August 2010

Basis for Conclusions
Exposure Draft ED/2010/9

156. DSR-Sitzung am 06.05.2011

156_09d_Leases_ED_BC_155_06d

Leases

Comments to be received by 15 December 2010

IFRS™

Basis for Conclusions on Exposure Draft

LEASES

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ISBN for this part: 978-1-907026-88-1
ISBN for complete publication (set of two parts): 978-1-907026-86-7

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Basis for Conclusions on the exposure draft *Leases*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) in reaching the conclusions in the exposure draft *Leases*. Individual board members gave greater weight to some factors than to others.

BC2 In March 2009 the IASB and the FASB published a joint discussion paper *Leases: Preliminary Views*. The paper set out the boards' preliminary views on significant components of an accounting model for leases. The boards developed their exposure draft after considering the 302 comment letters received on the discussion paper, as well as input obtained from their International Working Group on Lease Accounting, users of financial statements, preparers, auditors, regulators and others interested in the financial reporting of leases.

Summary of proposals

BC3 If confirmed, the proposals in the exposure draft would establish an accounting model in which:

(a) a lessee recognises an asset representing the right to use an underlying asset during the lease term (the 'right-of-use' asset) and a liability to make lease payments. The right-of-use asset is amortised over the lease term or the useful life of the underlying asset if shorter, and the lessee incurs interest expense on the liability to make lease payments.

(b) a lessor applies the performance obligation approach to leases when the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term. In the performance obligation approach, a lessor continues to recognise the underlying asset and also recognises an asset representing the right to receive lease payments from the lessee and a lease liability representing the obligation to permit the lessee to use the underlying asset (a 'performance obligation').

(c) a lessor applies the derecognition approach to leases when the lessor does not retain exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term. In the derecognition approach, a lessor recognises an asset representing the right to receive lease payments from the lessee. It derecognises a portion of the underlying asset representing the cost of the rights it transfers to the lessee during the lease term and recognises a residual asset for the rights it does not transfer. (The residual asset represents the lessor's rights to the underlying asset at the end of the lease term.)

BC4 In addition, the exposure draft proposes to permit lessees and lessors to apply a simplified method of accounting for short-term leases, defined as leases that, at the date of commencement of the lease, have a maximum possible lease term of twelve months or less.

The accounting models

The accounting model for lessees

BC5 The discussion paper set out the boards' preliminary view that a lessee should account for leases using a 'right-of-use' model in which a lessee recognises:

(a) an asset representing the right to use the underlying asset during the lease term;

(b) a liability for the obligation to make lease payments in return for the right to use the underlying asset;

(c) amortisation expense on the right-of-use asset; and

(d) interest expense on the liability to make lease payments.

BC6 In the boards' view, the principles underlying the proposed right-of-use model would address many of the problems in existing standards. In particular, application of the model:

(a) would reflect the assets and liabilities arising in all leases in the statement of financial position. In contrast, the existing requirements reflect only the assets and liabilities arising from leases the entity classifies as finance leases. Many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

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(b) would result in the same accounting for the majority of leases. This would increase comparability of the statement of financial position and the statement of comprehensive income for users of financial statements and reduce the opportunity to structure transactions to achieve a desired accounting outcome.

(c) would be possible for a wide range of leasing arrangements. For example, the measurement of a right-of-use asset arising from a three-year lease of an asset with an estimated useful life of 20 years would be small relative to the value of the underlying asset. In contrast, the measurement of a right-of-use asset arising from a 45-year lease of an asset with a life of 50 years would approximate the value of the underlying asset. The boards think that both situations would be appropriately represented using a right-of-use model.

(d) would be consistent with the boards' conceptual frameworks. A right-of-use asset is a resource controlled by the lessee as a result of entering into the lease (a past event) and from which future economic benefits are expected to flow to the lessee. It therefore meets the definition of an asset. An obligation to make lease payments is a present obligation of the lessee arising from entering the lease, the settlement of which is expected to result in an outflow from the lessee of resources embodying economic benefits. It therefore meets the definition of a liability.

Concerns about the right-of-use model

BC7 The boards considered the following concerns about a right-of-use model expressed by respondents to the discussion paper:

(a) *Consistency between the lease accounting model and the conceptual framework currently being developed by the boards would be possible only once the conceptual framework project has advanced further.* The boards think that progress in individual projects should not wait until the conceptual framework project is completed. The objective of the conceptual framework project, particularly the phase on the definition and recognition of elements, is to improve and clarify existing concepts. Furthermore, the proposals are consistent with the existing conceptual framework and it is unlikely that future developments in the conceptual framework project would cause the boards to revise their fundamental conclusions about the definitions of assets and liabilities arising from leases or their recognition.

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(b) *A right-of-use model would lead to recognising assets and liabilities for all executory contracts, including purchase orders and long-term sales and supply agreements.* Those who hold this view think that the application of a right-of-use model would inappropriately gross up the statement of financial position. However, in the boards' view, a simple lease is not an executory contract after the date of commencement of the lease. When the lessor provides access to the underlying asset, the lessee has an unconditional right to use the underlying asset and therefore an unconditional liability to make lease payments. At that point the lessor cannot prevent the lessee from using the underlying asset nor can the lessee avoid payment without causing a breach of contract.

(c) *The existing guidance is well understood by both preparers and users of financial statements, and the boards should address the implementation issues relating to the existing model rather than abandon a model that is not fundamentally flawed.* In the boards' view, the existing model is fundamentally flawed. When a lessee enters into a lease, it obtains a valuable right that meets the boards' definitions of an asset. Similarly, the lessee incurs an obligation that meets the boards' definitions of a liability. At present, if a lease is classified as an operating lease, the lessee does not recognise in the statement of financial position the right to use the underlying asset and the liability to make lease payments. In addition, the existence of two very different accounting models for leases (the finance lease model and the operating lease model) leads to similar transactions being accounted for very differently and to significant structuring opportunities.

(d) *The right-of-use model is too complex and its benefits would not outweigh the costs.* In the boards' view, the benefits of improved information resulting from this model would outweigh the costs of applying it, as discussed in paragraphs BC200–BC205.

Alternative models

BC8 Some respondents to the discussion paper expressed concern that, in the right-of-use model, the measurement of the liability to make lease payments would differ from that of the right-of-use asset subsequent to initial measurement. Those respondents think that the accounting model should represent the lease as a single contract with both an asset and a liability component. Accordingly, they proposed an approach in which:

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(a) a lease that has the same economic effect as a loan and purchase should be accounted for as the issue of debt and the purchase of an asset; and

(b) a lease that does not have the same economic effect as a loan and purchase should be accounted for in a way that links the amortisation of the asset and liability arising from the lease. Thus, the liability to make lease payments would be accounted for as proposed in the right-of-use model and amortised using the effective interest method, and the right-of-use asset would be subject to an amortisation pattern on a basis similar to that of an interest-bearing loan (ie low amortisation charges in the early years and increasing in later years).

BC9 Supporters of this approach think it would better reflect the economics of most leases in which a lessee pays for the right to use the underlying asset at the same time as it receives the right and consumes the benefits. Supporters of this approach also think it might be simpler for lessees to apply than other approaches because it would result in the lessee recognising rental expense evenly during the lease term, which is generally consistent with the treatment of such leases for tax purposes in some jurisdictions. In contrast, the proposed model results in recognition of expenses greater than the lease payments in the early years of a lease and lower than the lease payments in the later years.

BC10 However, in the boards' view, the alternative approach described in paragraph BC8 has the following problems:

(a) the treatment of the liability to make lease payments would be inconsistent with the treatment of other financial liabilities, which could reduce comparability for users of financial statements because no interest expense is recognised.

(b) although the value of the right-of-use asset and the liability to make lease payments are clearly linked at the inception of the lease, they are not necessarily linked subsequently because the value of the right-of-use asset can change with no corresponding change to the liability to make lease payments. Some board members view the purchase of the right-of-use asset as similar to the purchase of property, plant and equipment because the consideration is paid in instalments. The consideration would not be linked to the fair value of the property, plant and equipment under existing IFRSs.

(c) the treatment of amounts recognised in profit or loss is inconsistent with the boards' view that the lessee has acquired a right-of-use asset and is paying for that right over the term of the lease.

BC11 Accordingly, the boards rejected this approach when developing the exposure draft.

BC12 The discussion paper also described alternative models for accounting for leases (the whole asset model, the executory contract model and the model in existing lease standards) and discussed the strengths and weaknesses of these alternative models. Most respondents, particularly users of financial statements, supported the right-of-use model more than the other models. In particular, the responses expressed support for a single model for lessee accounting. Therefore, the exposure draft develops only a right-of-use model. The boards did not reconsider the alternative models described in the discussion paper.

The accounting model for lessors

BC13 The boards acknowledge that many of the problems associated with existing lease requirements relate to the treatment of operating leases in the financial statements of lessees. However, the existing lease requirements for lessors are inconsistent with the proposed approach to lessee accounting. Many respondents to the discussion paper recommended that the boards develop a consistent accounting model for lessees and lessors. Furthermore, the boards think it is important that accounting for leases by lessors should, as much as possible, be consistent with the proposals in their project on revenue recognition. Consequently, the boards decided to develop an exposure draft that addresses both lessee and lessor accounting.

BC14 The boards propose that lessors should also apply a right-of-use model in which a lessor would also recognise assets and liabilities arising from the lease. However, the boards think that application of the right-of-use model by lessors should differ depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term. The boards considered the following approaches for how a lessor would apply a right-of-use model:

(a) a performance obligation approach (see paragraphs BC16–BC18).

(b) a derecognition approach (see paragraphs BC19–BC22).

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BC15 [This paragraph in the FASB exposure draft is not used in the IASB exposure draft.]

Performance obligation approach

BC16 The performance obligation approach views the underlying asset as the lessor's economic resource. The lease creates a new asset, the right to receive lease payments, and a new lease liability, representing the obligation to permit the lessee to continue to use the underlying asset during the lease term (a 'performance obligation'). The asset and liability arising from the lease are separate from the underlying asset. When the lessor grants the lessee the right to use the underlying asset during the lease term in exchange for a right to receive lease payments from the lessee, it does not lose control of the underlying asset and, thus, continues to recognise the underlying asset in the statement of financial position, with no adjustments.

BC17 The obligation to permit the lessee to use the underlying asset is a present obligation of the lessor arising from past events that would result in an outflow of future economic benefits from the lessor. Thus, that obligation meets the boards' definitions of a liability. The lessor is committed to allowing the lessee to use the underlying asset for the entire lease term, even if the price or availability of similar assets changes or if there are changes in other economic factors. The lessor has an unconditional right to receive lease payments as a result of transferring to the lessee the right to use the underlying asset. The unconditional right is a resource controlled by the lessor as a result of past events from which future economic benefits are expected to flow to the lessor and, thus, meets the boards' definition of an asset.

BC18 Under the proposals in the exposure draft *Revenue from Contracts with Customers*, entities would recognise revenue when a performance obligation is satisfied. The performance obligation approach views the obligation to permit the lessee to use the underlying asset during the lease term as a performance obligation. That performance obligation is satisfied continuously during the lease term as the lessor permits the lessee to use the underlying asset. Therefore, the lessor would recognise lease income continuously during the lease term.

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Derecognition approach

BC19 The derecognition approach views the lessor as having transferred economic benefits associated with the underlying asset during or after the expected lease term to the lessee at the date of commencement of the lease. In exchange, the lessor receives an unconditional right to receive payments from the lessee. The lessor derecognises the economic benefits associated with the rights it transfers to the lessee when it transfers those rights. The remaining economic benefits, ie the lessor's residual interest in the underlying asset, are classified as a residual asset in the lessor's statement of financial position.

BC20 In the derecognition approach, the obligation to deliver the right-of-use asset to the lessee is the performance obligation. The obligation is satisfied at the date of commencement of the lease. Therefore, consistently with the proposals in exposure draft *Revenue from Contracts with Customers* the lessor may recognise at the date of commencement of the lease revenue that is not attributable to the financing component of the lease.

BC21 The boards discussed a full derecognition approach and a partial derecognition approach. In a full derecognition approach, the lessor derecognises the whole of the underlying asset and recognises a receivable for the right to receive payments and a residual asset, representing its rights after the lease term ends. The boards rejected a 'full' derecognition approach to lessor accounting because of concerns that the lessor would recognise a profit on day 1 equal to the difference between the carrying amount of the underlying asset and its fair value even though only a portion of the underlying asset has been transferred.

BC22 This concern is mitigated by using a partial derecognition approach. In a partial derecognition approach, the lessor derecognises only the portion of rights representing the use of the underlying asset during the lease term and recognises only the income arising on the portion of the underlying asset that is transferred to the lessee.

Selecting the accounting model for lessors (paragraphs 28, 29 and B22–B27)

BC23 The boards discussed whether to require lessors to apply a single accounting model to all leases. They discussed using the performance obligation approach for all leases, with limited exceptions, as well as using the derecognition approach for all leases except some leases of portions of buildings and short-term leases.

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BC24 Comments on the discussion paper and feedback received as part of the boards' outreach activities indicate that a majority of constituents support using a derecognition approach to lessor accounting for most leases. Those who support this approach think that the performance obligation approach is inconsistent with the boards' proposed approach to lessee accounting because they think that the recognition by the lessor of a liability representing the lessor's obligation to permit the lessee to use the underlying asset implies that the lessee does not have an unconditional obligation to make lease payments. In addition, some constituents expressed concerns regarding the grossing up of the statement of financial position that occurs under the performance obligation approach.

BC25 However, in the boards' view, a single approach to lessor accounting would not be appropriate for all leases because of differences in the economics of the business models for different lessors. The boards think that the performance obligation approach is appropriate for lessors in some circumstances and the partial derecognition approach is appropriate in others.

BC26 The boards propose that lessors should determine the appropriate approach to apply on the basis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. The boards think that if a lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, it would be inappropriate to apply an approach that derecognises all or part of the underlying asset. Therefore such lessors should not apply the derecognition approach. Conversely, if a lessor has not retained exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term it would be inappropriate to continue to recognise the whole of the underlying asset and the lessor should apply the derecognition approach.

BC27 In most cases an entity's business model will indicate when a derecognition or a performance obligation approach would be appropriate as follows:

- (a) The derecognition approach is likely to be appropriate when the entity's business model is primarily the provision of finance, because the profit of that business is derived from interest income and the principal risk associated with the business is credit risk.
- (b) The performance obligation approach is likely to be appropriate when the entity's business model is primarily to generate a return from the active management of the underlying assets either from

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leasing these assets to multiple lessees during their life or from use or sale of the asset at the end of the lease. The lessor may also generate a variable return during the term of the lease by accepting payments that are contingent on the usage or performance of the underlying asset. In that business model the principal risk is asset risk.

Scope

BC28 The discussion paper set out the boards' preliminary view that the scope of the proposed standard should be based on the scope of existing guidance. For the IASB, that is IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease*, and for the FASB it is Topic 840 on leases. The boards considered the differences between the existing definitions and eliminated the differences as described below.

Definition of a lease (Appendix A and paragraphs B1–B4)

BC29 The boards propose to define a lease as a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration. In the boards' view, this definition retains the principle in the definition of a lease in both IFRSs and US GAAP.

BC30 Existing requirements regard a contract as conveying a right to use the underlying asset when the contract conveys to the lessee the right to control the use of the underlying asset. There are three criteria to determine whether the contract conveys a right of use. The exposure draft carries forward those criteria with some clarification.

BC31 Existing requirements require classification of contracts as leases if the purchaser will obtain all but an insignificant amount of the output of an asset unless payments are specified in terms of a fixed price per unit of output or the current market price per unit of output because, in those circumstances, the entity pays for a product or service rather than the right to use the underlying asset. However, contracts in which the purchaser will obtain all but an insignificant amount of the output of an asset and the lease payments are specified in terms of the time that the underlying asset is made available for use, rather than in terms of the output from the asset, may meet the definition of a lease.

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BC32 The boards considered whether a contract that supplies the purchaser with all but an insignificant amount of the output of an asset and specifies lease payments in terms of units of output should be classified as a lease. The boards agreed with the conclusion in IFRIC 4 and Topic 840 that if the price that the purchaser will pay is specified per unit of output, the purchaser is paying for a product or service rather than the right to use the asset. Consequently, the boards propose to retain the concept that a contract that supplies the purchaser with all but an insignificant amount of the output of an asset and specifies lease payments in terms of a fixed price per unit of output or the current market price per unit of output is not a lease.

Scope exclusions (paragraphs 5–9, 64, 65, Appendix A and paragraphs B5–B10)

BC33 IAS 17 applies to all leases, with specified exclusions. Those exclusions include leases to explore for or use natural resources and leases of rights to use biological assets. Topic 840 applies only to leases of property, plant and equipment.

BC34 The boards propose that a standard on leases should exclude leases:

(a) to explore for or use natural resources, such as minerals, oil and natural gas, because accounting practices for assets relating to exploration and evaluation are diverse and differ from the accounting for other types of assets. Furthermore, the accounting for assets related to the exploration and use of natural resources is specified by another IFRS that is currently being reconsidered by the IASB.

(b) of biological assets (including living plants and animals), to ensure that requirements relating to biological assets are found in a single standard. Furthermore, for those who use IFRSs, the existing requirement that leases of biological assets be measured at fair value better reflects the economics of leasing biological assets than would the cost-based model proposed in the exposure draft, for the reasons discussed in the Basis for Conclusions on IAS 41 *Agriculture*.

BC35 The exposure draft proposes that a lessee should apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to leases between the date of inception and the date of commencement of a lease if the lease meets the definition of an onerous contract in IAS 37. The boards did not consider

it necessary to develop separate guidance for such contracts. After the date of commencement of the lease, the costs of meeting an obligation under the lease and the economic benefits expected from the lease would be accounted for separately and IAS 37 does not apply to the lease.

BC36 The exposure draft also proposes to exclude from its scope leases of most intangible assets to be consistent with most existing IFRS practice and US GAAP. Although the boards have identified no conceptual reason why a lease accounting standard should exclude intangible assets, the boards decided that they would not include leases of intangible assets within the scope of the proposed IFRS until they had considered the accounting for intangible assets more broadly.

Subleases

BC37 In the boards' view, leases of right-of-use assets (ie a sublease) should be accounted for as other leases. Therefore the exposure draft proposes that leases of right-of-use assets arising from a sublease are within the scope of the proposed IFRS.

Long-term leases of land

BC38 Some regard long-term leases of land as economically similar to the purchase or sale of the land and think they should be excluded from the scope of the proposed standard. However, the boards propose that long-term leases of land should be within the scope of the proposed standard because:

(a) leases are not purchases or sales of the land, no matter how long the lease. The lessor retains title to the land during the lease term and regains possession of the land at the end of the lease term. Because the value of land generally does not decline with time, the title to the land is likely to have a significant value at the end of the lease term and can be re-leased at a current market rate.

(b) there is no conceptual basis for differentiating long-term leases of land from other leases. Inevitably, any definition of a long-term lease of land would be arbitrary.

Non-core assets

BC39 Some regard assets that are not essential to the operations of an entity as being of little interest to users of an entity's financial statements because such assets do not relate to the entity's operations. Accordingly, they think that the costs associated with recognising and measuring the assets

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and liabilities arising from leases of such non-core assets would outweigh the benefits to users of financial statements. For example, these commentators think that information about assets and liabilities arising from the lease of a printer is important to assess the operations of a printing company, but would not be important in assessing the operations of a consumer products manufacturer. Those who hold this view state that entities should account for leases of non-core assets using the approach for operating leases in existing standards, ie by recognising the lease payments in the period they occur.

BC40 The exposure draft proposes to include leases of non-core assets within the scope of the proposed standard. Neither IFRSs nor US GAAP distinguish core and non-core purchased assets for the purposes of recognition, and the boards could not justify distinguishing a right-of-use asset relating to a core asset from one that relates to a non-core asset. Additionally, leases of non-core assets may give rise to significant assets and liabilities. In the boards' view, such assets and liabilities are relevant to users of financial statements, regardless of whether they arise from leases of core or non-core assets.

Short-term leases (paragraphs 64 and 65 and Appendix A)

BC41 The exposure draft proposes to define short-term leases as leases that, at the date of commencement of the lease, have a maximum lease term, including options to renew or extend, of twelve months or less. An entity determines whether a lease is a short-term lease at the date of inception of the lease. This definition is consistent with the distinction between long-term and short-term items in IFRSs.

BC42 Some responses to the discussion paper questioned whether the cost of tracking and recording a large number of short-term leases would outweigh the benefits of accounting for the rights and obligations arising from a lease as recognised assets and liabilities. Those who hold this view think that it would be sufficient to disclose information about short-term leases that describes the nature of the underlying asset, the value of lease payments and the length of the lease.

BC43 The boards disagree that disclosure is an adequate substitute for recognition. Short-term leases could give rise to material assets and liabilities. If an entity did not account for the assets and liabilities arising from short-term leases, the assets and liabilities in the statement of financial position would be incomplete and would not be a faithful representation of those short-term leases. Furthermore, a scope

exemption for short-term leases would introduce an artificial distinction between leases that are recognised and those that are not. Therefore, the exposure draft proposes that short-term leases are within the scope of the proposed standard.

BC44 The boards propose to mitigate concerns about the cost of accounting for short-term leases by providing simplified requirements for such leases (paragraphs 64 and 65).

BC45 For lessees, the simplified accounting requirements would provide users of financial statements with information on the assets and liabilities arising from short-term leases at the end of each reporting period. However, preparers would not necessarily be required to comply with all of the estimations and calculations proposed for other leases because the short lease period may make their impact on the financial statements insignificant.

BC46 For lessors, the simplified accounting requirements would reflect in profit or loss only the lease payments that are contractually due. The lessor would not be required to recognise in the statement of financial position the lease liability or the right to receive lease payments during the whole of the lease term, or to derecognise any portion of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease because the short lease period may make the assets and liabilities arising from those leases insignificant.

Contracts that contain both service and lease components (paragraphs 6 and B5–B8)

BC47 Many contracts contain service components and lease components. Some of these contracts may be primarily service contracts with embedded lease components, whereas others may be primarily leases with attached services, such as maintenance services.

BC48 Existing IFRSs require lessees to apply accounting for operating leases that is similar to that for service contracts. Furthermore, many contracts that contain both service and lease components would be classified as operating leases under existing IFRSs. Thus, compared with existing IFRSs, the right-of-use model places more importance on distinguishing between components of contracts that contain both service and lease components. Therefore, the boards propose to provide guidance on how entities should account for contracts that contain both service and lease components.

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BC49 The boards propose that both lessees and lessors should account separately for a distinct service component in a contract that contains both service and lease components. This approach ensures that the service element of a lease is accounted for on a basis that is consistent with the proposals in the boards' exposure draft *Revenue from Contracts with Customers*.

BC50 The exposure draft proposes that an entity should consider together all concurrently negotiated contracts with another entity when allocating lease and service components. If a lessee or a lessor using the performance obligation approach is unable to allocate the payments, the exposure draft proposes to treat the whole contract as a lease. However, in the boards' view, it would be rare to be able to identify a distinct service component and yet not be able to allocate the payments between the components.

BC51 The boards have different views on how a lessor that applies the derecognition approach should account for leases that include service components that are not distinct.

BC52 The FASB proposes that a lessor should not separate non-distinct service components of a contract because this approach is consistent with the proposals in the boards' exposure draft *Revenue from Contracts with Customers*. This is because *Revenue from Contracts with Customers* proposes that an entity should account for a separate performance obligation only if the promised asset is distinct from other goods or services promised in the contract. Additionally, the FASB notes that requiring different measurement of non-distinct service components for a lessor applying the derecognition approach (as the IASB proposes) would result in inconsistent measurement for a lessee's payables and a lessor's receivables.

BC53 The IASB proposes that a lessor that applies the derecognition approach should separate all service components of a contract to ensure that income from a service component is not recognised before the lessor provides that service. Although the IASB notes that this is inconsistent with how it proposes that lessees and lessors that apply the performance obligation approach treat non-distinct service components and could result in the lessee's payables and lessor's receivables being measured on different bases, the IASB thinks that it is more important that income from a service component is not recognised before the lessor provides that service. Additionally, the IASB thinks that it should be rare that a lessor will not be able to identify service components within a contract that contains service and lease components.

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BC54 The boards noted that a lessor that applies the performance obligation approach does not recognise income from service components before providing that service, regardless of whether the service component is separated from the lease component. Consequently, both boards propose that a lessor that applies the performance obligation approach should not be required to separate a non-distinct service component of a contract.

Leases of investment property (paragraph 7)

BC55 The proposals in this exposure draft for leases of investment property differ for IFRSs and US GAAP. In principle, a lease of investment property should be within the scope of the proposed standard.

BC56 However, IFRSs permit investment property to be accounted for using either a cost or a fair value model. Investment property analysts have told the IASB that these requirements provide useful information, especially when the fair value model in IAS 40 *Investment Property* is used. In particular, they say that total rental income is an important measure for investment property analysts.

BC57 Neither the performance obligation approach nor the derecognition approach to lessor accounting would reflect in the statement of financial position the present value of total expected rental income. Therefore, the IASB proposes that the lessor requirements would not apply to a lessor that accounts for investment property at fair value in accordance with IAS 40. Accordingly, the IASB proposes to amend IAS 40 to require lessors that use the fair value model to recognise lease income arising on the investment property (other than fair value gains and losses) on a straight-line basis over the lease term.

BC58 Existing US GAAP does not permit fair value measurement of investment property. However, the FASB has added to its agenda a project on investment properties to consider whether entities should be given the option (or be required) to measure an investment property at fair value through earnings. The outcome of that project could affect the accounting for leases associated with investment properties.

Distinguishing between a lease and a purchase or sale (paragraphs 8(a), B9 and B10)

BC59 The requirements in the exposure draft would apply to transactions in which one entity transfers to another the right to use an underlying asset. They would not apply to transactions in which control and all but a trivial amount of the risks and benefits associated with the underlying asset are transferred at the end of the lease term, because such transactions do not

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meet the proposed definition of a lease and are outside the scope of the proposed IFRS. Such transactions are purchases or sales within the scope of other IFRSs and US GAAP, in particular IAS 18 *Revenue* and Topic 605, Revenue Recognition.

BC60 The boards propose that an entity should determine whether a contract transfers the underlying asset to another entity using the principles developed in their projects on revenue recognition and consolidation. Those projects propose that transfer of control is the determining factor in whether an entity transfers an asset to another entity. However, an entity assesses control of the underlying asset at both the start and the end of the lease.

BC61 In some cases, a transaction may not be described as a purchase or sale but may transfer control of an underlying asset (rather than a right to use the underlying asset) from one party to another. For example, an entity obtains control of a machine if the lease includes a bargain purchase option exercisable after five years. Thus, the transaction represents a purchase rather than a lease. Such transactions would not be included within the scope of the proposed standard, even if the contract is described as a lease.

BC62 Some respondents to the discussion paper were concerned that attempting to distinguish between purchases or sales and leases would reintroduce a classification requirement that would increase the complexity of the proposals. However, the boards think that purchases or sales and leases have different economic effects and that the accounting should reflect those economic differences, regardless of the way that the contract describes the transaction.

Purchase options (paragraph 8(b))

BC63 The boards considered whether a purchase option is:

(a) a term of the lease that should be accounted for as if it were an option to extend the lease term; or

(b) a means of terminating the lease that should be accounted for only when it is exercised.

BC64 The boards concluded that when a lessee exercises a purchase option, it terminates the lease and purchases the underlying asset. Thus, the exercise price of the option is not a lease payment and should not be included in the measurement of assets and liabilities arising from a lease.

Accordingly, the boards propose that purchase options should not be accounted for until they are exercised. However, bargain purchase options are considered when determining if a transaction is a lease or a purchase or sale.

Measurement: lessees

Initial measurement of the liability to make lease payments (paragraphs 12(a), 13–15 and B11–B13)

BC65 The exposure draft proposes that a lessee should measure the liability to make lease payments at the present value of the lease payments (paragraph 12(a)) at the date of inception of the lease. Nearly all respondents to the discussion paper supported this approach. In the boards' view, the present value of lease payments, discounted using an appropriate discount rate, is a reasonable approximation to fair value. However, the boards concluded that it would normally be less complex for lessees to determine the present value than fair value. The exposure draft proposes that the amount of lease payments to be discounted is determined on a similar basis for lessees and lessors. Paragraphs BC110−BC131 discuss the boards' conclusions on how to determine the amount of the lease payments to be discounted.

Discount rate (paragraphs 12(a) and B11–B13)

BC66 The discussion paper proposed that the discount rate used to determine the lessee's liability to make lease payments should be the lessee's incremental borrowing rate, ie the rate that takes into account the credit standing of the lessee, the length of the lease and the nature and quality of the security provided. The discussion paper also discussed the boards' view that the lessee should not use the rate implicit in the lease, ie the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset.

BC67 In theory, the rate implicit in the lease should equal the lessee's incremental borrowing rate. However, the rate implicit in the lease is affected by differences between the lessee's and lessor's estimates of contingent rentals and the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor. Thus it may be difficult for lessees to determine the

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rate implicit in the lease for some leases, particularly those in which the underlying asset has a significant residual value at the end of the lease (such as for leases currently classified as operating leases) or in which there are significant contingent rentals.

BC68 Respondents to the discussion paper said that the rate implicit in the lease is often relatively easy to determine and has the advantage of being specific to the transaction. Some respondents also said that using the lessee's incremental borrowing rate for the lease obligation would not necessarily reduce complexity because the incremental borrowing rate must reflect the credit standing of the lessee as well as the security provided by the underlying asset. The degree of security could be different from lease to lease and from period to period, depending on the fair value of the underlying asset. Lastly, the incremental borrowing rate may not be readily obtainable when the lease term is long.

BC69 The boards agreed with respondents that the rate implicit in the lease could be readily determined in some circumstances. However, there would be circumstances in which the rate implicit in the lease would be difficult to determine. Accordingly, the exposure draft proposes that the lessee should discount the liability to make lease payments using the lessee's incremental borrowing rate or the rate the lessor charges the lessee if that rate can be readily determined. The rate the lessor charges the lessee could be the rate implicit in the lease.

Initial measurement of the right-of-use asset (paragraphs 12(b) and 13–15)

BC70 The discussion paper proposed that, at the date of inception of the lease, a lessee should measure the right-of-use asset at cost.

BC71 Cost for a right-of-use asset is the amount of the liability to make lease payments during the lease term, ie the present value of the lease payments discounted at an appropriate discount rate, plus any initial direct costs incurred by the lessee. At initial recognition, cost represents a reasonable approximation of the fair value of the right-of-use asset. Nearly all respondents to the discussion paper supported the boards' preliminary view that lessees should measure a right-of-use asset at cost.

BC72 The boards considered the view that lessees should initially measure the right-of-use asset at fair value because this may provide a more relevant assessment of the economic benefits derived from the use of the underlying asset. However, initial measurement of a right-of-use asset at cost is consistent with the measurement of many non-financial assets,

such as assets within the scope of IAS 16 *Property, Plant and Equipment* and Topic 360, Property, Plant, and Equipment, and IAS 38 *Intangible Assets* and Topic 350, Intangibles—Goodwill and Other. The boards think that it would increase comparability for users of financial statements if entities measured right-of-use assets on a basis similar to that of the underlying asset. Furthermore, initial measurement of the right-of-use asset at cost is easier and less costly for entities to apply than fair value measurement because there is usually no active market for right-of-use assets and cost usually provides a reasonable approximation to the fair value of the right-of-use asset at its inception.

Subsequent measurement (paragraphs 16–24)

BC73 The exposure draft proposes that after the date of commencement of a lease, the lessee should measure both the liability to make lease payments and the right-of-use asset at amortised cost.

BC74 The boards did not propose that such assets and liabilities should be measured at fair value after initial measurement because:

(a) it would be inconsistent with the subsequent measurement of many other non-financial assets and non-derivative financial liabilities, thus decreasing comparability for users of financial statements. Some respondents to the discussion paper suggested including an option to measure at fair value liabilities to make lease payments that are similar to other financial liabilities. However, in the boards' view, such an option is inappropriate because it would impair the ability for users of financial statements to compare liabilities to make lease payments.

(b) it would be more complex and costly for entities to apply than a cost-based approach because it requires the use of both current expected cash flows and current market interest rates.

(c) it would be inconsistent with the proposal that initial measurement of assets and liabilities arising from a lease should not be at fair value (see paragraphs BC65 and BC72).

BC75 Some respondents to the discussion paper suggested that lessees should account for any liability to make lease payments as a financial liability. However, although the liability to make lease payments meets the definition of a financial liability, such a liability has features unique to

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leases because the liability is linked to a right-of-use asset. Additionally, leases often include specific lease terms such as options and contingent rentals. Therefore, the boards concluded that lessors should not account for a liability to make lease payments as a financial liability.

Revaluation (paragraphs 21–23)

BC76 IFRSs permit the revaluation of non-financial assets, such as property, plant and equipment. US GAAP does not permit revaluation. The boards think that an entity should be permitted to measure a right-of-use asset on the same basis as assets in the same class as the underlying asset. Therefore, the exposure draft proposes the following approaches to the revaluation of right-of-use assets:

(a) lessees using IFRSs would have the option to revalue right-of-use assets.

(b) lessees using US GAAP would not be permitted to revalue right-of-use assets unless required to do so to recognise an impairment loss.

BC77 In the boards' view, the benefits of increased understandability for users of financial statements and improved comparability between entities that report in accordance with either IFRSs or US GAAP would outweigh the disadvantage of non-convergence.

BC78 Revaluation of right-of-use assets by lessees using IFRSs would be consistent with the accounting permitted by other IFRSs for non-financial assets that are initially measured at cost. Accordingly, when the underlying asset is property, plant or equipment, the revalued right-of-use asset would be comparable to property, plant and equipment that is revalued in accordance with IFRSs. Such non-financial assets are subject to depreciation or amortisation and may be subsequently remeasured at fair value, if fair value can be reliably measured. The exposure draft proposes to carry forward the requirements in other IFRSs for entities to make revaluations with such regularity that the carrying amount of the asset at the end of the reporting period does not differ materially from its fair value.

BC79 The IASB considered whether lessees should apply the revaluation model in IAS 38 to the revaluation of the right-of-use asset. IAS 38 permits entities to measure intangible assets at a revalued amount, which is the fair value of the asset at the date of revaluation, determined by reference to an active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. However, the IASB

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thinks that an active market for right-of-use assets would be very rare. This would mean that very few right-of-use assets would be revalued and would result in inconsistent accounting between owned assets and similar leased assets. Accordingly, the IASB proposes to permit revaluation of the right-of-use asset in accordance with IAS 38 but to remove the requirement for entities to determine the fair value of the revalued right-of-use asset by reference to an active market. As a result, the exposure draft proposes that right-of-use assets may be carried at a revalued amount, ie the fair value of the asset at the date of revaluation (which need not be determined by reference to an active market) less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

BC80 The exposure draft proposes that if an entity applying IFRSs revalues a right-of-use asset, it should revalue the entire class of asset (ie the entire class of assets comprising all owned and leased assets) to which the underlying asset belongs. That would result in information that is more relevant to users of financial statements because entities would measure all owned and leased assets in the same class of asset in the same way. It would also be consistent with the requirement in IAS 16 and IAS 38 that an entity must revalue all assets in a class of assets. However, the IASB decided not to propose requiring an entity to revalue leases of an asset whenever it revalues owned assets in that class of asset. In the IASB's view, to do so might increase the burden on reporting entities because they may not have the information available to revalue the right-of-use asset, even if they have that information for their owned assets.

BC81 Because US GAAP does not permit revaluation of non-financial assets, the FASB is proposing that lessees applying US GAAP cannot revalue right-of-use assets. Permitting such revaluations would create inconsistency between the accounting for a right-of-use asset and an owned asset in US GAAP.

Impairment (paragraph 24)

BC82 The exposure draft proposes two approaches to the impairment of right-of-use assets:

(a) entities applying IFRSs apply the impairment requirements of IAS 36 *Impairment of Assets*; and

(b) entities applying US GAAP apply the impairment requirements of Section 360-10-35.

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BC83 This approach would result in divergence between IFRSs and US GAAP because requirements on impairment in IFRSs and US GAAP differ. However, in the boards' view the benefits of increased understandability for users of financial statements and improved comparability of leased and owned assets for entities that report under either IFRSs or US GAAP outweigh this disadvantage.

BC84 The boards rejected an approach in which all lessees would apply the requirements of either IFRSs or US GAAP for right-of-use assets because such an approach would result in an impairment model for right-of-use assets that is different from that for other non-financial assets in IFRSs or US GAAP. This could cause difficulties in determining impairment for a group of assets comprising both leased and owned assets. In the boards' view, consistent accounting between right-of-use assets and other non-financial assets provides more useful information than adopting a common approach for impairment of right-of-use assets. Such information would be easier for reporting entities in each jurisdiction to implement and would benefit users of financial statements through increased comparability between assets that the reporting entity owns and those that it leases.

BC85 The boards also decided not to develop a new impairment approach that applied only to right-of-use assets. Having a different impairment accounting model for right-of-use assets and other non-financial assets would be difficult to justify because right-of-use assets are similar to other non-financial assets subject to amortisation and impairment. In addition, such an approach would add complexity to the proposed standard.

Reassessment of lease term (paragraph 17(a))

BC86 Paragraphs BC132 and BC133 describe the boards' reasons for requiring both lessees and lessors to reassess the lease term after initial measurement. The boards propose that a lessee should adjust the carrying amount of the right-of-use asset to reflect changes in the measurement of the related liability to make lease payments arising from the reassessment of a lease term. In contrast, entities recognise changes in most other liabilities in profit or loss. In the boards' view, the proposal to adjust the right-of-use asset for changes in the related obligation is justified because a change in the assessed lease term represents the lessee's expectation to acquire more or less of the right to use the underlying asset.

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Reassessment of contingent rentals and expected payments under term option penalties and residual value guarantees (paragraphs 17(b) and 18)

BC87 Paragraph BC134 describes the boards' reasons for requiring both lessees and lessors to reassess contingent rentals, term option penalties and residual value guarantees during the lease term. The exposure draft proposes that changes in amounts payable under contingent rental arrangements, term option penalties and residual value guarantees arising from current or prior periods should be recognised in profit or loss. All other changes, ie those arising from expectations about future periods, would be recognised as an adjustment to the lessee's right-of-use asset.

BC88 This proposal would require lessees to identify the amount of the adjustment to the liability to make lease payments that relates to past or current periods. Thus, it is more complex than an approach in which all changes are treated in the same way. However, in the boards' view, this approach best reflects the economics of many leases because it recognises costs in the periods to which those costs relate. For example, if lease payments are linked to sales and the liability to make lease payments increases because of an increase in expected future sales, the increase in the obligation would be recognised as an adjustment to the right-of-use asset. Lessees would recognise the increase in the carrying amount of the right-of-use asset in profit or loss (through amortisation) in those future periods in which the future economic benefits represented by the right-of-use asset are recognised. This approach is also consistent with the accounting for changes in estimates in accordance with both IFRSs and US GAAP, which require changes in accounting estimates to be accounted for in the period that is affected by the change (ie current and future periods).

BC89 An increase in the amount payable under a residual value guarantee arises from a decrease in the value of the underlying asset. Accordingly, some might view adding such an increase to the carrying amount of the right-of-use asset as counter-intuitive. However, in the boards' view, changes in amounts payable under residual value guarantees are changes in the cost of the right-of-use asset that was determined at the date of inception of the lease. Accordingly, the boards think that entities should account for residual value guarantees in the same way that they account for contingent rental arrangements. In addition, the boards note that the proposed requirement for lessees to review right-of-use assets for impairment would ensure that assets arising from leases are not overstated.

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No reassessment of the discount rate (paragraph 19)

BC90 The exposure draft proposes that entities should not revise the discount rate under the amortised cost-based approach when there are subsequent reassessments of the expected lease term or contingent rentals, unless the lease payments are contingent on variable reference interest rates. Paragraph BC135 describes the boards' reasons for this requirement.

Measurement: lessors

Performance obligation and derecognition approaches: right to receive lease payments

BC91 Paragraphs BC92–BC98 discuss the proposed measurement of the lessor's right to receive lease payments, which is common to both the performance obligation approach and the derecognition approach for lessor accounting.

Initial measurement of the right to receive lease payments (paragraphs 33(a), 34–36, 49(a) and 51–53)

BC92 The exposure draft proposes that a lessor should measure the right to receive lease payments on a basis consistent with the measurement of similar assets under US GAAP. Accordingly, the exposure draft proposes that a lessor should measure the right to receive lease payments at the present value of the lease payments discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor. US GAAP requires entities to measure non-cash consideration for property, goods or services in a way similar to cash consideration, ie at the present value of the consideration exchanged between the contracting parties at the date of the transaction. Paragraphs BC110–BC131 discuss the reasons for the boards' conclusions on how to determine the present value of lease payments.

BC93 Some respondents to the discussion paper suggested that entities should account for the right to receive lease payments as a financial asset. However, although rights to receive lease payments meet the definition of financial assets, the boards think that such rights often have features unique to leases such as options and contingent rentals. Therefore, the boards concluded that a lessor should not account for a right to receive lease payments in the same way as other financial assets unless those rights are impaired, transferred or derecognised.

BC94 The boards considered whether a lessor should measure the right to receive lease payments at fair value on initial measurement. However, the boards propose not to require fair value measurement for the right to receive lease payments for reasons similar to their reasons for not proposing fair value measurement of the right-of-use asset, as described in paragraph BC72. The boards also decided that they would not propose an option to measure the right to receive lease payments at fair value because to do so would impair comparability between reporting entities with similar lease assets.

Discount rate (paragraphs 33(a) and 49(a), Appendix A and paragraphs B12 and B13)

BC95 The boards considered whether the discount rate used to determine the present value of lease payments should be the rate implicit in the lease, the lessee's incremental borrowing rate, or the rate the lessor charges the lessee. The boards rejected requiring the use of the lessee's incremental borrowing rate because in some cases it would yield a transaction price that differs from the known fair value of the underlying asset. However, the boards also think that the rate implicit in the lease would not be appropriate in all circumstances, for example in some property leases when the residual value of the underlying asset can appreciate rather than depreciate. The boards note that the rate the lessor charges the lessee may be the lessee's incremental borrowing rate, the rate implicit in the lease or some other rate appropriate for the type of lease. The boards propose that lessors should use the rate the lessor charges the lessee because that rate reflects the specific features of the contract.

Subsequent measurement of the right to receive lease payments (paragraphs 37(a), 39–41, 54 and 56–59)

BC96 The boards propose that the right to receive lease payments should be measured at amortised cost after initial measurement for the reasons described in paragraph BC74.

Impairment (paragraphs 41 and 58)

BC97 The exposure draft proposes that a lessor should evaluate the right to receive lease payments for impairment in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* (for entities using IFRSs) and the impairment guidance in Topic 310, Receivables (for entities using US GAAP). Although the right to receive lease payments meets the definition of a financial asset, it is not accounted for as one either initially or subsequently (see paragraph BC93). However, the impairment model

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for financial instruments requires a direct estimate of future cash flows and reflects the credit risk associated with those cash flows. In the boards' view, that model is more appropriate for rights to receive lease payments than the impairment model for non-financial assets that depends on other asset risks. The boards think it would add undue complexity to the proposed standard to develop a new impairment approach for a particular class of financial assets.

Reassessment (paragraphs 39 and 56)

BC98 Paragraphs BC132–BC134 describe the boards' reasons for requiring entities to reassess the lease term, contingent rentals and expected payments under term option penalties and residual value guarantees after initial measurement. Consistently with the treatment of changes arising from reassessment by lessees, the lessor adjusts the right to receive lease payments to reflect changes arising from reassessment. Paragraph BC135 describes the boards' reasons for proposing that discount rates should not be reassessed after initial measurement.

Performance obligation approach (paragraphs 33–41)

Initial and subsequent measurement of the lease liability (paragraphs 33(b), 37(b) and 38)

BC99 The measurement of the lease liability in the performance obligation approach is based on the proposals in the boards' exposure draft *Revenue from Contracts with Customers*. Therefore, an entity should:

(a) measure the lease liability at the amount of customer consideration on initial recognition.

(b) after initial measurement, remeasure the lease liability to reflect the extent to which it has satisfied the obligation to permit the lessee to use the underlying asset.

(c) treat changes in uncertain consideration as changes in the original transaction price.

BC100 For a lessor, the lease liability is a performance obligation. The initial measurement of the lease liability is equal to the present value of lease payments receivable. The lessor satisfies the performance obligation by permitting the lessee to use the underlying asset continuously during the lease term. In the boards' view, this means that the lessor satisfies the performance obligation on a continuous basis. Accordingly, the lessor should:

(a) measure the lease liability at the present value of lease payments receivable (paragraph 33(b)).

(b) remeasure the lease liability at the end of each reporting period to reflect satisfaction of that obligation (paragraphs 37(b) and 38).

(c) adjust the lease liability for any change in the right to receive lease payments resulting from a reassessment of the lease term, amount of contingent rentals or expected payments under term option penalties and residual value guarantees to the extent that those lease payments relate to unsatisfied obligations (paragraph 39(b)(ii)). (This mirrors the accounting by the lessee, which adjusts the right-of-use asset for any changes in the lessee's liability to make lease payments relating to future periods.)

(d) recognise in profit or loss any change in the right to receive lease payments resulting from a reassessment of amounts receivable under contingent rentals, or expected payments under term option penalties and residual value guarantees to the extent that those lease payments relate to satisfied obligations (paragraph 39(b)(i)).

Derecognition approach (paragraphs 49–59)

BC101 Paragraphs BC21 and BC22 describe the full and partial derecognition approaches. The boards acknowledge that the partial derecognition approach is the more complex of the two approaches to apply. However, the boards regard a partial derecognition approach as more consistent with a model that regards a lease as a transfer of some of the rights to use an underlying asset. This is because in a partial derecognition approach, the lessor derecognises only the portion of the underlying asset that it transferred to the lessee. In contrast, a full derecognition approach would regard the lessor as having transferred the entire underlying asset to the lessee and having created a new right to the residual asset for the lessor.

BC102 Furthermore, in a full derecognition approach, the entity recognises at the commencement of the lease all the gains and losses that relate to the underlying asset. In the boards' view this would overstate the gains and losses arising from the contract. In a partial derecognition approach, the lessor recognises gains and losses at the commencement of the lease that relate only to the rights transferred to the lessee. Therefore, the exposure draft proposes a partial, rather than a full, derecognition approach for leases in which the lessor has not retained exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term.

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Initial measurement

Initial measurement of the residual asset (paragraphs 49(b) and 50)

BC103 The boards discussed the following two alternatives relating to the initial measurement of the lessor's residual asset:

(a) measure the residual asset at fair value.

(b) measure the residual asset as an allocation of the carrying amount of the underlying asset.

BC104 Some commentators supported measuring the residual asset at fair value. Those that supported the use of fair value think that fair value would provide information that is more relevant to users of financial statements, while imposing little additional cost to lessors, that would be expected to have already made assumptions about the expected fair value of the residual asset before entering into the lease.

BC105 However, the boards propose that the residual asset should be measured on the basis of an allocation of the carrying amount of the underlying asset because that would avoid additional costs for lessors for whom it might be difficult to measure the fair value of the residual asset, given that the residual asset has not been transferred. In addition, measuring the residual asset on such a basis would avoid requiring the lessor to recognise revenue at the date of commencement of the lease for the portion of the underlying asset not subject to the lease. Measuring the residual asset at fair value would result in similar effects as the full derecognition approach which the boards rejected. That is, the lessor would recognise a profit at the date of commencement equal to the difference between the carrying amount of the underlying asset and its fair value even though only a portion of the entire leased asset had been transferred. Accordingly, the exposure draft proposes that the residual asset should be measured by allocating the carrying amount determined at the date of inception of the lease.

Subsequent measurement

Subsequent measurement of the residual asset (paragraph 55)

BC106 The boards propose that after initial measurement the lessor should not measure the residual asset at fair value because it would be costly for entities and could result in the recognition of unrealised gains. However, the boards think that the carrying amount of a residual asset should be adjusted to reflect any impairment. The boards considered an approach

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in which the lessor accretes the residual asset during the lease term to its expected value at the end of the lease term. This would reduce the number of situations in which a lessor recognises large gains on re-leasing an asset. However, the boards rejected this approach because it would be inconsistent with the cost-based approach to initial recognition. Therefore, the boards propose that lessors should not remeasure the residual asset during the lease term, other than for impairment.

Reassessment of lease term (paragraph 56(a))

BC107 The reassessment of the lease term may result in changes to the relative fair values of the lessee's right to use the underlying asset and the rights retained by the lessor.

BC108 The boards propose that a lessor should adjust the carrying amount of the residual asset so that the amount reflects the relative fair value of what has been transferred (the right to receive lease payments) and what has been retained (the residual asset). In the boards' view, this is an appropriate way of allocating the cost of the underlying asset between what has been sold and what has been retained. Consistently with the recognition of the residual asset at the date of commencement of the lease, a longer lease term results in higher lease income and lease expenses, and a shorter lease term results in lower lease income and lease expenses.

Reassessment of contingent rentals and expected payments under term option penalties and residual value guarantees (paragraph 56(b))

BC109 A change in contingent rentals or expected payments under term option penalties and residual value guarantees represents a change in the total consideration that the lessor expects to receive for transferring a right-of-use asset to the lessee. The exposure draft proposes that entities should recognise such changes in consideration in profit or loss in order to be consistent with the treatment of the consideration at the date of commencement of the lease. The boards rejected adjusting the lessor's residual asset for changes in the right to receive lease payments arising from performance-based or index-based contingent rentals because such changes do not necessarily represent changes in the lessor's remaining rights relating to the underlying asset.

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Measurement issues common to lessee and lessor accounting

Reflecting uncertainties in the lease payments (paragraphs 13–15, 34–36, 51–53 and B16–B21)

BC110 Both the lessee and lessor accounting models propose that assets and liabilities arising from leases should be measured on the basis of the present value of lease payments, discounted using an appropriate discount rate.

BC111 Determining the present value of lease payments involves the following steps:

(a) determining the lease term, in other words the number of lease payments.

(b) determining the number and amount of lease payments required during the lease term.

(c) discounting the amount of the lease payments to their present value and determining their weighted average.

BC112 In some leases, the payments under the lease are not fixed because:

(a) there may be changes to the lease term (eg if there are options to extend or terminate a lease); and

(b) there may also be changes in the amount of the lease payments arising from contingent rental arrangements, term option penalties or residual value guarantees.

BC113 The exposure draft proposes that amounts paid to exercise a purchase option included in a lease are not lease payments. When a lessee exercises a purchase option, it purchases the underlying asset and the contract is no longer a lease. The amount paid to exercise the option would not be a lease payment but would be part of the cost of acquiring the underlying asset.

Lease term: options to extend or terminate the lease (paragraphs 13, 34 and 51, Appendix A and paragraphs B16–B20)

BC114 Leases often grant the lessee the right to extend the lease beyond the initial lease period or to terminate the lease before the end of the lease period.

BC115 The discussion paper proposed that an entity should account for options to extend or terminate a lease at a date that differs from the end of the initial lease period by assuming the most likely of the possible lease terms. Such an approach would:

(a) be simpler to apply than other approaches that would require separate measurement of options.

(b) eliminate the need to differentiate between options to renew and options to terminate a lease.

(c) reflect entity-specific factors that might influence whether the option is exercised.

(d) result in the measurement of the lease reflecting the expected outcome.

(e) avoid the measurement reliability problems inherent in other approaches considered by the boards (see paragraph BC120).

BC116 Respondents to the discussion paper said that determining the present value of lease payments on the basis of the most likely lease term might result in the recognition of a liability that does not meet the definition of a liability. They also said that this approach does not distinguish between a five-year, non-cancellable lease and a three-year lease with an option to extend for two years that is likely to be exercised.

BC117 However, the boards think that using the most likely lease term is a practical solution to the problems associated with the accounting for leases with options. If optional periods are not included in the lease term, the right-of-use asset or the lease liability might be misstated. Furthermore, the other approaches the boards considered for determining the lease term, including a qualitative assessment, determination based on a probability threshold or a components approach, would either create significant structuring opportunities or be complex to apply.

BC118 In the boards' view, the lease term should reflect the entity's reasonable expectation of what the term will be. To clarify that this differs from the term with the highest probability of occurring, the exposure draft proposes that an entity should account for options to extend or terminate a lease by assuming the longest possible lease term that is more likely than not to occur.

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BC119 The exposure draft proposes that an entity should consider all relevant factors when it determines the lease term, including contractual and non-contractual factors, business factors, and lessee-specific factors (eg past practice and intention). To do otherwise could result in the entity using a lease term that does not reflect the longest possible lease term that is more likely than not to occur. Accordingly, an entity should consider options to renew a lease at market rent when it determines the longest possible lease term that is more likely than not to occur. Some board members would have preferred a higher threshold than 'more likely than not', such as 'reasonably assured'. They are concerned that 'more likely than not' could result in more frequent reassessment of the liability, which could diminish the usefulness of financial reporting.

BC120 The boards also considered the following approaches:

(a) *The components approach*, in which an option to extend or terminate a lease is recognised and measured separately from the assets and liabilities arising from the lease for the term specified in the lease. However, such an approach would introduce complexity, ignore the interrelationship between the term of a lease and the exercise of options, and be difficult to apply because options may be difficult to measure reliably.

(b) *The disclosure approach*, in which an entity recognises a right to receive, or a liability for, lease payments for the minimum contractual term and discloses the existence of any options to extend the term. Although this approach would be simple to apply, it would provide less useful information to users of financial statements because the measurements of the asset and liability ignore the existence of the options and thus potentially misrepresent the assets and liabilities arising from a lease. Furthermore, if an entity has many leases, the disclosures could be lengthy, complex and difficult to understand.

(c) *The probability-weighted measurement approach*, in which the measurement of the lease asset or liability reflects the probability of each possible outcome. In this approach, an 80 per cent probability that an option to extend a lease will be exercised is incorporated into the measurement of the liability to make lease payments or the right to receive lease payments by weighting the extended term by 80 per cent and the shorter term by 20 per cent. Although some respondents to the discussion paper expressed support for a probability-weighted measurement approach, most said that such an approach would add complexity without

providing more relevant information. The boards noted that uncertainty over the lease term affects whether an asset or a liability exists to be recognised, rather than the measurement of that asset or liability. In the boards' view, a probability-weighted approach is not appropriate to determine whether an asset or liability exists. Thus, the boards do not propose to adopt this approach for determining the lease term because it might be difficult to measure reliably the probability of exercise of an option, and to avoid an entity recognising a lease term that does not reflect a possible outcome, which some find counter-intuitive.

(d) *Recognise options that provide an incentive to exercise approach*, in which optional lease periods are reflected in the recognised assets and liabilities only if the arrangement includes an incentive to extend the lease such as penalties payable on cancellation, reduced rentals during optional periods or where the costs of not exercising the option to use the asset make renewal likely. The boards do not propose to adopt this approach because it ignores the effects of options that are likely to be renewed but do not include an incentive for renewal.

Amount of the lease payments: contingent rentals, term option penalties and residual value guarantees (paragraphs 14, 35, 52 and B21)

BC121 In some leases, the amount of each lease payment is variable rather than fixed. This variability can arise because of features, such as contingent rentals, based on:

(a) price changes, or changes in an external rate or the value of an index. In this type of lease, the amount of the lease payments is adjusted for changes in market lease rates, an external rate, such as LIBOR, or the value of an index, such as the consumer price index.

(b) the lessee's performance derived from the underlying asset. For example, a lease of retail property may specify that the lease payments are based on a specified percentage of sales made from that property.

(c) the usage of the underlying asset. For example, a car lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.

BC122 Some think that recognising assets or liabilities for contingent rentals misrepresents the nature of the contingency because:

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(a) the effect of contingent rentals based on usage or performance is to reduce the lessee's exposure to the risk associated with the underlying asset during or after the expected lease term. However, the effect of recognising a liability in respect of payments of this type is to suggest that the entity is exposed to more risk.

(b) the lessee's liability to make and the lessor's right to receive contingent rentals do not exist until the future event requiring the payment occurs (ie the underlying asset is used, a sale is made or the level of an index changes).

Accordingly, some think that entities should only provide disclosure of contingent rentals.

BC123 However, in the boards' view, the liability to pay contingent rentals and the right to receive lease payments exist at the date of inception of the lease. Such contingent rentals meet the definition of a liability for the lessee and an asset for the lessor. It is only the amount to be paid that is uncertain. The boards noted that the measurement of non-financial liabilities generally does not include payments that can be avoided. However, the lessee's liability is a financial liability. In addition, not reflecting contingent rentals in the measure of a liability to make lease payments could have the following implications:

(a) Lessees could have a right-of-use asset and lessors could have a right to receive lease payments that would not be recognised or could be significantly understated.

(b) Lessees could structure lease payments as contingent in order to avoid recognising a liability.

BC124 The boards rejected an approach in which only unavoidable contingent rental payments would be reflected in the measurement of the liability to make, or right to receive, lease payments. Unavoidable contingent rentals include lease payments contingent on indices and unavoidable performance-based contingent rentals (eg when the lessee is contractually required to keep the leased premises open to customers for a specified number of hours per day). Unavoidable performance-based contingent rentals exclude most usage-based contingent rentals. Recognising only unavoidable contingent rentals would be consistent with the definition of a liability in IAS 37.

BC125 In the boards' view, the measurement of the right-of-use asset and right to receive lease payments should reflect all rights received, even if the payment or receipt of these rights is contingent. For example, a lease could specify zero fixed lease payments and high contingent rentals.

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The right-of-use asset and right to receive lease payments for such a lease would be zero if contingent rentals were not included in the measurement of those rights. In the boards' view, the treatment of contingent rentals should be consistent with the treatment of lease payments in an optional lease extension. A lessee would recognise a right-of-use asset and a lessor would recognise a right to receive lease payments in the optional period, even if the lessee controls the option. This consistency would aid comparability with other leased and owned assets. The boards noted differences in the approach between IAS 37 and other IFRSs, but concluded that introducing recognition criteria similar to that in IAS 37 would result in the understatement of right-of-use assets by lessees and of rights to receive lease payments by lessors. It would also decrease comparability, introduce structuring opportunities and increase complexity.

BC126 The boards considered the view that it may be difficult for a lessor to estimate contingent rentals that depend on the actions of lessees. However, the boards expect that entities negotiate leases with contingent rental arrangements with some level of understanding about the likely amount of payments. Accordingly, the most useful information is obtained when a right to receive lease payments and a lease liability include an estimate of the expected lease payments. However, to address concerns about reliability, the boards propose that the lessor's right to receive lease payments should reflect contingent rentals and amounts receivable under residual value guarantees only if they can be measured reliably. This is consistent with the proposals in the boards' exposure draft *Revenue from Contracts with Customers*.

BC127 This exposure draft proposes that entities should account for residual value guarantees, in which a lessee compensates a lessor if the value of the underlying asset at the end of a lease is less than a specified amount, in the same way as it accounts for contingent rentals. In the boards' view, a residual value guarantee is equivalent to a contingent payment at the end of the lease term. The boards considered the view that entities should account for residual value guarantees separately because they are linked to the value of the underlying asset and may meet the definition of a derivative. Those with this view think that such guarantees should not affect the amount of the right-of-use asset or the right to receive lease payments. However, the boards think that residual value guarantees are often so interlinked with other lease terms that it could be misleading to recognise such guarantees separately.

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How to estimate amounts payable for contingent rentals (paragraphs 14, 35, 52 and B21)

BC128 The exposure draft proposes that an entity should measure the effect of contingent rentals using an expected outcome technique that requires the entity to consider a reasonable number of possible cash outflows and their probability distribution. The boards considered concerns that an expected outcome technique could be costly. However, an expected outcome technique need not always consider all possible outcomes using complex models and techniques. The boards think that it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows.

BC129 The boards rejected a measurement approach based on the most likely lease payments. Although such an approach would be consistent with the proposal that the lease term should be based on the longest possible term that is more likely than not to occur, and could be simpler and easier to apply than an expected outcome approach, the boards think that such an approach:

(a) would place too much emphasis on a single outcome.

(b) might provide misleading information to users of financial statements when the distribution of possible outcomes is skewed.

(c) would require additional guidance when two or more outcomes have the highest probability.

BC130 Therefore, the exposure draft proposes that the present value of lease payments should reflect a probability-weighted estimate of contingent rentals payable.

Contingent rentals based on an index or rate (paragraphs 14(a), 35(a) and 52(a))

BC131 In principle, forecasting techniques should be used to determine the effect of contingencies based on changes in an index or a rate. However, forecasting contingencies on the basis of changes in an index or a rate requires macroeconomic information that entities may not have readily available. In the boards' view, the usefulness of the additional information obtained using such a forecast would not justify the costs of obtaining it. However, if forward rates or the prices stipulated in the contract are readily available for the period of the lease term (eg from a government department or public service agency), using such forecasts would limit costs to adjusting the available rates or indices, while providing better information to users of financial statements. Therefore, the exposure draft

proposes that if lease payments are contingent on changes in an index or a rate, such as the consumer price index or the prime (basic) interest rate, the entity should measure the present value of lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the entity would use prevailing rates or indices.

Reassessment

Reassessment of lease term (paragraphs 17(a), 39(a) and 56(a))

BC132 In the discussion paper, the boards concluded that users of financial statements receive more relevant information when entities reassess the lease term at each reporting date because reassessment reflects current market conditions and, in the boards' view, using lease terms established at initial recognition throughout the lease arrangement could be misleading. Respondents to the paper were generally supportive of this preliminary view. Consequently, the exposure draft proposes that lessees and lessors should reassess the lease term at each reporting date.

BC133 Some respondents to the discussion paper were concerned that reassessment of lease terms would be costly for an entity with many leases. To address that concern, paragraphs 17(a), 39(a) and 56(a) propose that detailed examination of every lease is not required unless there has been a change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability.

Reassessment of contingent rentals, term option penalties and residual value guarantees (paragraphs 17(b), 39(b) and 56(b))

BC134 The exposure draft proposes that entities should reassess the expected lease payments if any new facts or circumstances indicate that there has been a significant change to the lease payments. The boards noted that reassessment of the expected lease payments would provide more relevant information to users of financial statements because it would reflect current economic conditions. However, the boards concluded that the benefits of reassessment would outweigh the cost of performing the reassessment only if there is an indication that there is a significant change in the lease payments.

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No reassessment of the discount rate (paragraphs 19, 40 and 57)

BC135 The boards think that options to extend the lease term have features that are economically similar to loan commitment facilities that permit multiple draw-downs. For these multi-draw loan facilities, the interest rate to be charged is set at inception and reflects the possibility of further draw-downs. Applying a similar approach to leases, the incremental borrowing rate used at inception for a lease with an option to extend would reflect the option to extend at the rate the lessor charges the lessee. The option to extend is an integral part of the lease at the date of inception of the lease, and the pricing of the lease should reflect the option. Therefore, the boards propose that the discount rate used to determine the present value of lease payments should not be revised when there are subsequent reassessments of the expected lease term or contingent rentals, unless the lease payments are contingent on variable reference interest rates. The boards also noted that this conclusion reflects conditions at the date of inception of the lease, which is consistent with the notion of cost-based measurement. This approach is less complex and costly for preparers to apply. The IASB also noted that this approach is consistent with the measurement principles of amortised cost in IAS 39 and [draft] IFRS *Financial Instruments: Amortised Cost and Impairment*.

Initial direct costs (paragraphs 12(b), 33(b) and 49(a), Appendix A and paragraphs B14 and B15)

BC136 Initial direct costs are incremental costs directly attributable to negotiating and arranging a lease. The exposure draft proposes that lessees and lessors should capitalise initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively.

BC137 The boards considered whether an entity should recognise initial direct costs as an expense when incurred. This approach would be consistent with the accounting for transaction costs arising in business combinations and arising on the acquisition of some financial instruments that are measured initially at fair value. However, the boards rejected this approach because capitalising initial direct costs is consistent with the treatment of the costs associated with acquiring other financial and non-financial assets (eg property, plant and equipment and intangible assets). In general, existing guidance includes

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in the cost of an asset the incremental costs directly attributable to the acquisition of the asset. Maintaining consistency between lease assets and underlying assets increases comparability and reduces structuring opportunities.

BC138 The boards also considered whether initial direct costs incurred by lessees should be allocated between the asset and liability arising from a lease at the date of commencement of the lease. However, the boards think that such an approach would be costly for entities to apply with little incremental benefit for users of financial statements and would add complexity to any proposed standard.

Measurement: subleases

BC139 An entity sometimes acts as both a lessee and a lessor of the same asset. In a sublease, an intermediate lessor enters into a leasing arrangement as both (a) a lessee, leasing an underlying asset from a head lessor, and (b) a lessor, subleasing the same underlying asset to a sublessee for the same or shorter term.

BC140 The boards considered how their tentative decisions for lessee and lessor accounting would apply to subleases. The exposure draft proposes that an intermediate lessor, as a lessee in a head lease, would account for the assets and liabilities arising from the head lease in accordance with the lessee model proposed in the exposure draft. Similarly, the intermediate lessor, as a lessor in a sublease, would account for the assets and liabilities arising from the sublease in accordance with the lessor model proposed in the exposure draft.

BC141 The boards acknowledged that the accounting for lessees and lessors could result in different measurements of assets and liabilities arising under a head lease and a sublease because a lessor measures a lease asset only on the basis of lease payments that can be measured reliably (paragraphs 35(a) and (b) and 52(a) and (b)), whereas a lessee does not consider measurement reliability (paragraph 14(a) and (b)) when it determines the liability to make lease payments (see paragraph BC126). Additionally, different discount rates may be used in each transaction. However, the boards think that a head lease and a sublease are separate transactions and entering into a sublease should not result in a different measurement basis compared with other leases. As noted in paragraph BC150, the boards propose separate presentation for a liability to make lease payments arising under a head lease.

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Presentation: lessees and lessors

BC142 The proposals for presentation of assets and liabilities arising from leases in the exposure draft do not consider the proposals in the boards' project on financial statement presentation. The boards will consider the effects of that project at a later date.

Presentation: lessees (paragraphs 25–27)

Statement of financial position (paragraph 25)

BC143 The exposure draft proposes that a lessee should present a right-of-use asset with property, plant and equipment so that the economic benefits arising from both leased and owned assets are presented in a similar way. Although some view a right-of-use asset as an intangible asset, the boards think that classifying a right-of-use asset with property, plant and equipment provides better information about how the lessee uses the underlying asset than classifying it as an intangible asset. Thus, such classification provides useful information about the productive capacity of a business.

BC144 However, the boards think that there are important differences between a right-of-use asset and an owned asset. For example, there may be greater financial flexibility for the payments associated with a right-of-use asset than for an owned asset or there may be greater risks because, for example, the lessee may need to replace the right-of-use asset at the end of the lease term but may not be able to secure a favourable rate for the replacement lease. Accordingly, the exposure draft proposes that in the statement of financial position lessees should present right-of-use assets separately from assets that are not leased.

BC145 Similarly, the exposure draft proposes that a lessee should present the liability to make lease payments separately from other financial liabilities in the statement of financial position. In the boards' view, a liability to make lease payments is a unique class of liability that is linked to a corresponding asset and may have features such as options and contingent rentals that differ from those in other liabilities. Thus, separate presentation of the liability to make lease payments provides users of financial statements with information that is important to

understanding the extent to which an entity uses lease arrangements and highlights the relationship between the liability to make lease payments and the right-of-use asset. The majority of responses to the discussion paper supported this view.

Statement of comprehensive income (paragraph 26)

BC146 The exposure draft proposes that lessees should present amortisation expense on the right-of-use asset and interest expense on the liability to make lease payments as separate line items in profit or loss or in the notes. In the boards' view, in most cases, disclosure in the notes would be sufficient to highlight the expenses that relate to leases. However, if considered relevant to an understanding of the entity's financial performance, an entity would present such items in profit or loss.

Statement of cash flows (paragraph 27)

BC147 The exposure draft proposes that lessees should classify separately cash repayments of amounts borrowed and interest payments arising from leases as financing activities in the statement of cash flows. This is because such amounts arise from a lease liability, which the entity incurs as part of a financing activity to acquire a right-of-use asset.

Presentation: lessors (paragraphs 42–45 and 60–63)

Performance obligation approach (paragraphs 42–45)

Statement of financial position (paragraphs 42 and 43)

BC148 The exposure draft proposes a form of linked presentation in which a lessor presents gross in the statement of financial position the underlying asset, the right to receive lease payments and the lease liability, totalling those amounts to a net lease asset or lease liability. The boards think that such a presentation has the following advantages:

(a) It reflects the interdependency of the underlying asset, right to receive lease payments and lease liability, while acknowledging that the criteria for offsetting that would permit the right to receive lease payments and the lease liability to be presented net are not met.

(b) It reflects that the lessor continues to own the leased asset.

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(c) It alleviates the concern that presenting separately the underlying asset, a right to receive lease payments and an offsetting lease liability inappropriately overstates both total assets and total liabilities in the statement of financial position.

BC149 The exposure draft also proposes that lessors should present the underlying asset, right to receive lease payments and lease liability separately from other assets and liabilities in order to distinguish assets and liabilities arising from a lease from other assets and liabilities. In the boards' view, information about assets and liabilities arising from a lease is important to understanding the lessor's lease arrangements. For example, rights to receive lease payments may include amounts receivable in an optional period or under contingent rental arrangements.

BC150 For lessors in a sublease, the boards propose that a liability to make lease payments arising under a head lease should be presented separately from the other assets and liabilities in the leasing arrangement (paragraph 43). This is consistent with the presentation requirements for lessees and lessors that are not in a sublease arrangement (paragraph 42).

Statement of comprehensive income (paragraph 44)

BC151 The boards propose that entities should present interest income, lease income and depreciation expense separately in profit or loss so that users of financial statements are informed about the income and expenses that relate to leases.

BC152 The FASB proposes that interest income, lease income and depreciation expense should total to a net lease income or net lease expense. Net presentation of income and expense is consistent with net presentation of a net lease asset or net lease liability in the statement of financial position. However, the IASB regards these items as separate components of comprehensive income that entities should recognise on a basis consistent with other interest income, and income and depreciation arising from non-leased assets. Therefore, the IASB does not propose to require presentation of a net total for interest income, lease income and depreciation expense.

Statement of cash flows (paragraph 45)

BC153 In the boards' view, lease income represents a lessor's income from operating activities. Therefore, the exposure draft proposes that an entity should classify cash flows arising from a right to receive lease payments and interest income from leases as operating activities, separately from other operating cash flows in the statement of cash flows.

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Derecognition approach (paragraphs 60–63)

Statement of financial position (paragraph 60)

BC154 The exposure draft proposes that rights to receive lease payments should be presented separately from other financial assets. The boards think that the nature of those assets, and therefore the cash flows that could be expected to arise from those assets, differs from other financial assets. Thus, separate presentation would provide information that is more useful to users of financial statements.

BC155 The exposure draft proposes that a residual asset should be presented separately within property, plant and equipment because the residual asset represents the lessor's interest in the underlying asset at the end of the lease term (which is property, plant and equipment), but has a risk profile and measurement approach different from other property, plant and equipment.

BC156 The boards propose that rights to receive lease payments and residual assets that arise from a sublease should be distinguished from other rights to receive lease payments and residual assets. This should enable users of financial statements to identify the relationship between the right to receive lease payments and the residual asset under the sublease and the liability to make lease payments arising from the head lease.

Statement of comprehensive income (paragraphs 61 and 62)

BC157 Business models vary among lessors. The boards propose to permit lessors to present lease income and lease expenses either gross or net. That would enable them to present the effects of leases in a way that provides information that reflects the economics of the lease.

BC158 If a lessor presents lease income and lease expenses gross, the exposure draft proposes that interest income on lease assets should be presented separately from other interest income so that users of financial statements can identify the interest relating to the right to receive lease payments. The nature of those assets and, therefore, the cash flows that could be expected to arise from them differ from other receivables. Accordingly, the boards think that separate presentation would provide information that is more useful to users.

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Statement of cash flows (paragraph 63)

BC159 The exposure draft proposes that in the statement of cash flows entities should classify separately cash repayments of a right to receive lease payments and interest income arising in leases as operating activities because all lease income represents income from operating activities for lessors (consistently with the conclusions in paragraph BC153).

Sale and leaseback transactions (paragraphs 66–69 and B31)

BC160 In a sale and leaseback transaction, one entity (the lessee) transfers an asset it owns to another party (the lessor) and then leases back that same asset.

BC161 The boards considered whether the transferred asset must be an entire leased asset (a 'whole asset' approach) or whether a bundle of rights and obligations associated with an asset could qualify for sale and leaseback treatment (a 'partial asset' approach). For example, in a sale and leaseback of an office building, the lessee would continue to recognise a portion of the building representing the right to use the building during the leaseback period and derecognise that portion of the building relating to the rights transferred to the lessor (eg ownership rights, the right to use the building after the end of the leaseback period and rights to change or develop the property). However, the boards do not propose a partial asset approach because they think it is more complex than a whole asset approach, without giving proportionate benefit to users of financial statements.

BC162 The boards propose that a transaction should be treated as a sale and leaseback transaction only if there is a sale of the underlying asset. The boards propose to use the same criteria for a sale as those used to distinguish between purchases or sales and leases (see paragraphs BC59–BC62). If the transaction meets those criteria, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee.

BC163 The lease payments and the sales price in a sale and leaseback transaction are usually interdependent because they are negotiated as a package. Thus, the sales proceeds might be more than the fair value of the asset because the leaseback lease payments are above a market rate, or the sales proceeds might be less than the fair value because the leaseback lease payments are below a market rate. That could result in the misstatement

of gains and losses on disposal and the right-of-use asset for the lessee, and the carrying amount of the underlying asset and the lease liability (if the lessor applies the performance obligation approach to lessor accounting) for the lessor.

BC164 The boards considered requiring entities to defer gains and losses that arise from a sale and leaseback transaction. However, deferring gains or losses is inconsistent with the boards' conceptual frameworks and would increase the complexity of the proposed requirements.

BC165 The exposure draft proposes that if the sale consideration and leaseback rentals are not at market rates, a lessee should adjust:

(a) the right-of-use asset to reflect current market lease payments for that asset; and

(b) the gain or loss on disposal of the underlying asset by any difference between the present value of lease payments specified in the lease and the fair value of the expected lease payments.

BC166 Because a combined transaction is accounted for as a sale and leaseback only when the transferee/lessor remains exposed to significant risks and benefits associated with the underlying asset during or after the expected lease term, the lessor would apply the performance obligation approach to the lease component. The exposure draft proposes that a lessor should adjust the lease liability by any difference between the fair value of the underlying asset and the cost of the asset under the performance obligation approach to lessor accounting.

BC167 In the boards' view, such adjustments ensure that the asset, liabilities, gains and losses recognised by both the lessee and lessor are neither understated nor overstated.

Disclosure: lessees and lessors (paragraphs 70–86)

BC168 In determining the disclosures for leases, the boards considered:

(a) the existing requirements in IAS 17 and Topic 840.

(b) IFRS 7 *Financial Instruments: Disclosures* (IAS 17 states that a lessee has to comply with the disclosure requirements in IFRS 7). However, the boards propose that entities should not be required to disclose the fair value of lease liabilities because doing so would reintroduce the costs and complexity that the boards intended to avoid by requiring such liabilities to be measured at amortised cost.

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BC169 In selecting the disclosure objectives, the boards considered work in other related projects. As a result, the boards propose that disclosures about leases should:

(a) identify and explain the amounts in the financial statements arising from leases.

(b) enable users of financial statements to evaluate the amount, timing and uncertainty of cash flows arising from leases (paragraph 70).

Disaggregation (paragraph 71)

BC170 The boards propose that an entity should aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics. The boards think this gives entities the flexibility to decide on an appropriate level of disclosure (whether by class, nature or function). Such disclosure enables users of financial statements to see the entity's risk exposure without combining information that has different characteristics.

Nature of lease arrangements (paragraphs 73(a) and 78)

BC171 IAS 17 and Topic 840 require a lessee or a lessor to disclose the nature of its lease arrangements. This might include information such as the basis on which contingent rentals are determined and the existence of restrictions imposed. The boards propose carrying forward this requirement because it provides users of financial statements with a basic understanding of the lessee's or lessor's leases. In addition, the boards think that disclosures about management's judgement on how contingent rentals are determined and the types of options that were recognised provide users of financial statements with better information about future cash flows.

BC172 Because the lessor's decision about which lessor accounting model to apply will have a significant effect on the amounts recognised in the financial statements, the boards propose that a lessor should disclose information about its exposure to the risks or benefits associated with the underlying asset during or after the expected lease term that it used in determining whether to apply the derecognition or performance obligation approach.

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Rights and obligations arising between the date of inception and date of commencement of the lease (paragraph 73(b))

BC173 Assets and liabilities arise at the date of inception of the lease. However, before the date of commencement of the lease, the lease is executory, ie it depends on future action by both parties. The boards do not propose that lessees and lessors should recognise a lease between the dates of inception and commencement of the lease, unless the contract is onerous (see paragraph 5(d)), because doing so would be inconsistent with the treatment of many other non-financial executory or forward contracts. Furthermore:

(a) at the date of inception of a lease, the value of the right to use an underlying asset would be equal to the present value of lease payments in most cases. Consequently, at the date of inception of the lease, the net measurement of a lease would normally be zero.

(b) the time between the dates of inception and the commencement of the lease is usually short. Thus, the costs associated with remeasurement would outweigh the benefits of remeasuring the contract.

BC174 However, in some cases, the assets and liabilities that arise from signing a lease could be significant before the date of commencement of the lease. Accordingly, the boards propose that entities should disclose information about the terms of the lease when the assets and liabilities between the dates of inception and commencement of the lease are significant. Such disclosures would inform users of financial statements that there may be significant assets and liabilities arising from leases that would be recognised in future periods.

Short-term leases (paragraph 75)

BC175 The exposure draft proposes additional disclosures for entities that apply the option to use simplified accounting for short-term leases to inform users of financial statements if and when an entity applies the simplified requirements and of the amounts in the financial statements relating to those leases.

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Sale and leaseback transactions (paragraph 76)

BC176 The exposure draft proposes that lessees should disclose the existence of sale and leaseback transactions, their terms and conditions and the gains and losses arising from those transactions. That would inform users of financial statements about transactions that could give rise to significant non-recurring gains and losses and cause a significant change in the capital structure of the entity.

Reconciliation of opening and closing balances (paragraphs 77 and 80)

BC177 The exposure draft proposes that a lessee should provide a reconciliation of opening and closing balances of right-of-use assets and liabilities to make lease payments and that a lessor should provide similar reconciliations for the rights to receive lease payments, lease liabilities (performance obligation approach) and residual assets (derecognition approach) because such reconciliations inform users of financial statements about changes to those assets and liabilities during the reporting period. This disclosure would be similar to that required for all intangible assets and property, plant and equipment.

BC178 In the boards' view, disaggregating such reconciliations by the type of underlying asset provides users of financial statements with information about how the underlying asset is used that is comparable to information about similar owned assets.

BC179 The exposure draft also proposes that a lessee should separately identify the total cash lease payments paid in the period because doing so provides users of financial statements with insight into the effect of leases on cash flows during the period.

Assumptions and estimates (paragraph 83)

BC180 The exposure draft proposes disclosures about a lessee's assumptions and estimates about the amortisation method used, options, contingent rentals, term option penalties, residual value guarantees and the discount rate used when determining the present value of lease payments because such disclosures provide users of financial statements with information about significant judgements.

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Information about risks (paragraph 84)

BC181 The exposure draft proposes that a lessee should disclose information about the risks arising from a lease because this will help users of financial statements to assess how those risks could affect the entity's cash flows.

Maturity analyses (paragraphs 85 and 86)

BC182 The exposure draft proposes that lessees should disclose a maturity analysis of the contractual maturities of their liabilities to assist users of financial statements in understanding and evaluating the nature and extent of liquidity risks. Entities would disclose the amounts due on an annual basis for the next five years, plus a lump sum for the remaining years. These maturity analyses are consistent with the maturity analyses required by US GAAP for leases and other financial liabilities. The IASB notes that this means lessees may present their lease obligations differently from other financial liabilities (for which the entity determines the appropriate maturity categories). However, in the IASB's view, comparability between leases in different jurisdictions is more important than comparability between liabilities within IFRSs.

BC183 The exposure draft also proposes that lessors should disclose a similar maturity analysis of the timing of the amounts due on their rights to receive lease payments. In the boards' view, such disclosure would assist users of financial statements to assess the expected timing and amount of future cash flows arising from the right to receive lease payments.

Effective date (paragraph 87)

BC184 The boards plan to consider the effective dates and transition for standards to be completed in 2011 collectively and therefore, they may modify their previously stated preferences in the case of some individual standards. As part of that consideration, the boards will consider whether to permit early adoption of the standard on leases.

BC185 Consequently, this proposed IFRS does not specify a possible effective date, nor whether the proposed requirements could be adopted early, but the boards intend to provide enough time to implement the proposed changes.

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Transition

Lessees and lessors (paragraphs 88–96)

BC186 The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach.

BC187 Unless transitional provisions are specified in a new IFRS, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to apply the changes in accounting policy arising from initial application of a new IFRS retrospectively unless impracticable. Similarly, for entities using US GAAP, Topic 250 *Accounting Changes and Error Corrections*, establishes, unless impracticable, retrospective application as the preferred method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. However, the boards think that the costs of a fully retrospective approach, which would require entities to calculate the carrying amounts of all outstanding leases as if those leases had always been accounted for in accordance with the proposed requirements, would be excessive and that the benefits provided by the information obtained by doing so would not outweigh those costs.

BC188 On the other hand, if the requirements in the proposed IFRS were applied only to leases that are entered into after the date of initial application of the proposed standard (a fully prospective approach), there would be inconsistent accounting for leases, both at the date of initial application and subsequently, depending on their dates of inception. This would be particularly true for leases that are currently classified as operating leases. Because leases can extend for many years, fully prospective approach would reduce comparability and thus reduce the usefulness of the information provided to users of financial statements while those leases remain outstanding.

BC189 To balance the necessity for comparable information about leases with the costs of restating contracts that may have been entered into many years previously, the exposure draft proposes that at the date of initial application entities should recognise assets and liabilities for all outstanding leases (paragraph 88). However, the measurement of those assets would be simplified by requiring the measurement of the assets and liabilities arising from a lease to be based only on the remaining lease

payments. Thus, costs would be reduced because entities would not be required to determine how assets and liabilities would have been measured in previous periods, but comparability at the date of initial application would be maintained.

Lessees only (paragraphs 90–93)

Uneven lease payments (paragraph 91)

BC190 In some cases, lease payments are not even during the term of the lease but include relatively large amounts at the beginning or end of the lease term. The boards think that in such cases the present value of the lease payments during the remaining term of the lease may not reflect the economic benefits available to the lessee. Accordingly, the exposure draft proposes that lessees should adjust the right-of-use asset on initial application to reflect any impairment or adjustments for lease payments prepaid or accrued.

Leases that do not have options, contingent rentals, term option penalties or residual value guarantees (paragraph 92)

BC191 Some think that the costs of restating assets held under finance leases and the associated liability as right-of-use assets and obligations to make lease payments would exceed the benefits because such leases already result in assets and liabilities in the statement of financial position. For many simple finance leases, there would be little difference between the accounting under the existing and proposed requirements, and thus the benefits of restating the assets and liabilities for those leases would be marginal.

BC192 However, when there are options, contingent rentals, term option penalties and residual value guarantees, there could be large differences in the measurement of assets and liabilities arising from the lease. For example, the exposure draft proposes that a lessee's lease liability include amounts expected to be paid under residual value guarantees, but a lessee currently measures the liability on the basis of the maximum amount payable.

BC193 The exposure draft proposes that, when an entity first applies the proposed standard, it need not remeasure the assets and liabilities arising from leases currently classified as finance leases if those leases do not include options, contingent rentals, term option penalties or residual value guarantees (paragraph 92). Instead, the carrying amount of the liability to make lease payments and the right-of-use asset at the date of

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initial application would be the carrying amount of the assets and liabilities arising from the lease determined in accordance with the previous requirements. For entities using IFRSs, this means that if the underlying asset is property, plant or equipment that has been revalued, the right-of-use asset is measured at the revalued carrying amount of the leased property, plant or equipment.

Discount rate on transition (paragraph 90(a))

BC194 The boards decided that a lessee should discount the remaining lease payments using the lessee's incremental borrowing rate at the date of initial application. In the boards' view, the costs of requiring a lessee to determine the incremental borrowing rate at the inception of a lease would not outweigh the benefits of providing this information.

Lessor only (paragraphs 94–96)

Discount rate on transition (paragraphs 94(a) and 95(a))

BC195 The boards decided that the original rate that the lessor charges the lessee should be used to discount the lease payments because such a rate is consistent with the rate used in new leases and is likely to be available to the lessor.

Performance obligation approach: previously derecognised assets (paragraph 94(c))

BC196 The exposure draft proposes that on transition a lessor should reinstate previously derecognised leased assets at depreciated cost, adjusted for impairment and (for entities using IFRSs) revaluation. The boards noted that this approach would result in recognition of an asset that is measured on a basis similar to other property, plant and equipment.

BC197 In some cases, entities might not have the information to determine what the depreciated cost would have been. However, an entity should have adequate information to be able to estimate the depreciated cost on the basis of the original cost of the asset, the date of acquisition of the asset and the period over which the asset is depreciated.

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BC198 The boards did not propose requiring the reinstated asset to be measured at fair value using the revaluation model for property, plant and equipment in IAS 16 because to do so would create inconsistencies with the treatment of property, plant and equipment under US GAAP. However, entities using IFRSs would be permitted to measure the reinstated asset at fair value in accordance with the revaluation model in IAS 16.

Derecognition approach: lessor's residual asset (paragraph 95(b))

BC199 The boards propose that on initial application, the lessor should measure the residual asset at fair value, determined at the date of initial application, because:

(a) it is less complicated than measuring the residual asset based on a cost allocation of an historical carrying amount; and

(b) it is consistent with IFRS 1, which permits first-time adopters of IFRSs to use fair value as deemed cost for property, plant and equipment.

Cost-benefit considerations

BC200 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users of financial statements in making economic decisions. To attain this objective, the boards endeavour to ensure that new standards will meet a significant need and that the overall benefits of the resulting information justify the costs of obtaining it. Although the costs to implement new standards might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

BC201 The evaluation of costs and benefits is necessarily subjective. In making their judgement, the boards considered the following:

(a) the costs incurred by reporting entities.

(b) the costs incurred by users of financial statements when information is not available.

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(c) the comparative advantage that reporting entities have in developing information, compared with the costs that users of financial statements would incur to develop surrogate information.

(d) the benefit of better economic decision-making as a result of improved financial reporting.

(e) the costs of transition for users of financial statements, reporting entities and others.

BC202 The objective of the proposed IFRS is to establish principles so that lessees and lessors report relevant and representationally faithful information to users of financial statements about the amounts, timing and uncertainty of the cash flows arising from leases. However, the boards also considered the cost of implementing the proposed IFRS and applying it on a continuous basis. During the development of the draft IFRS, the boards obtained views from the International Working Group on Lease Accounting and from users of financial statements, regulators, preparers, auditors and others from a range of industries across different geographical locations. Those activities helped the boards evaluate the relative costs and benefits of the proposed IFRS.

BC203 During their outreach activities, the boards discussed the proposed model, in particular, the concerns about its implementation. Many interested parties agreed that the overall lease model is appropriate. However, some preparers, particularly those in the retail industry, thought that the administrative burden arising from implementing the model outweighed the benefits it provided. Their specific concerns were:

(a) Determining an appropriate discount rate for each contract and measuring the liability to make lease payments on an amortised cost basis would place a significant strain on resources, especially if an entity has a large volume of small leases with different terms.

(b) The cost of reassessing contingent rentals and options to extend or terminate a lease on a lease-by-lease or store-by-store basis at each reporting date is unduly burdensome, especially for entities that have a large volume of leases, and such reassessment does not necessarily result in more accurate or useful information.

(c) A new lease model would not change the way a business operates or add benefit to the business. However, it would result in significant costs because it would require a change to management reporting.

(d) There would be practical difficulties in gathering and compiling lease information that might be distributed all over the world and be associated with leases that have very different contract terms.

BC204 In contrast, the majority of users of financial statements think that the proposed model is an improvement to existing lease accounting requirements. Many users note that the proposed standard would increase the accuracy of the information provided as well as increase comparability between entities. In particular, they regard the following as improvements:

(a) Because users of financial statements would no longer need to make adjustments to operating lease information, the information produced under the proposed model would be more useful for decision-making and would result in improved comparability because there would be less weight placed on individual analysts' judgements.

(b) Because assets and liabilities would include the effects of contingent features and amounts payable in optional periods, users would receive better information about expected cash flows, so long as changes in estimates and assumptions are clearly disclosed in the notes to the financial statements. Previously, analysts found it difficult to determine the duration of leases and the expected amount of the lease payments.

BC205 In the light of the feedback received, the boards modified the treatment of options and contingent rentals in the proposed model for lessees and lessors and simplified the accounting for short-term leases. However, the basic model has been retained. In particular, as noted in paragraphs BC133 and BC134, the boards think that the benefits of reassessment would outweigh the costs only if there is an indication of a significant change in the expected lease payments. Therefore, the exposure draft proposes that detailed examination of every lease is not required unless a significant change in the lease payments is expected to occur. Having made this change, the boards think that the benefits of the proposed IFRS outweigh the costs involved in its initial and continuing application.

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Alternative view of Stephen Cooper

AV1 Mr Cooper voted against publication of the exposure draft because he disagrees with the proposals relating to the inclusion of some optional lease periods and some contingent rentals in the recognition and measurement of the lessee's right-of-use asset and lessor's receivable. Mr Cooper strongly supports the adoption of the right-of-use model for lessee accounting; however, he thinks that the proposed treatment of options and contingent rentals would overstate financial leverage and would not provide useful information. He also disagrees with the proposed transition provisions for both lessee and lessor accounting and the subsequent measurement of the residual asset in the derecognition approach to lessor accounting.

Optional lease periods

AV2 Paragraphs 13, 34 and 51 require optional lease periods to be included in the recognition and measurement of the lessee's right-of-use asset and the lessor's receivable based upon the longest period more likely than not to occur. Mr Cooper disagrees with this approach. In his view optional lease periods should be reflected in the measurement of recognised assets and liabilities only when the arrangement includes an incentive to extend the lease period such as penalties payable on cancellation or reduced rentals in the optional period, or where costs of customisation or installation make renewal likely. However, if the exercise of options to extend merely depends on future business conditions it is inappropriate to reflect this in the measurement, even if extension or renewal of the lease is likely.

AV3 Mr Cooper thinks that options to cancel and extend leases provide a lessee with flexibility to react to changing business circumstances and consequently these features reduce risk. If all lease payments in (more likely than not) optional lease periods are included in the recognition and measurement of the right-of-use asset then the resulting liability and related measures of financial leverage are overstated. Mr Cooper appreciates that the impact of optional lease periods is included in the proposed disclosures, which he supports; however, he does not consider this is enough to mitigate the problem.

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AV4 Mr Cooper thinks that the consequence of including all optional lease periods in the recognition and measurement of the lessor's receivable (under both the performance obligation and derecognition models) is that investors may underestimate the business risk of the lessor. In his view the overstatement of the receivable implies exposure to credit risk when the reality is an exposure to underlying asset risk.

Contingent rentals

AV5 Mr Cooper's concerns over contingent rentals are similar to those for optional lease periods. Paragraph 14 requires all forecast contingent rentals to be included in the calculation of the expected lease payments and hence the measurement of the lessee's liability. A similar approach is applied for the lessor except that only lease payments that can be reliably estimated are included (paragraphs 35 and 52). Mr Cooper supports this approach if rentals are contingent on an index or rate but disagrees where rentals vary according to asset usage or performance. As with optional lease periods Mr Cooper thinks that such contingent rental arrangements provide the lessee with additional flexibility and contribute to reduced business risk whereas for the lessor they increase exposure to asset risk. Reflecting all expected contingent rentals in the measure of the lessee's liability and the lessor's receivable does not provide relevant information about the economics of such leasing arrangements.

AV6 Mr Cooper also has concerns over the reliability of measures that include estimates of contingent rentals based upon management forecasts of business performance over many years.

AV7 Mr Cooper also questions whether lease payments which an entity has no contractual or constructive obligation to pay meet the definition of a liability. In paragraph BC123 there is the assertion that the liability definition is satisfied and that the inclusion of contingent rentals is simply a question of measurement. Mr Cooper accepts that this is a valid interpretation of the *Framework*, but does not believe that it is the only interpretation. Accordingly he is of the view that the decision regarding the treatment of contingent rentals (and similarly optional lease periods) must be based upon the relevance of the resulting financial statement information.

AV8 Paragraph BC123(b) states that one reason for the proposed approach to optional lease periods and contingent rentals is to avoid structuring opportunities. Mr Cooper does not think this concern should outweigh the provision of relevant information and considers that it is possible to

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avoid structuring opportunities by establishing principles for identifying where optional lease periods and contingent rental arrangements lack economic substance and represent disguised minimum rental payments and through appropriate disclosure.

Transitional provisions

AV9 Mr Cooper disagrees with the proposed transitional provisions described in paragraphs 88–96. He thinks that the proposed approach will lead to a misleading and inappropriate reduction in profit of a lessee on transition and increased profit growth in subsequent periods. The opposite effect will arise for lessors. The recognition of a right-of-use asset and related liability by a lessee would be expected to produce a higher aggregate expense in the early part of a lease term compared with simply recognising rentals as an expense, with the opposite effect in the latter part of a lease term. This is a consequence of treating the transaction as a financing and the existing approach to amortisation. Mr Cooper does not disagree with this and observes that the impact of this on overall profitability for a lessee applying the new approach would generally be small given that different leases will all be at different stages in their life. However, if, as proposed, all leases are effectively reset to 'year 1' on transition then the impact on profits could be significant and misleading.

AV10 Mr Cooper thinks that other transitional provisions should be considered. For example, in addition to the proposed approach fully retrospective application could also be permitted or the proposed transitional provisions could be amended so that the right-of-use asset is not set equal to the transition liability, but instead takes account of the impact of the remaining lease term compared with the original lease period.

Subsequent measurement of residual asset in the derecognition approach

AV11 Mr Cooper disagrees with the requirement in paragraph 55 not to remeasure the residual asset in the derecognition approach for lessor accounting. He agrees with the initial measurement, but thinks that this amount should then be accreted to reflect the time value of money. In his view a failure to do so understates the profitability of the lessor during the period of the lease with a catch-up arising when the asset is sold or used in a subsequent period or periods.

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