Revised IASB Exposure Draft *Leases*

Additional public consultation

EFRAG will have access to the information that you provide in response to this questionnaire. Your response will be also shared with participating European national standard setters on an anonymous answer (ie, participants' identity will remain confidential).

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Background

1 In May 2013, the IASB and the FASB ('the Boards') published a revised Exposure Draft Leases ('the ED'). The core principle of the ED is that lessees shall recognise assets and liabilities for all leases (other than short-term leases).

2 Constituents in Europe have repeatedly expressed concerns that the definition and criteria to identify a lease may capture arrangements that are in substance services. However, no consensus has emerged on an alternative definition or criteria to identify a lease during the comment period or in the extensive outreach performed by the Boards.

3 In January 2014, the Boards started their re-deliberations on the Leases proposals. In March, the two Boards tentatively decided to support two different approaches for lessees, which are briefly explained below.

4 EFRAG and the National Standard Setters of France, Germany, Italy and the UK are interested in:

(a) examples of transactions that would qualify as leases under the proposals, but that in the constituents' view are in substance services and therefore should not be recognised on a lessee's balance sheet; and

(b) constituents' views on the two alternative approaches.

Please refer to the detailed questions on page 7 below.

5 EFRAG and the National Standard Setters conducted two prior surveys to consult on the proposals in the ED, including the definition of, criteria to identify a lease, separation of components and possible simplifications. The findings from these surveys are available at:

(a) http://www.efrag.org/files/ED%20Leases%202013/ED_Leases_2013_-_Report_on_leases_field-test.pdf

(b) http://www.efrag.org/files/EFRAG%20public%20letters/Leases/EFRAG_limited_survey_on_the_simplifications_to_ED_Lease.pdf

6 Please document your observations and findings in English in the sections specified. If you have any questions about this consultation, please contact your designated point of contact.

7 Participants may choose not to respond to all the questions. In the conclusions to be drawn from this public consultation, more weight will be given to responses that are substantiated by facts and analysis.

8 Participants are requested to submit their replies <u>no later than</u> **Friday 22nd August.**

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DEFINITION AND CRITERIA TO IDENTIFY A LEASE

9 The ED requires entities to determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and

(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration (that is, the customer has the ability both to direct the use of the identified asset and to derive the economic benefits from use of that asset during the period of use).

10 At their May 2014 meeting, the Boards clarified the following regarding whether fulfilment of the contract depends on the use of an identified asset:

(a) fulfilment depends on the use of an identified asset when the supplier has no practical ability to substitute an alternative asset or the supplier would not benefit from substituting an asset; and

(b) a customer should presume that fulfilment of the contract depends on the use of an identified asset if it is impractical for the customer to determine either (1) whether the supplier has the practical ability to substitute an alternative asset or (2) whether the supplier would benefit from the substitution.

11 Regarding the right to control the use of an identified asset, the Boards decided to:

(a) provide additional guidance on how to determine which decisions most significantly affect the economic benefits to be derived from use of the identified asset and which party to the contract has the ability to most significantly affect those economic benefits particularly, when the supplier and the customer both have decision-making rights; and

(b) remove the guidance that was proposed in the ED on assets that are incidental to the delivery of services.

DESCRIPTION OF THE APPROACHES

Common features

12 Including the tentative decisions made at the June 2014 meeting, the two Boards are converged on the following aspects in relation to lessee accounting:

(a) The definition of a lease;

(b) The recognition of all leases (other than the exemptions noted below) on a lessee's balance sheet;

(c) The criteria and guidance to identify if an arrangement contains a lease;

(d) The requirement to separate lease and non-lease components, and guidance to allocate total consideration;

(e) The initial measurement of the lease liability (present value of the future lease payments) and right-of-use asset (the amount of the lease liability plus initial direct costs);

(f) The guidance on discount rates, options and variable lease payments;

(g) The requirement to present or disclose right-of-use assets and lease liabilities separately from other assets or liabilities;

(h) The possibility to use a 'portfolio approach'; and

(i) An exemption for (and definition of) short-term leases.

13 The Boards have agreed not to specify how to present lease liabilities, although both Boards agree that lease liabilities meet the definition of financial liabilities.

14 The approaches of the two Boards differ in relation to:

(a) The subsequent measurement of the right-of-use asset for those leases that, in the FASB model, are not in substance purchases of the underlying asset;

(b) The presentation of the lease expense in the income statement;

(c) The presentation of the lease payments in the statement of cash flows; and

(d) An exemption for 'small' assets (eg laptops and office furniture).

IASB approach

15 The IASB approach requires a lessee to recognise a right-of-use asset and a lease liability at the commencement date of each lease. An entity may elect not to recognise assets and liabilities in relation to:

(a) Short-term leases; and

(b) Leases of 'small' assets.

16 After commencement, a lessee shall measure the lease liability at the present value of future lease payments and amortise the right-of-use asset over the lease term in accordance with the requirements in IAS 16 *Property, Plant and Equipment*. This results generally in a straight-line amortisation of the right-of-use asset and a declining interest expense on the lease liability.

17 A lessee shall present the interest expense on the lease liability within finance (interest) costs and the amortisation of the right-of-use asset typically within the same line item as depreciation on items of property, plant and equipment (ie within operating expenses). Without further guidance regarding presentation, lessees applying IFRS would apply the requirements in IAS 1 *Presentation of Financial Statements*. This is likely to result in a lessee (that applies IFRS) presenting lease liabilities either as a separate line item or together with similar financial liabilities.

FASB approach

18 The FASB model distinguishes between leases that are in substance purchases of the underlying asset (written as leases) and leases that are not in substance purchases of the underlying asset. The distinction is based on the principle used in IAS 17 *Leases* to distinguish finance leases from operating leases.

19 A lessee shall recognise a right-of-use asset and a liability for all leases, whether they are in substance purchases or not. An entity may elect not to recognise assets and liabilities for short-term leases.

20 For leases that are in substance purchases, a lessee shall account for the transaction in the same manner as any other financed purchase. After commencement, this results generally in a straight-line depreciation of the asset and a declining interest expense on the lease liability.

21 After commencement, leases that are not in substance purchases are accounted for using a single approach that recognises a single lease expense measured generally on a straight-line basis over the lease term. The lease liability is measured at each reporting date at the present value of future lease payments, while the right-of-use asset equals the lease liability (as adjusted for any prepaid/accrued rent).

22 The single lease expense shall be presented within operating expenses. Liabilities arising from leases that are in substance purchases shall not be presented together with liabilities arising from leases that are not in substance purchases. The FASB staff noted that for example, in the United States, current operating lease obligations are not considered debt in the event of bankruptcy, which may suggest that characterization of the obligation as operating rather than debt-like in nature would be appropriate.

Rationale for the approaches

23 Under both approaches, the commencement of a lease gives rise to an asset and a liability. Both boards concluded that the lessee has obtained control of the right to use the underlying asset when the lessor makes the underlying asset available for use by the lessee. The lessee has a liability because it has a present obligation to make lease payments, arising from the lessor’s transfer of the right of use at lease commencement.

24 The IASB approach views a lease as providing a lessee with a non-financial asset that it typically uses over time and for which it pays over time. Accordingly, the IASB approach requires a lessee to account for the right-of-use assets consistently with other non-financial assets and lease liabilities consistently with other similar financial liabilities. Such an approach removes the need for a lease classification test, compared to the existing requirements in IAS 17 and the FASB approach. A lessee could use its existing systems for finance leases, or its existing systems for fixed assets or financial liabilities when applying the proposed accounting. Alternatively, it could use its existing systems used to produce operating lease disclosures as the starting point for measuring the lease liability.

25 The FASB approach views a lease as a single unit of account. A single lease expense is recognised generally on a straight-line basis because it represents the generally equal benefit the lessee receives each period throughout the lease term, as well as the periodic cost of the access to that benefit. If payments are equal over time the lease asset and lease liability should decline at the same rate over time. Under the FASB approach, the effect of leases on the income statement (ie, the cost recognition pattern and presentation of lease expense) would be unchanged from existing guidance.

26 Because of how the single lease expense, the right of use asset and the lease liability are calculated under this approach, lessees can apply this approach using their existing systems and processes for producing the straight-line lease expense and existing lease disclosures in the notes with little incremental change. At each reporting date, lessees would only need to record the right of use asset and liability using information already produced and tracked by existing systems.

Questions

Identification of a lease

Q1 You are invited to provide examples of transactions that would qualify as leases under the proposals, but you consider to be in substance services.

Q2 For these transactions, please specify the following:

(a) Why should this transaction not be treated as a lease and recognised by a lessee?

(b) What changes could be made to the definition and/or criteria to identify a lease, to exclude this transaction from the scope of the proposals?

(c) How common in practice is this type of transaction?

Alternative approaches

Q3 Assuming that the Boards confirm the scope of application and the guidance to identify a lease, which of the approaches described above in paragraphs 14 to 21 do you prefer? Please explain the reasons for your views.

Q4 Based on the description above, which of the two approaches you believe to be less complex and costly to implement? Please explain the reasons for your views.