure the lease receivable and the residual asset to reflect current market rates for lease payments for that asset.
- The transferee (i.e., the buyer-lessee) with a Type B lease would measure the underlying asset for the Type B lease, to reflect current market rates for lease payments for that asset.

The lessor and the lessee would subsequently account for the lease in a manner that reflects current market rates.

| Illustration 44  —Sale and leaseback transaction — buyer-lessee obtains control |
|-------------------|--------------------------------------------------------------------------------|
| Entity Q sells a building and the underlying land to an unrelated party, Entity C, for CU2.5 million in cash. The assets were carried at CU900,000 on Entity Q’s books just before the transaction. Concurrent with the sale, Entity Q leases back the building and the underlying land for a period of 10 years, with annual payments of CU150,000 payable at the end of each year. Entity Q determines that the rate the lessor charges the lessee is 3.46%. The market rates for the lease of the building and underlying land are CU120,000 payable annually, at the end of each year. |

For simplicity, assume there are no variable payments, amounts expected to be payable under a residual value guarantee, purchase or termination options, or initial direct costs associated with the lease.
Illustration 44 – Sale and leaseback transaction – buyer-lessee obtains control (continued)

The transfer of the building and underlying land is determined to be a sale because Entity C obtains control of the underlying asset through the transaction, in accordance with the new revenue recognition standard and:

- The lease term is not for the major part of the remaining economic life of the asset
- The present value of the lease payments does not account for substantially all of the fair value of the asset

Finally, assume that Entity Q and Entity C both determine that the lease is a Type B lease.

Analysis:

Seller-lessee

The lease payments are not at market rates. Therefore, Entity Q would be required to adjust the gain on the sale of the building and underlying land for the difference between the present value of the lease rates in the contract of CU1.25 million (present value of 10 annual payments of CU150,000) and the present value of the market lease rates of CU1.0 million (present value of 10 annual payments of CU120,000). Entity B would record the sale of the building and underlying land, as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU 2,500,000</td>
</tr>
<tr>
<td>Land and building</td>
<td>CU 900,000</td>
</tr>
<tr>
<td>Financial liability</td>
<td>CU 250,000</td>
</tr>
<tr>
<td>Gain on sale of underlying asset</td>
<td>CU 1,350,000</td>
</tr>
</tbody>
</table>

To recognise the sale of the underlying asset and to recognise a financial liability for off-market lease payments in leaseback

At lease commencement, Entity Q would recognise the lease-related asset and liability using the current market rates for the property. Therefore, the initial measurement of the right-of-use asset and lease liability is CU1.0 million (i.e., the present value of 10 market-rate annual lease payments of CU120,000 using the 3.46% discount rate):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 1,000,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 1,000,000</td>
</tr>
</tbody>
</table>

To initially recognise the lease-related asset and liability

After lease commencement, Entity Q would account for the Type B lease in accordance with the ED. Entity Q would treat CU120,000 of the annual payments of CU150,000 as lease payments. That is, CU120,000 of the annual payments would be used to reduce the lease liability (including the accreted interest).

Entity Q would accrete the financial liability (initially measured at CU250,000) over the term of the arrangement using the 3.46% discount rate. The remaining CU30,000 of the annual payments, which are not applied to the lease liability above, would reduce the financial liability (and accreted interest) so that it would be zero at the end of the term of the arrangement.
Illustration 44 — Sale and leaseback transaction — buyer-lessee obtains control (continued)

If the lease payments were at market rates, Entity Q would account for the transaction as described above, but it would not adjust the gain or the initial measurement of the liability on the sale of the underlying asset and separately account for a financial liability.

**Buyer-lessee**

Entity C would account for the transaction, as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land and building</td>
<td>CU 2,250,000</td>
</tr>
<tr>
<td>Financial asset</td>
<td>CU 250,000</td>
</tr>
<tr>
<td>Cash</td>
<td>CU 2,500,000</td>
</tr>
</tbody>
</table>

To recognise the purchase of the underlying asset and to recognise a financial asset for off-market lease payments in the leaseback

Subsequently, Entity C would account for the Type B lease in accordance with the ED. Entity C would treat CU120,000 of the annual payments of CU150,000 as lease payments. That is, CU120,000 of the annual payments would be recognised as lease income in each annual period.

Entity C would accrete the financial asset (initially measured at CU250,000) over the term of the arrangement using the 3.46% discount rate. The remaining CU30,000 of the annual payments, which are not recognised as lease income, would reduce the financial asset (including accreted interest) as payments are received so that it would be zero at the end of the term of the arrangement.

If the lease payments were at market rates, Entity C would account for the transaction as described above, but it would not adjust the purchase price of the underlying asset and separately account for a financial asset.

7.3.1.2 Transactions where the transferee does not obtain control of the underlying asset

When the transferee (buyer-lessee) does not obtain control of the underlying asset, the transferor (seller-lessee) would not derecognise the underlying asset (i.e., no sale would occur - a ‘failed sale-leaseback’). Instead, the transferor would recognise a financial liability in accordance with applicable accounting standards for financial liabilities. Similarly, the transferee would not recognise the underlying asset and would instead recognise the amounts paid to the transferee as a receivable in accordance with other applicable accounting standards.

Illustration 45 — Sale and leaseback transaction — seller-lessee retains control

Entity T sells equipment (underlying asset) to an unrelated party, Entity E for CU2.2 million in cash. The equipment has a total economic life of seven years and a carrying amount CU1.5 million on Entity T’s books just before the transaction. Concurrent with the sale, Entity T leases back the equipment for a period of six years, with annual payments of CU400,000 payable at the end of each year. The rental rates for the equipment lease are market rates. Entity T determines that the rate the lessor charges the lessee is approximately 5.47%.
Assume that both Entity T and Entity E determine that the transfer of the equipment is not a sale because control of the equipment has not passed to Entity E. That is, sale recognition is precluded because the lease term (six years) is for the major part of the remaining economic life of the underlying asset (seven years).

**Seller-lessee**

Entity T would not derecognise the equipment and would continue to depreciate the equipment in accordance with IAS 16 and the entity's accounting policies. Entity T would recognise the CU2.2 million of proceeds received as a financial liability:

<table>
<thead>
<tr>
<th>Cash</th>
<th>CU 2,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial liability</td>
<td>CU 2,200,000</td>
</tr>
</tbody>
</table>

*To recognise proceeds received, and related financial liability, for failed sale-leaseback transaction*

Entity T would account for the financial liability in accordance with other accounting standards.

**Buyer-lessor**

Entity E would not recognise the equipment. Instead, Entity E would recognise the CU2.2 million in cash paid as a receivable (i.e., a financial asset):

<table>
<thead>
<tr>
<th>Receivable</th>
<th>CU 2,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU 2,200,000</td>
</tr>
</tbody>
</table>

*To recognise cash paid, and related financial asset, for failed sale-leaseback transaction*

Entity E would account for the receivable in accordance with other accounting standards.

**How we see it**

When a sale and leaseback transaction results in the seller-lessee retaining control of the underlying asset, the ED requires the buyer-lessor to account for cash paid as a receivable (i.e., a financial asset). This accounting does not appear to be consistent with the accounting for other financial assets because the buyer-lessor’s asset will ultimately be settled through a combination of cash payments and non-financial assets (i.e., the underlying asset). Therefore, it is unclear how buyer-lessors would consider the nature of the underlying asset (i.e., a non-financial asset) when subsequently measuring the receivable recognised using the accounting approach described in the ED.

**7.3.2 Disclosure**

A transferor (seller-lessee) in a sale and leaseback transaction would be required to disclose:

- The main terms and conditions of the transaction
- Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets
The proposal does not specify any disclosures to be made for failed sale and leaseback transactions (i.e., transactions in which the transferee-lessee does not obtain control of the underlying asset). However, such transactions would be subject to other applicable standards, including the relevant disclosure provisions.

7.3.3 Build-to-suit transactions
Build-to-suit lease transactions involve various forms of lessee involvement in the construction of an asset for the lessee’s own use. The proposal does not address matters related to a lessee’s involvement in asset construction (i.e., when the lessee would be viewed as the owner of the asset).

The Boards explain, in the basis for conclusions, that entities would apply other applicable standards (e.g., IAS 16) when costs are incurred to construct or design an asset before that asset is ready for use. If the lessee controls the underlying asset before the lease commencement date, the lessee would apply the sale and leaseback provisions of the proposal to account for the transaction.

8. Effective date and transition
8.1 Effective date
The proposal does not specify an effective date. The Boards will consider feedback they receive before determining one.

How we see it
We do not expect a final standard to be effective before 1 January 2017.

The proposal would require the transition provisions to be applied as of the beginning of the earliest comparative period (date of initial application) presented in the year of adoption. As an example, assuming an effective date of 1 January 2017, a calendar-year entity that includes two years of information (i.e., the preceding period and current period) would use 1 January 2016 as its date of initial application.

The proposal would require entities to evaluate all existing arrangements at the date of initial application to determine whether the arrangements are leases or contain leases. No existing arrangements would be grandfathered. If an existing arrangement is a lease, it would be evaluated to determine whether it is classified as a Type A or Type B lease.

8.2 Transition
Entities would be permitted to apply the proposal on a full retrospective basis in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. The Boards have also proposed that a modified retrospective approach could be used as an alternative to full retrospective adoption.

Entities applying the modified retrospective approach would use certain ‘shortcut’ calculations to initially measure lease-related assets and liabilities. They also would be able to use hindsight to determine the lease term or whether an existing arrangement contains a lease at all. The modified retrospective approach is intended to approximate a full retrospective approach, but at a lower cost and with less effort than full retrospective adoption.
The approach selected would have to be applied consistently for all existing lessee and lessor arrangements. For example, an entity would not be permitted to apply a full retrospective approach for lessee arrangements and the modified retrospective approach for lessor arrangements.

Given the long-term nature of many lease arrangements, the Boards decided against a prospective approach (i.e., applying the proposals only to leases that commence after the transition date). Although a prospective approach would be the least costly for preparers, the Boards concluded that the information provided would not be beneficial to users of financial statements. The Boards believe it is important for financial statements to provide users with trend information in comparative periods. The Boards determined that a prospective approach would not provide such information, especially for entities with long-term operating leases. For example, in the case of an entity with a 15-year operating lease, financial statement users might not obtain a clear picture of the true effects of the proposed leases model for up to 15 years after implementing the ED’s requirements.

Consistent with the Boards’ desire to provide trend information in the comparative periods, the proposal would not grandfather any existing arrangements. That is, all leases existing at the date of initial application would be included in the transition provisions.

Following either transition approach, entities would adjust the balance sheet (e.g., a lessee would recognise a lease liability, a right-of-use asset, and adjust equity) at the beginning of the earliest comparative period presented. The subsequent comparative periods presented, if any, would also be adjusted to reflect the accounting under the proposed standard.

Under the modified retrospective approach, for finance leases existing at the date of initial application, lessees and lessors would be permitted to use the existing carrying amounts of lease-related assets and liabilities as the initial measurements.

Entities that make an accounting policy election to account for short-term leases using a method similar to current operating lease accounting would not apply the proposed recognition and measurement requirements to qualifying short-term leases.

8.2.1 Lessee modified retrospective transition for leases previously classified as finance leases

For arrangements currently classified as finance leases that continue to be leases under the proposal, lessees would not make adjustments to the carrying amounts of the lease assets and lease liabilities. The Boards believe the costs of requiring lessees to remeasure lease-related assets and liabilities, at the transition date, would likely outweigh the benefits because the proposed requirements would be very similar to existing accounting for finance leases. Instead, such lessees would reclassify the lease assets as right-of-use assets and the lease liabilities as liabilities to make lease payments. After the date of initial application, lessees would account for the right-of-use asset and the lease liability in accordance with the ED, but lessees would not apply the lease liability reassessment provisions. The right-of-use assets and lease liabilities for such leases would be presented as if they were associated with Type A leases for the purposes of financial statement presentation and disclosure.
8.2.2 Lessee modified retrospective transition for leases previously classified as operating leases

The lessee would initially recognise and measure a lease liability at the present value of the remaining lease payments, discounted using the lessee’s incremental borrowing rate at the effective date. Lessees would be permitted to use a single discount rate for a portfolio of leases that have reasonably similar characteristics (e.g., a similar remaining lease term for a similar underlying asset). The lessee’s calculation of the discount rate for a portfolio of leases would consider the lessee’s total financial liabilities, including leases in other portfolios.

How we see it

It is unclear whether entities would classify arrangements previously classified as operating leases in transition using information as of the lease commencement date or another date (e.g., beginning of the earliest period presented in the financial statements). Exception criteria may be met when assessed as of a particular date (e.g., the commencement date) and not met when assessed as of a different date (e.g., the effective date).

8.2.2.1 Right-of-use asset - Type A lease

For each Type A lease, a right-of-use asset would be recognised and measured at the date of initial application based on a proportion of the lease liability. That proportion, called the ‘applicable proportion’, would be the remaining lease term at the date of initial application relative to the total lease term. Lessees would use the key concepts described in section 3 above to determine the lease term and lease payments. The right-of-use asset would be the product of the lease liability and the applicable proportion (i.e., the percentage described above).

If the lease payments are uneven over the lease term, the right-of-use asset’s initial measurement would be adjusted for any previously recognised prepaid or accrued lease payments. For example, previously prepaid rent amounts would increase the right-of-use asset and deferred rent liabilities would reduce the right-of-use asset. Such adjustments would be made for uneven lease payments, because the present value of uneven payments over the remaining lease term may not reflect the economic benefits available to the lessee at the transition date. Additionally, lessees would not be required to include initial direct costs in the measurement of the right-of-use asset.

After the date of initial application, lessees would apply the ED’s provisions to account for the right-of-use asset and the lease liability.

| Illustration 46 – Lessee modified retrospective transition for a Type A lease that was previously classified as an operating lease |
| Entity Q (lessee) enters into a five-year lease of equipment on 1 January 20X5. The annual lease payments due at the end of each year are CU30,000 in years one and two and CU34,000 in years three through five. Entity Q determines the lease is an operating lease and the annual straight-line rent expense amount is CU32,400. |
| For simplicity, assume there are no residual value guarantees, variable lease payments, options to extend or terminate the lease, options to purchase the asset or initial direct costs associated with the lease. |
| On 1 January 20X6 (before transition adjustments), Entity Q had an accrued rent liability balance of CU2,400, which reflected rent expense incurred but not paid. |
Entity Q presents two years in its financial statements (current and previous financial year). Assume that the effective date for Entity Q is 1 January 20X7. Therefore, 1 January 20X6 is the beginning of the earliest comparative period presented in the financial statements in which Entity Q first applies the provisions of the leases ED. At the effective date (1 January 20X7), Entity Q’s incremental borrowing rate is approximately 5.64%.

Entity Q determines that the lease is a Type A lease.

**Lease liability**

On 1 January 20X6, Entity Q measures the lease liability as CU115,000. The lease liability is calculated as the present value of one annual lease payment of CU30,000 and three annual lease payments of CU34,000, discounted at 5.64%.

**Right-of-use asset**

Entity Q then determines the carrying amount of the right-of-use asset at 1 January 20X6 based on the following:

- An estimate of the commencement-date lease liability
- The proportion of the commencement-date lease liability that relates to the remaining lease term (i.e., the applicable proportion)

To estimate the commencement-date lease liability, Entity Q first determines the average lease payment for the remaining four years of the lease, or CU33,000 [(CU30,000 + CU34,000 + CU34,000 + CU34,000) ÷ four years]. Entity Q then calculates the estimated commencement-date lease liability to be CU140,380 based on the present value of five annual payments (i.e., the five-year lease term) of CU33,000, discounted at 5.64%. Entity Q then determines the applicable proportion to be 80% (i.e., four remaining years ÷ five-year lease term). Entity Q applies the applicable proportion to the estimated commencement-date liability to arrive at the transition date measurement of the right-of-use asset (before adjustments for accrued rent) as follows:

<table>
<thead>
<tr>
<th>Estimated commencement-date liability</th>
<th>CU140,380</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable proportion</td>
<td>80%</td>
</tr>
<tr>
<td>Right-of-use asset (before accrued rent adjustments)</td>
<td>CU112,304</td>
</tr>
</tbody>
</table>

The difference between the right-of-use asset (CU112,304) and the lease liability (CU115,000) is recorded as an adjustment to opening retained earnings at 1 January 20X6. Entity Q records the following entry to reflect the transition of the operating lease to a Type A lease:

\[
\begin{align*}
\text{Right-of-use asset} & \quad \text{CU 112,304} \\
\text{Retained earnings} & \quad \text{CU 2,696} \\
\text{Lease liability} & \quad \text{CU 115,000}
\end{align*}
\]

*To record transition of an operating lease to a Type A lease*
Entity Q would apply the provisions of the ED for Type A leases to determine the financial statement amounts to be reflected in other periods presented.

8.2.2.2 Right-of-use asset – Type B lease

For each Type B lease, lessees would initially recognise and measure a right-of-use asset at an amount equal to the lease liability, calculated as described above.

Similarly to how they account for Type A leases, lessees would adjust the initial measurement of the right-of-use asset for any previously recognised prepaid or accrued lease payments. For example, previously prepaid rent amounts would increase the right-of-use asset and deferred rent liabilities would reduce the right-of-use asset. Such adjustments would be made for uneven lease payments because the present value of such uneven payments over the remaining lease term might not reflect the economic benefits available to the lessee at the transition date. Additionally, lessees would not be required to include initial direct costs in the measurement of the right-of-use asset.

After the date of initial application, lessees would apply the ED’s provisions to account for the right-of-use asset and the lease liability.

Entity R determines that the lease is a Type B lease.
Lease liability
On 1 January 20X6, Entity R measures the lease liability as CU115,000. The lease liability is calculated as the present value of one annual lease payment of CU30,000 and three annual lease payments of CU34,000, discounted at 5.64%.

Right-of-use asset
The right-of-use asset (before adjustment for accrued rent) is equal to the lease liability. Entity R records the following entry to reflect the transition of the operating lease to a Type B lease:

Right-of-use asset  CU 115,000
Lease liability     CU 115,000

To record transition of an operating lease to a Type B lease

Entity R would also make an adjustment to the right-of-use asset for the amount of previously accrued rent (CU2,400):

Accrued rent   CU 2,400
Right-of-use asset      CU 2,400

To adjust right-of-use asset at transition and to derecognise previously accrued rent

Entity R would apply the provisions of the leases ED for Type B leases to determine the financial statement amounts to be reflected in other periods.

8.2.3 Lessor modified retrospective transition
8.2.3.1 Leases previously classified as finance leases
For leases classified as finance leases under today’s standards, the carrying amount of the net investment in the lease, immediately prior to the date of initial application, would become the carrying amount of the lease receivable at the beginning of the earliest comparative period presented. Lessors would not recognise a residual asset at transition (or thereafter) for such leases. Lessors would:

- Subsequently recognise interest income on the lease receivable and reduce the lease receivable for lease payments received
- Not apply the proposal’s provisions for reassessing lease receivables
- Not apply the proposal’s provisions for reassessing residual assets
- Classify the amounts recorded as lease receivables for such leases as lease receivables arising from Type A leases for the purposes of presentation and disclosure

The Boards believe the costs of requiring lessors to remeasure lease-related assets would likely outweigh the benefits because the proposed requirements would be very similar to existing accounting for finance leases. Similarly, lessors would not be required to consider initial direct costs when determining the carrying amount of lease receivables at transition because the costs would likely outweigh the benefits.
Lessors would subsequently measure such lease receivables using the proposed standard, except that the lease receivable would not be reassessed. Additionally, lessors would not apply the proposed standard for residual assets to such leases.

Illustration 48 – Lessor modified retrospective transition for a Type A lease that was previously classified as a finance lease

Entity T manufactures equipment for a cost of CU150,000. The equipment has an eight-year economic life. Entity T (lessor) then enters into a six-year lease of the equipment on 1 January 20X5. The lease calls for annual payments of CU35,000, due at the end of each year. Entity T determines the lease is a finance lease. At the lease commencement date:

- The fair value of the equipment is CU207,500
- The unguaranteed residual value at the end of the lease is CU55,000
- The rate implicit in the lease is approximately 6.45%
- The present value of the unguaranteed residual value is CU37,800
- The present value of the annual rent payments is CU169,700
- The gross investment in the lease is CU265,000 (six annual payments of CU35,000, plus the unguaranteed residual value of CU55,000)
- The net investment is CU207,500
- Unearned income is CU57,500

For simplicity, assume there are no residual value guarantees, variable lease payments, options to extend or terminate the lease, options to purchase the underlying asset, selling costs or initial direct costs associated with the lease.

At commencement, Entity T recognises the following entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment in lease</td>
<td>CU 207,500</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>CU 112,200</td>
</tr>
<tr>
<td>(CU150,000 cost – CU37,800 present value of residual value guarantee)</td>
<td></td>
</tr>
<tr>
<td>Equipment held for lease</td>
<td>CU 150,000</td>
</tr>
<tr>
<td>Sales</td>
<td>CU 169,700</td>
</tr>
</tbody>
</table>

To record finance lease at commencement

Entity T records the following entry in the first year of the lease:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU 35,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>CU 13,384</td>
</tr>
<tr>
<td>Net investment in lease</td>
<td>CU 21,616</td>
</tr>
</tbody>
</table>

To record lease income and receipt of lease payment

On 1 January 20X6, Entity T’s net investment in the lease has a carrying amount of CU185,884 (CU207,500 + CU13,384 - CU35,000). At transition, Entity T reclassifies the net investment to a lease receivable:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>CU 185,884</td>
</tr>
<tr>
<td>Net investment in lease</td>
<td>CU 185,884</td>
</tr>
</tbody>
</table>

To classify net investment in a finance lease as a lease receivable at transition
The modified retrospective approach would give lessors less transition relief than lessees.
To measure the lease receivable, lessors would discount the lease payments using the rate the lessor charges the lessee, determined at the lease commencement date, subject to any adjustments required to reflect impairment. For leases that commenced before the effective date, lessors would not be required to include initial direct costs in the measurement of the lease receivable at the date of initial application. Lessors would also be permitted to use hindsight in the comparative reporting periods to determine whether a contract contains a lease or to determine the lease term (e.g., if the contract contains an option to extend or terminate the lease).

The modified retrospective approach does not provide lessors with as much transition relief as lessees. The Boards believe that lessors’ leasing activities are generally a central part of their revenue generating activities and, therefore, it is important that trend information about leasing activities be made available to users of financial statements when the lessor first applies the proposal’s requirements. Also, it is important to note that the Boards are not proposing any transition relief for lessors regarding the discount rate to be applied in transition. The Boards believe that applying the original rate that the lessor charges the lessee is consistent with the rate that would be applied to new leases accounted for under the proposal. Additionally, the Boards believe the rate the lessor charges the lessee at lease commencement should be used in transition because that rate would also likely be available to the lessor.

**Illustration 49 — Lessor modified retrospective transition for an operating lease classified as a Type A lease**

Entity S (lessor) enters into a five year lease of equipment on 1 January 20X5. The annual lease payments due at the end of each year are CU30,000 in years one and two and CU34,000 in years three through five. Entity S determines the lease is an operating lease and the annual straight-line rent expense amount is CU32,400.

For simplicity, assume there are no residual value guarantees, variable lease payments, options to extend or terminate the lease, options to purchase the asset or initial direct costs associated with the lease.

On 1 January 20X6 (before transition adjustments), the equipment was recognised at CU175,000 (CU200,000 historical cost less CU25,000 accumulated depreciation based on an eight-year economic life) in the entity’s financial statements. Additionally, Entity S had a rent receivable balance of CU2,400, which reflected rent income that had been earned but not received from the lessee.

The rate implicit in the lease (i.e., the rate the lessor charges the lessee) is 7.87% at the commencement date. At 1 January 20X6:

- The fair value of the equipment is CU185,750
- The present value of the remaining lease payments is CU109,230 (one annual payment of CU30,000 and three annual payments of CU34,000, discounted at 7.87%)
- The amount Entity S expects to derive from the equipment at the end of the lease term is CU103,600. The present value of the expected value of the equipment at the end of the lease term, discounted at 7.87%, is CU76,520 (gross residual asset)

Entity S determines that the lease is a Type A lease.
Illustration 49 – Lessor modified retrospective transition for an operating lease classified as a Type A lease (continued)

**Lease receivable**
The lease receivable is measured at the present value of the remaining lease payments or CU109,230.

**Residual asset**
Entity S would determine the residual asset to recognise at 1 January 20X6 as the gross residual asset, less the unearned profit. As described above, the gross residual asset value is CU76,520.

To calculate the unearned profit, Entity S first determines the amount of profit related to the lease:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of equipment at 1 January 20X6</td>
<td>CU 185,750</td>
</tr>
<tr>
<td>Less: Carrying amount of equipment at 1 January 20X6</td>
<td>175,000</td>
</tr>
<tr>
<td><strong>Total profit at 1 January 20X6 (A)</strong></td>
<td><strong>CU 10,750</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>CU 109,230</td>
</tr>
</tbody>
</table>

Divide by: Fair value of equipment at 1 January 20X6

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quotient (B)</td>
<td>58.80%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit related to lease (A) x (B)</td>
<td>CU 6,321</td>
</tr>
</tbody>
</table>

Entity S would then calculate the unearned profit as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total profit at 1 January 20X6</td>
<td>CU 10,750</td>
</tr>
<tr>
<td>Less: Profit related to lease</td>
<td>6,321</td>
</tr>
<tr>
<td><strong>Unearned profit</strong></td>
<td><strong>CU 4,429</strong></td>
</tr>
</tbody>
</table>

Entity S determines the recognised residual asset at 1 January 20X6 to be CU72,091 (CU76,520 - CU4,429).

The difference between the assets previously recorded (net equipment balance of CU175,000 and accrued rent of CU2,400) and the assets recognised at 1 January 20X6 (lease receivable of CU109,230 and recognised residual asset of CU72,091) is recorded as an adjustment to retained earnings. Entity S records the following entry to reflect the transition of the operating lease to a Type A lease:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>CU 109,230</td>
</tr>
<tr>
<td>Residual asset</td>
<td>CU 72,091</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>CU 25,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>CU 200,000</td>
</tr>
<tr>
<td>Rent receivable</td>
<td>CU 2,400</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>CU 3,921</td>
</tr>
</tbody>
</table>

*To record transition of operating lease to Type A lease*

Entity S would apply the provisions of the ED for Type A leases to determine the financial statement amounts to be reflected in other comparative periods.
8.2.3.3 Type A leases previously classified as operating leases, with securitised receivables

If prior to transition, a lessor had securitised receivables arising from leases that were classified as operating leases under today’s leasing standards, the lessor would continue to account for those transactions as secured borrowings in accordance with applicable standards.

8.2.3.4 Leases previously classified as operating leases – Type B leases

For current operating leases that are determined to be Type B leases, lessors would use the carrying amount of the underlying asset, immediately before the date of initial application, as the initial measurement of the underlying asset upon transition.

8.2.4 Sale and lease back transactions

For a previous sale and leaseback transaction that was accounted for as a sale and finance lease, an entity would:

- Not reassess the transaction to determine whether it is a sale and leaseback transaction
- Not remeasure the lease assets and lease liabilities at the beginning of the earliest comparative period presented
- Continue to amortise any deferred gain or loss in respect of the transaction

As described earlier, the Boards provided transition relief for leases that are classified as finance leases under today’s standards. To maintain consistency with that approach, the Boards also provided the transition relief above for previous sale and leaseback transactions, which were determined to be a sale and finance leaseback.

For previously recognised sale and leaseback transactions that did not result in a finance lease, entities would be required to reassess whether the transferee (buyer-lessor) has obtained control of the underlying asset. That reassessment would be made based on the control provisions in the new revenue recognition standard, if either of the following applies:

- A previous sale and leaseback transaction was accounted for as a sale and an operating lease in accordance with IAS 17
- A previous transaction was assessed to determine whether it was a sale and leaseback transaction in accordance with IAS 17, but it did not qualify for sale and leaseback accounting

If upon reassessment the transferee (buyer-lessor) is determined to have obtained control of the underlying asset in accordance with the new revenue recognition standard (i.e., the transaction is accounted for as a sale and a lease), the lessee would measure the lease assets and liabilities using the lessee transition requirements for leases previously classified as operating leases. The lessee would also derecognise any deferred gain or loss at the beginning of the earliest comparative period presented. The lessor would apply the proposal’s transition requirements to the leaseback.
8.2.5 Amounts previously recognised in respect of a business combination
Lessees that previously recognised an asset or liability relating to favourable or unfavourable terms of an operating lease in accordance with IFRS 3, would derecognise that asset or liability and adjust the carrying amount of the right-of-use asset by a corresponding amount.

Subsequent to the date of initial application entities would apply the ED’s provisions to account for the lease assets and lease liabilities

8.2.6 Disclosure
Entities would be required to provide transition disclosures required by IAS 8. However, entities would not be required to disclose the effect of the change on income from continuing operations, net income or other affected financial statement line items or per-share amounts. Additionally, entities that elect to use certain of the specified forms of relief (i.e., not including initial direct costs in transition measurements, use of hindsight) would be required to disclose that fact.
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