August 2010

Exposure Draft

Snapshot: Leases

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This snapshot is an introduction to a proposed IFRS on leases. The project is being undertaken jointly by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB).

This snapshot provides an overview of the proposals published for public comment by the IASB and the FASB on 17 August 2010.

Project objective: To provide information in the financial statements about the amounts, timing and uncertainty of cash flows arising from lease contracts.

Project stage: The IASB and FASB published a discussion paper on leases in March 2009. The exposure draft published on 17 August 2010 has been developed on the basis of that discussion paper, after taking into consideration feedback received. The exposure draft sets out a proposal for a new IFRS.

Next steps: The boards invite comment from interested parties and will undertake further outreach, including field work, during the comment period. The field work will be used to assess the ease of application and the costs and benefits of the proposed IFRS.

Comment deadline: The exposure draft *Leases* is open for public comment until 15 December 2010.

This Snapshot has been prepared by staff and is not an official technical document of the IASB.

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Why are we undertaking this project?

According to the *World Leasing Yearbook 2010*, leasing activity in 2008 amounted to US$640 billion. However, the assets and liabilities arising from many of those contracts are not shown in a lessee's statement of financial position (balance sheet).

The problem is that IAS 17 *Leases*—and the equivalent requirements in US generally accepted accounting principles (GAAP)—have two lease categories: finance leases (called capital leases under US GAAP) and operating leases. Categorisation is based on various factors. If a lease is classified as a finance lease, assets and liabilities are shown on the lessee's balance sheet. However, for an operating lease the lessee does not show any assets or liabilities on the balance sheet. The lessee simply accounts for the lease payments as an expense over the lease term. Hence, investors[1] have to estimate the effect of operating leases on financial leverage and earnings.

If lessees recorded the assets and liabilities that arise from all lease contracts, investors would better understand leasing activity.

There are greater deficiencies in the quality of information in relation to lessees than lessors. However, many believe that it is important to have consistent accounting for lessees and lessors. The exposure draft therefore proposes a consistent accounting model for both lessees and lessors.

(1) The term 'investors' generally means investors, analysts and others that use financial statements of a company to make investment decisions.

How do the proposals address problems with today's accounting for leases?

This table summarises some problems with current accounting and how the proposals would address those problems.

Problem	Proposed solution
Operating lease accounting understates the assets and liabilities of lessees. Leasing is an important source of finance for many businesses. It is therefore important that lease accounting should provide investors with a complete picture of a company's leasing activities. Operating leases give rise to assets and liabilities that many investors believe should be accounted for in the financial statements of lessees. However, because the assets and liabilities are not recorded in lessees' financial statements, indicators of leverage (debt to equity and asset to equity ratios) are understated. Investors routinely adjust the financial statements of lessees for the effects of operating leases. Such adjustments are either arbitrary or based on estimates.	**The proposed model would reflect assets and liabilities arising from all lease contracts.** Investors would no longer need to adjust the amounts presented in the balance sheet and the income statement to reflect the assets, liabilities and finance costs arising from lessees' operating leases.
Similar transactions can be accounted for differently. Economically similar transactions can be accounted for very differently because of the distinction between operating and finance leases. This makes it hard for investors to compare different entities and the implications of different leases. This also provides opportunities to structure transactions to achieve a particular accounting outcome.	**The proposals would result in the same accounting for most lease contracts by lessees.** This would increase comparability of financial statements for investors and reduce the opportunity to structure transactions to achieve a desired accounting outcome.

What is being proposed?

The boards are proposing a 'right-of-use' accounting model where both lessees and lessors record assets and liabilities arising from lease contracts. The assets and liabilities are recorded at the present value of the lease payments. They are subsequently measured using a cost-based method.

Lessees

A lessee has acquired a right to use the underlying asset, and it pays for that right with the lease payments.

A lessee would record:

- an asset for its right to use the underlying asset (the *right-of-use* asset), and
- a liability to pay rentals (*liability for lease payments*).

The right-of-use asset would originally be recorded at the present value of the lease payments. It would then be amortised over the life of the lease and tested for impairment. A lessee (under IFRSs) could revalue its right-of-use assets.

The right-of-use asset would be presented within the property, plant and equipment category on the balance sheet but separately from assets that the lessee owns.

Today lessees could have an operating or a finance lease. Operating leases are not recorded on the balance sheet.

The exposure draft proposes recording all leases on the balance sheet.

	Accounting	Result
Today: Two different types of leases		
Finance lease	Underlying asset and lease liability recorded on balance sheet Interest and depreciation expense in P&L Disclosure of future minimum lease payments	Investors use financial statement information
Operating lease	No asset or liability recorded on balance sheet Rent expense in P&L Disclosure of future minimum lease payments	Investors make adjustments that are arbitrary or based on estimates
Proposals:		
One model for all leases	Lease results in a right-of-use asset and a liability to make lease payments that will be recorded on the balance sheet Amortisation and interest in P&L Additional information in notes	Investors have information in the financial statements about expected cash flows for all leases

What is being proposed? – continued

Lessors

The accounting would reflect the exposure of the lessor to the risks or benefits of the underlying asset.

- When the lease transfers significant risks or benefits of the underlying asset to the lessee the lessor would apply the *derecognition* approach.
- When the lessor retains exposure to significant risks or benefits of the underlying asset the lessor would apply the *performance obligation* approach.

The *derecognition* approach requires the lessor to take part of the underlying asset off its balance sheet (derecognise it) and record a right to receive lease payments. It is possible that a lessor could record a gain on commencement of the lease under this approach.

The *performance obligation* approach requires the lessor to keep the underlying asset on its balance sheet and to record a right to receive lease payments and a liability to permit the lessee to use the underlying asset (a lease liability). The lessor records income over the expected life of the lease.

Is there a transfer of significant risks or benefits of the underlying asset?

yes → DERECOGNITION

Balance sheet	
Residual asset	X
Right to receive lease payments	X
Income statement	
Revenue	X
Cost of sales (gross or net based on business model)	(X)
Interest income	X

no → PERFORMANCE OBLIGATION

Balance sheet	
Underlying asset	X
Right to receive lease payments	X
Lease liability	(X)
Net lease asset/(liability)	X
Income statement	
Lease income	X
Depreciation expense	(X)
Interest income	X

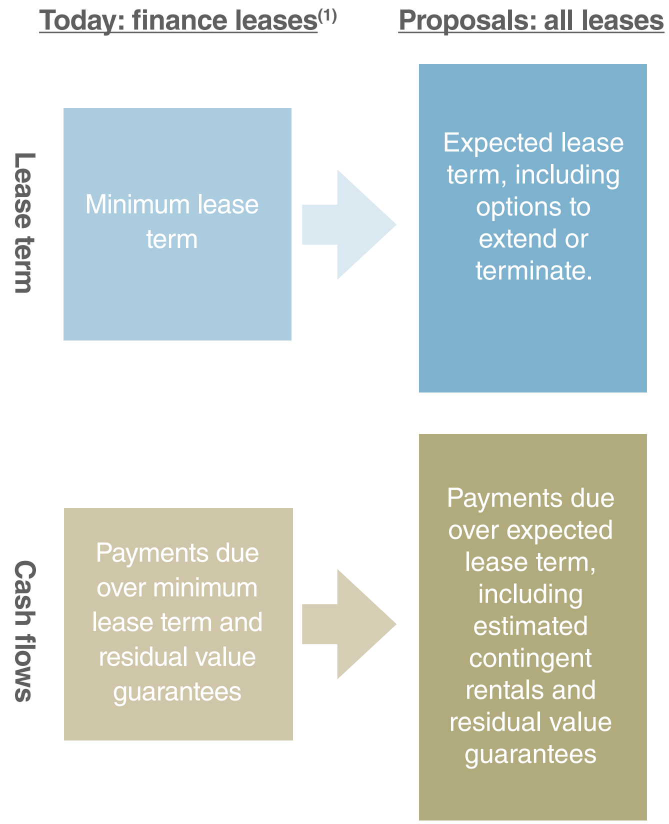
Lease term and contingent features

Many lease contracts include variable features. For example, leases often include options to renew or terminate the lease, contingent rentals (for example, rentals that vary depending on sales) or residual value guarantees.

The proposals would require lessees and lessors to determine the assets and liabilities on the basis of the longest possible lease term that is more likely than not to occur.

Lessees would always include contingent rentals but lessors would only include contingent rentals that they can measure reliably. Lessees and lessors must also include estimates of residual value guarantees.

Including these items informs investors about expected cash flows. Current requirements generally exclude such items, making it more difficult for investors to estimate future cash flows.



(1) No assets and liabilities are recorded for operating leases.

Common questions and responses

In March 2009 the boards began their consultation on the leases project with the publication of a discussion paper that identified the main problems and presented the boards' initial thoughts on possible solutions to these issues. The boards have also undertaken extensive outreach activities to keep interested parties up to date on the progress of the project and to seek feedback on the boards' continuing deliberations.

As part of this process, the boards consulted their Working Group on Lease Accounting, which comprises investors, preparers and others from around the world. The boards also undertook numerous face-to-face and small group meetings with users of financial statements, regulators, preparers, auditors and others from a range of industries and geographical locations. In addition, the boards have held webcasts and recorded a range of topic-specific podcasts.

The following table sets out responses to some common questions and concerns raised so far.

Question	Response
Why not exclude 'non-core' assets (for example, photocopiers) from the lessee model?	The boards noted that leases of 'non-core' assets can give rise to significant assets and liabilities. Information about these assets and liabilities is relevant to investors.
Why eliminate the distinction between operating and finance leases? Why not just address existing lessee accounting implementation issues?	Existing standards do not meet the needs of investors. This is because operating leases are not recorded on the balance sheet, and the existence of two very different accounting models for leases means that similar transactions can be accounted for differently. This makes financial statements more difficult for investors to understand and compare and provides opportunities to structure transactions so as to achieve a particular lease classification and accounting outcome. The boards concluded that more fundamental changes are required and the proposed model addresses these issues.

Question	Response
Does the cost of tracking information about short-term leases outweigh the benefits of including them in the proposed model?	Yes. To try to address these concerns, the proposals include simplified accounting for short-term leases—leases having a maximum term of 12 months or less. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities, and allow lessors to use accrual accounting.
Why include contingent rentals and options to extend?	The boards believe this provides better information to investors about the expected cash flows arising from the lease contract (rather than excluding them completely). Also, if optional periods are not included, the related right-of-use asset and right to receive lease payments may be understated, or structuring opportunities may be created.
How will service and lease contracts be distinguished?	The proposals use existing guidance by incorporating the principles under IFRIC 4 *Determining whether an Arrangement contains a Lease* into the exposure draft.
Why not account for the lessor's right to receive lease payments as a financial asset and the lessee's liability for lease payments as a financial liability?	Although they meet the definitions of a financial asset and liability, they have features unique to lease contracts such as options and contingent rentals. Accordingly, the proposals set out specific accounting requirements for such assets and liabilities.

Common questions and responses – continued

Question	Response
Are all lease transactions covered by the proposals?	No. The following items would not be affected by the proposals: • Contracts that are labelled as leases but are actually purchase or sale arrangements are not covered by the proposals. • The accounting for some specialised assets will remain unaffected. Lessors with investment properties accounted for at fair value under IAS 40 *Investment Property* will continue to apply the requirements in IAS 40. The accounting for biological assets will remain within IAS 41 *Agriculture*. The requirements in those standards already provide sufficient useful information. • Leases of intangible assets (for example: software, patents and licences) and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources are excluded until the accounting for such items can be considered more broadly.

What happens now?

The deadline for comments on the exposure draft is 15 December 2010.

The exposure draft includes questions on the proposals. Respondents are invited to comment on any or all of the questions as well as on any other matter that they think the IASB should consider in finalising the proposals. Because this is a joint project any comment letter sent to the IASB or FASB will be considered by both boards. Comment letters will be posted on the boards' websites at www.ifrs.org or www.fasb.org.

The boards will consider all feedback and discuss responses to the proposals in public meetings.

The boards also plan to hold public round-table meetings towards the end, or after the end, of the comment period.

The boards plan to issue the new standard in 2011.

Stay informed

The boards will announce on their websites the dates of any meetings at which they discuss the responses to the exposure draft.

To stay up to date about the project, to view the exposure draft, submit your comments or to subscribe to a lease email alert on this project visit www.ifrs.org.

Notes

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