cutting through complexity

Leases

Tatsumi Yamada

Board Member and Partner

KPMG AZSA LLC

(Former Board Member of the IASB)

Contents

- Project Development
- Key point related to recognition of assets and liabilities
  - Separation of service component
- Scope
- Lessee Accounting
  - Two models: SLE Model and I&A Model
  - Lease Liability (LL)/Right-of-use (ROU) Asset
- Lessor Accounting
- Sale and Leaseback Transactions
- Other

Project Development

- Joint project with the FASB
- March 2009: Discussion Paper *Leases - Preliminary Views*
- August 2010: Exposure Draft *Leases*
- 2Q 2013: Exposure Draft *Leases* (expected)
- Example A : Three-year contract for office cleaning with a cleaning company for $100 p.a.
- Example B: Three-year lease contract of a copy machine for $100 p.a.
- No asset or liability is recognised in the case of Example A, but a lease liability (LL) of $300 and a right-of-use (ROU) asset of $300 are recognised in the case of Example B

Perceived Deficiencies and Objectives of the Project

- Existing lease accounting doesn't meet users' needs
  - Accounting depends on classification
  - Users adjust financial statements to recognise assets and liabilities arising in operating leases
- Complexity
  - Difficult to define dividing line between finance and operating
- Operating Lease (OL) accounting should be removed (but remain for lessors in limited cases)
  - This amendment will affect all the entities that use OL accounting

Key Point Related to Recognition of Assets and Liabilities

- To treat an executory contract as a non-executory contract in the case of a lease contract
- Example A: Three-year contract for office cleaning with a cleaning company for $100 p.a.
- Example B: Three-year lease contract of a copy machine for $100 p.a.
- No asset or liability is recognised in the case of Example A, but a lease liability (LL) of $300 and a right-of-use (ROU) asset of $300 are recognised in the case of Example B

Separation of Service Component

- The IFRS on Leases will apply to a contract that contains both a service component (SC) and a lease component, except
  - Lessee: to apply the IFRS on Revenue to SC if SC is distinct and the lessee is able to do so
  - Lessor: to apply the IFRS on Revenue to SC if SC is distinct and the lessor is able to do so
- Example: a car lease contract with service maintenance agreement
  - Monthly payment of 1,000 including 200 for service maintenance
  - 800 for a car lease should be recognised as a right-of-use (ROU) asset and a lease liability (LL)
  - 200 for service should NOT be recognised as ROU asset and LL

Scope

Excluded

- Contracts representing the purchase/sale of the underlying asset (UA)
- Leases of intangible or biological assets
- Leases to explore for or use natural resources
- Service component (SC) of a contract that contains a SC and a lease component, if it meets certain criteria (mentioned in the previous slide)

Included

- Sales and leaseback transactions
- Subleases
- In-substance purchase/sales

Lessee (Two Models)

- Lessee should recognise a right-of-use (ROU) asset and a lease liability (LL)
- At initial recognition, LL should be measured at the PV of the lease payments (= ROU)
- Two models: Single Lease Expense (SLE) Model (Type 2) and Interest & Amortisation (I&A) Model (Type 1)
- SLE Model: (a) LL should be measured at amortised cost
  (Type 2) (b) recognise total lease expense on a straight-line basis (single line)
  (c) adjust the carrying amount of the ROU asset by the difference between the total lease expense and the interest expense on the LL
- I&A Model: (a) LL should be measured at amortised cost, recognising interest expense in the
  (Type 1) Statement of Comprehensive Income (SCI)
  (b) amortise the ROU asset on a straight-line basis, recognising amortisation expense in the SCI
- Short -term (less than 1 year) Lease: choice of OL Model or Asset/liability Recognition Model

Classification Test

- The test will be based on the extent of consumption of the underlying asset (UA)
  (i.e. whether the lessee acquires more than an insignificant portion of the utility of the UA)
- Practical expedient: This should be based on the nature of the UA
  Lease of real estate (land, buildings, part of buildings or both)

Leases - Lessee - Right-of-use Model and Measurement

- Right-of-use Model

	Type1 (I&A)	Type2 (SLE)
SFP	A right-of-use (ROU) asset An obligation to pay rentals (LL)	A right-of-use (ROU) asset An obligation to pay rentals (LL)
SCI	Amortisation of ROU asset Interest expense on LL	Single lease expense (SLE)

- Measurement

		Initial Measurement	Subsequent Measurement
T-1 (I&A)	LL	PV of lease payments discounted using incremental borrowing rate	Amortised cost – no revision of incremental borrowing rate
	ROU Asset	Cost	Amortised cost – option to revalue
T-2 (SLE)	LL	PV of lease payments discounted using incremental borrowing rate	Amortised cost – no revision of incremental borrowing rate
	ROU Asset	Cost	Balancing figure (a plug)

Leases - Lessee - SLE Model

- Example: (office lease：accounting by lessee)
  - a 3-year office lease, total lease payments are $300M ($100M/year)
  - Discount rate is 5%; payment is made at year end
  - PV of minimum lease payments is =96+91+86=273
  - Interest expense=14+9+4=27
  - Deprecation of Right-of-use (ROU) Asset=273/3=91

	YEAR1	YEAR2	YEAR2
Book value	273	187	96
Interest expense	14	9	4
Amount paid	-100	-100	-100
Book value	187	96	0

- In the Single Lease Expense (SLE) Model, to make the lease payment (rental expense) a fixed amount, the ROU asset is calculated as a plug.

ROU Asset (I&A Model)

	YEAR 1	YEAR 2	YEAR 3
Book value	273	187	96
Amortisation	86	91	96
Book value	187	96	0

ROU Asset (SLE Model)

	YEAR 1	YEAR 2	YEAR 3
Book value	273	182	91
Amortisation	91	91	91
Book value	182	91	0

Leases - Lessee - Office Rental

■ Journal Entries (Office Rental ：Lessee)

	Interest and Amortisation (I&A) Model				Single Lease Expense (SLE) Model			
Contract DT	ROUA	273	／ LL	273	ROUA	273	／LL	273
Year 1	LL	100	／ Cash	100	LL	100	／ Cash	100
	Interest exp	14	／ LL	14	Rental exp	100	／ LL	14
	Amortisation	91	／ ROUA	91			／ ROUA	86
Year 2	LL 100		／ Cash	100	LL 100		／ Cash	100
	Interest exp	9	／ LL	9	Rental exp	100	／ LL	9
	Amortisation	91	／ ROUA	91			／ ROUA	
91								
Year 3	LL	100	／ Cash	100	LL	100	／ Cash	100
	Interest exp	4	／ LL	4	Rental exp	100	／ LL	4
	Amortisation	91	／ ROUA	91			／ ROUA	96

Initial Measurement :

PV of lease payments discounted using lessee's incremental borrowing rate

- Lease Term: including significant economic incentive to extend the term of the lease
- Variable Lease Payments (VLP) that depend on a rate or index
- Purchase Options: if there is significant economic incentive
- Residual Value Guarantees (RVG)
- Termination Penalties

Subsequent Measurement:

- Amortised cost using the effective interest method
- Facts and circumstances indicated that there would be significant changes in the LL:
  - Reassessment of lease term: to adjust ROU asset
  - Reassessment of RVG and VLP:
    - to adjust ROU asset if related to future periods
    - to recognise as profit or loss if related to current or previous periods
- Lessee's incremental borrowing rate is reassessed when there is a change in lease payments due to:
  - A change in assessment of significant economic incentive to exercise a renewal or purchase option

Leases – lessee – Right-of-use (ROU) Asset

Initial Measurement :

ROU asset is initially measured as the sum of:

- PV of lease payments
- Initial direct costs
- Prepaid lease payments

Subsequent Measurement:

ROU asset (I&A Model) :

- Amortise over shorter of lease term or economic life
- Can be revalued
- Impairment testing based on IAS 36

ROU asset (SLE Model):

- ROU asset considered linked to LL
- ROU asset is measured as a plug
- Impairment testing based on IAS 36

Lessor (Two Models)

- Two models: the Receivable and Residual (R&R) Model and the Operating Lease (OL) Model
- R&R Model: (a) recognise a lease receivable (LR) and a residual asset (RA) on commencement of the lease
  (b) measure the LR initially at the PV of the lease payments
  (c) recognise the RA as an allocation of the carrying amount (CA) of the underlying asset (UA) based on the LR and FV of the UA
  (d) as a result, there is a Day 1 gain as the difference (LR + RA – CA of the UA)
  (e) recognise interest income on both the LR and RA over the lease term
- OL Model: (a) continue to recognise the UA
  (b) recognise the lease payments over the lease term (straight-line basis)
- Short-term Lease: apply the OL Model
- The criteria for the lessee are used to distinguish leases to which the R&R Model or the OL Model applies

Classification Test (Same as the Lessee)

- The test will be based on the extent of consumption of the UA
  (i.e. whether the lessee acquires more than an insignificant portion of the utility of the UA)
- Practical expedient: This should be based on the nature of the UA
  Lease of real estate (land, buildings, part of buildings or both)

Sales and Leaseback Transactions (SLBT)

- When determining whether a sale has occurred in a sale and leaseback transaction (SLBT), an entity should apply the guidance developed in the Revenue Recognition project to the entire transaction
- The existence of the leaseback does not, in isolation, prevent the transaction from being accounted for as a sale and a leaseback
- However, if the leaseback is of such a nature that the seller/lessee has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset, a sale has not occurred
- For the purpose of a SLBT, the seller/lessee is assumed to have the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset if:
  - the lease term is for the major part of the economic life of the underlying asset; or
  - the PV of the minimum lease payments accounts for substantially all or the FV of the UA
- If there are multiple lease components in the transaction, the assessment should be performed for each lease component separately
- If an entity concludes that a sale has not occurred in accordance with the revenue recognition guidance, the entire transaction should be accounted for as a financing arrangement

Challenges in Applying the New IFRS on Leases

- It might be difficult to gather information to recognise ROU assets and LL, e.g. copy machines
- Separation between service component (SC) and lease component and application of the different accounting might be burdensome
- Two models may be a cause of complexity
- Whether the Single Lease Expense Model for lessees is conceptually justifiable
- Whether the Receivable and Residual (R&R) Model for lessors is easy to apply

cutting through complexity

Contact

Tatsumi Yamada

Head of IFRS, KPMG Asia Pacific

Board Member and Partner, KPMG AZSA LLC

TEL : +81 3 3548 5555 Ext. 3968

Tatsumi.yamada@jp.kpmg.com

www.azsa.or.jp