

The New Models for Lease Accounting

A Review of the IASB's revised Exposure Draft ED/2013/6 Leases

By Tan Liong Tong

In May 2013, the IASB issued a revised exposure draft ED/2013/6 *Leases* to introduce new models for lease accounting. The proposals in the new models would affect all reporting entities and would bring about fundamental changes to the current practice on lease accounting. Hence, it is imperative that preparers and other users of financial statements are aware, and understand these developments, which would later be part of the IFRS Framework when the proposals are finalised.

This article examines the history, reasons for and rationale of the proposed standards on leases, explains the salient features and draws some implications on practice. It aims to assist preparers and users of financial statements better understand the requirements of the proposed standards and prepare for application when they become part of the IFRS-compliant Malaysian Financial Reporting Standards in the near future.

1. History, Reasons and Rationale

The first version of IAS 17 was issued by the then IASC in September 1982 and revised in December 1997. The second revised version was issued by the IASB in December 2003. In April 2009, an amendment was made to the IAS about the classification of land leases as part of the *Annual Improvements to IFRSs* in 2009. The revised IAS 17 remains effective to date.

The related interpretations on lease accounting issued are:

- a) SIC-15, Operating Leases – Incentives (issued in December 1998);
- b) SIC-27, Evaluating the Substance of Transactions Involving the Legal Form of a Lease (issued in December 2001); and
- c) IFRIC 4, Determining whether an Arrangement contains a Lease (issued in December 2004).

The current IAS 17 classifies leases into one of two categories: finance leases and operating leases. The classification is based largely on the criterion of the extent to which significant risks and rewards incident to ownership of the asset lie. Users have expressed concern that applying this “risks and rewards” approach has resulted in many assets and liabilities under lease contracts failing the recognition test, i.e., they are unrecognised (off-balance sheet). In an operating lease, a lessee would just need to record the lease payments as an expense.

The IASB noted that investors and other users of financial statements have to estimate the effect of operating leases on financial leverage and earnings, as there are deficiencies in the quality of information on lease accounting under the current IAS 17. The current lease accounting does not provide a complete picture of an entity's leasing activities. Many investors believe that operating leases give rise to assets and liabilities, and hence, should be reflected in the statement of financial position. Otherwise, the indicators of gearing or leverage are understated. If similar transactions are accounted differently, it would be hard for users to compare different entities and the implications of different leases. It could also lead to structuring opportunities whereby lease contracts could be structured in a particular way that they lead to a particular outcome. For example, a lease contract can be structured in a way that it does not meet any of the “bright-line” indicators of IAS 17, and therefore, classified as an operating lease in order to “disguise” the gearing of a lessee, and thereby achieves a particular capital structure. The information provided can be misleading.

The IASB's project on leases aims to correct those deficiencies in IAS 17. In March 2009, the IASB and the FASB published a joint discussion paper on leases. In August 2010, the original exposure draft, ED/2010/9, *Leases*, was issued to set out a proposal for a new IFRS on leases. The IASB received almost 800 comment letters in response to the 2010 ED. It also held extensive consultation with interested parties at more than 300 meetings and other events throughout the world, including conferences, workshops and

round-table discussions. On the basis of the feedback received and the discussions, the proposals in the original ED have been changed substantially, including the lessee and lessor accounting models and how lease assets and lease liabilities are measured.

2. The Original 2010 ED

The IASB emphasises that similar transactions should be accounted for in a similar manner. It believes that reflecting all assets and liabilities under lease contracts would achieve this requirement. The proposed approach in the original 2010 ED to lease accounting focused on the rights and obligations of the counterparties in a lease contract (quite similar to the approach used for financial instruments in IAS 39). Recognising all the rights and obligations in leases as assets and liabilities would provide a more complete picture of an entity's leasing activities.

For lessee accounting, the original 2010 ED proposed a right-of-use model which would require a lessee to recognise assets and liabilities for the rights and obligations created by leases. Feedback to the ED indicated that there was general support for the recognition of assets and liabilities arising from leases by lessees.

However, that original ED also proposed a single model for the recognition of expenses arising from leases. Regardless of the nature of the underlying asset or the lease term, a lessee recognises a straight-line amortisation of the right-of-use asset and an interest expense based on the effective interest rate method. This would have the effect of a faster recognition of expenses in profit or loss in the earlier years of a lease contract than in the later years. For current finance leases, a faster recognition of expenses is supportable because such leases are viewed primarily as financing transactions, similar to a purchase of an asset with borrowings. However, for current operating leases (e.g. leases of property and other short-term leases), a faster recognition of expenses is not supportable. Many lessees view their operating leases as an operating transaction in that they are merely paying a rent for the use of the underlying asset. That rent paid is generally even over the lease term. Lease transactions are diverse with differing economics. Many commentators noted that a single lease accounting model would not reflect the differing economics of the wide variety of lease contracts. They believe that the differing nature of leases warrants different expense treatments.

For lessor accounting, the original 2010 ED proposed two mutually exclusive models depending on the extent of risks and benefits of the underlying asset retained by the lessor. A lessor applies the derecognition model if it has not retained significant risks and benefits. In contrast, it applies the performance obligation model if significant risks and rewards are retained. This hybrid approach was subject to much criticism. Many commentators had argued that it is not consistent with the single "rights and obligations" approach proposed for lessee accounting. There was generally little support for the performance obligation model mainly because it could artificially inflate the assets and liabilities of a lessor.

The original 2010 ED also included some highly subjective and complex measurement requirements. For example, determining the lease term in a lease would require estimate of the probability of occurrence of the longest possible most likely lease period, taking into account all options to extend. Similarly, the measurement of lease liabilities must include probability-weighted estimates of all variable lease payments, including those linked to sales or use of the underlying asset in a lease.

3. The Fundamental Approach to the New Lease Accounting

3.1 The Lessee Accounting Model

The revised ED retains the "*right-of-use*" model proposed in the original 2010 ED which would require a lessee to recognise assets and liabilities for the rights and obligations created by leases. This model reflects that, at the commencement date of a lease, the lessee obtains a right to use the underlying asset for a period of time, and the lessor makes the underlying asset available for use by the lessee. For example, if a

tenancy contract conveys a right to use a property for five years with monthly rental payments over the tenancy term, the entity that has received the right to use the underlying property recognises that right-of-use as an asset and a corresponding lease liability to make rental payments over the tenancy term. With this proposal, there will be no longer a distinction of finance leases and operating leases for lessee accounting. For current finance leases, the proposal would not change the requirements to capitalise lease assets and lease liabilities. However, for current operating leases, the proposal would have the effect of recognising lease assets and lease liabilities (under the current IAS 17, such leases are off-balance sheet).

The Consumption Principle

The revised ED proposes a dual approach to the recognition, measurement and presentation of expenses and cash flows arising from a lease to reflect the *differing economics* of the variety of lease transactions. Determining which approach to apply is based on the *principle of consumption* of the underlying asset, i.e., how much of that asset is consumed or used up by the lessee. Many commentators have argued that there is a difference between a lease for which the lessee pays for a part of the underlying asset that it consumes (or uses up) during the lease term, and a lease for which the lessee merely pays for use.

For leases of equipment and vehicles, such as airplanes, ships, manufacturing equipment, cars, trucks, etc., a lessee typically consumes part of the equipment or vehicle. Equipment or vehicles are depreciating assets, whose values not only decline over their economic lives, but generally decline faster in the earlier years of their lives than in the later years. For such leases, the lessor prices a lease to recover the value of the part of the asset consumed as well as obtaining a return on its investment in the asset.

For other leases, such as leases of real estates (land and/or buildings), the lessee merely uses the underlying asset without consuming more than an insignificant part of it. Property typically has a relatively long life, and a large portion of the lease payments for some property leases relates to the land element inherent in those leases. Land has an indefinite life and the value of the land would not be expected to be consumed by a lessee. In such cases, the lessor prices a lease to obtain a return on its investment in the underlying asset (without requiring recovery of the investment itself).

Thus, under the revised ED, an entity would classify a lease based largely on the *nature* of the underlying asset. Most leases of equipment and vehicles would be classified as “Type A” leases whilst most leases of property would be classified as “Type B” leases.

For Type A leases, a lessee effectively acquires a part of the underlying asset that is consumed over the lease term and pays for that consumption over time in the form of lease payments. Accordingly, the lessee recognises amortisation of the right-of-use asset in the same line item as other similar expenses (such as depreciation of an item of property, plant and equipment) and interest on the lease liability in the same line item as interest on other similar financial liabilities. The lease is more akin to a financing transaction for the acquisition of part of an asset.

In contrast, for Type B leases, lease payments made represent amounts paid to provide the lessor with a return on its investment in the underlying asset, i.e., a charge for the use of the asset. The return to the lessor on such asset is relatively even over the lease term. Accordingly, the lessee recognises and presents those payments for the use of the underlying asset as one amount (i.e. a lease cost) in profit or loss on the straight-line basis. The amount recognised as a lease cost is equivalent to a rental paid for the use of a property. The lease of a Type B asset is more akin to an operating transaction rather than a financing transaction.

3.2 The Lessor Accounting Model

Unlike the proposals in the original 2010 ED (which proposed a hybrid approach using either a derecognition model or a performance obligation model), the revised ED has simplified the lessor accounting requirements that are based primarily on whether a lease is a Type A lease or a Type B lease. The IASB has changed the lessor accounting proposals to more closely reflect how a lessor prices its leases

in respond to feedback on the 2010 ED. For practical reasons, there are few changes proposed to the accounting applied by lessors for finance leases. For current operating leases, the extent of change would depend on the nature of the underlying asset, i.e., whether the asset is property or equipment.

For Type A leases (most leases of equipment and vehicles), the revised ED retains the derecognition approach of the original 2010 ED by requiring that a lessor shall: (a) recognise a lease receivable and a retained interest in the underlying asset (a residual asset); (b) derecognise the entire underlying asset; (c) recognise the resulting profit or loss on the portion of the asset deemed sold; and (d) subsequently recognise interest income on both the lease receivable and the residual asset over the lease term.

For Type B leases (most leases of property) there is generally no change to the current requirements on operating leases of property. This means that the underlying asset in the lease would continue to be recognised by the lessor and it subsequently recognises rental income from the lease arrangement, generally on the straight-line basis. The IASB did not propose to change the lessor accounting for such leases because it was informed that many lessors of property view their leasing activities as an important component of their broader investment strategy. Leases are priced to earn a particular yield based on the fair value of the property and the lessor would often expect to also generate returns from capital appreciation. Also, most leases of property would meet the definition of investment property in IAS 40, which permits a lessor to measure the property at fair value. Users of financial statements had informed the IASB that information about rental income and the property's fair value provides them with more useful information about the lessor's leasing activities than other approaches. Other approaches, such as the performance obligation approach proposed in the original 2010 ED, are also likely to be more complicated to apply. These are the persuasive reasons for the IASB to retain the current operating lease requirements for lessor accounting of property leases.

4. Steps in the Application of the Proposed Standards

The definition of a lease has been changed to "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". Thus, all contracts that meet the definition of a lease, regardless of their legal form (whether termed as a lease or otherwise) and regardless of the period of time, would be subject to this new requirement. Apart from the traditional lease arrangements, the recognition requirement would apply to leases with periods that are significantly less than the economic lives of the underlying assets (under the current IAS 17, such leases would typically fail the finance lease criteria), short to medium term rental of property, plant and equipment, and arrangements that though not having the legal form of a lease, convey a right to use a specified asset (such as a contract in a power plant concession).

In applying this (draft) Standard, an entity (whether lessee or lessor) undertakes the following steps:

- (a) Identify whether a contract is or contains a lease (identifying a lease);
- (b) If a contract contains a lease, identify the separate lease components in the contract;
- (c) Allocate the consideration to the lease components and other components;
- (d) Determine the lease term;
- (e) Classify the lease as either Type A lease or Type B lease;
- (f) Recognise and measure the lease assets and lease liabilities, and the related income and expenses in accordance with the requirements for Type A leases and Type B leases; and
- (g) Present and disclose both Type A leases and Type B leases.

5. Identifying a Lease

The (draft) Standard requires that at the inception of a contract, an entity shall determine whether that contract is or contains a lease by assessing: (a) whether the fulfilment of the contract depends on the use of an identified asset; and (b) whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

5.1 Fulfilment of a Contract depends on the Use of an Identified Asset

In straightforward cases, an asset is identified by being explicitly specified in a contract. These may include a contract to lease a manufacturing plant whereby the identified asset is the manufacturing plant, a contract to lease an airplane whereby the identified asset is the airplane, and a contract to lease a property whereby the identified asset is the property.

The (draft) Standard however clarifies that even if an asset is explicitly specified, fulfilment of a contract does not depend on the use of an identified asset if the supplier (i.e. the entity that provides the good or service) has the substantive right to substitute the asset throughout the term of the contract. In contrast, even if an asset is not explicitly specified in a contract, fulfilment of the contract can depend on the use of an identified asset if the supplier does not have a substantive right to substitute the asset.

A supplier's right to substitute an asset is substantive if: (a) the supplier can substitute alternative assets in place of the asset without requiring the consent of the customer (i.e. the entity that receives the good or service under the contract); and (b) there are no barriers (economic or otherwise) that would prevent the supplier from substituting alternative assets in place of the asset during the term of the contract, such as when costs of substituting the asset are so high or when alternative assets are neither readily available nor could they be sourced within a reasonable time period or without incurring significant costs.

The fulfilment condition is met even if a supplier has the right or obligation to substitute other assets in place of the underlying asset if the asset is not operating properly or a technical upgrade becomes available. In addition, the fulfilment condition is met even if a supplier has the right or obligation to substitute other assets for any reason only on or after a particular date. In this case, fulfilment of the contract can depend on the use of an identified asset until the date that the right or obligation to substitute becomes available.

The (draft) Standard further clarifies that a physically distinct portion of an asset (e.g. a floor of a building) can be an identified asset. However, a capacity portion of an asset (e.g. a capacity portion of a fibre-optic cable that is less than substantially all of the capacity of the cable) cannot be an identified asset because it is not physically distinct from the remaining capacity of the asset.

5.2 Contract conveys the Right to Control the Use of an Identified Asset

This condition is satisfied if, throughout the term of the contract, the customer has the ability to: (a) direct the use of the identified asset; and (b) derive benefits from the use of the identified asset.

Ability to direct the use

This means that the contract must convey rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from the use of the asset throughout the term of the contract. Examples of such decision rights about use of an asset include determining or being able to change: (a) how and for what purpose the asset is employed during the term of the contract; (b) how the asset is operated during the term of the contract; or (c) the operator of the asset.

Ability to derive the benefits from use

This refers to a customer's ability to obtain substantially all of the potential economic benefits from the use of the asset throughout the term of the contract. Economic benefits can be derived directly or indirectly in many ways, such as by using, consuming, holding or sub-leasing the asset. The benefits include the primary output and by-products in the form of products and services and other benefits that could be realised from a commercial transaction with a third party.

5.3 Separating Lease Components in a Contract

Some leases of assets include a component for servicing the assets. For example, a lease of a highly specialised machine that requires the lessor to provide technical and backup services on the use of the

machine over the lease term. Other revenue or purchase contracts may have embedded lease components. In such contractual arrangements, the parties need to apply the revenue standard (for example, the proposed IFRS on *Revenue from Contracts with Customers*), to identify separate performance obligations within the contract.

If a contract contains a lease, an entity identifies each lease component within the contract. It considers the right to use an asset to be a separate lease component if: (a) it can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee; and (b) the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

An entity accounts for each lease component as a separate lease, separately from non-lease components of a contract. It allocates the consideration in the contract to each separate lease component that has been identified. For a lessor, it allocates the consideration in the contract using the requirements of the (draft) IFRS on *Revenue from Contracts with Customers*. For a lessee, it allocates the consideration in a contract based on a hierarchy depending on the availability of observable stand-alone prices of the components in the contract (similar to the allocation of consideration in multiple-element revenue contracts).

5. Lease Term

In the original 2010 ED, lease term was defined as “the longest possible term that is more likely than not to occur”. Determining the lease term using this definition is complex because if the lease period is variable, an entity would need to estimate the probability of occurrence for each possible lease period, taking into account the effects of any options to extend or terminate the lease. Allocating per cent probability to each possible lease period is highly subjective.

In this revised ED, the procedure to identify the lease term in a lease has been simplified. Lease term is defined as the non-cancellable period for which the lessee has the right to use the underlying asset, together with: (a) periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise the option; and (b) periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

Significant Economic Incentive

Significant economic incentive to exercise, or not to exercise, an option is a new concept and its application in determining the lease term requires judgement. An entity considers all factors relevant to the assessment and these may include contract-based, asset-based, market-based and entity-based factors. These are inter-related qualitative factors, not quantitative bright-line indicators. The Application Guidance provides some examples of factors that must be considered in combination, and these are: (a) contractual terms and conditions for the optional periods compared to current market rates, including any purchase option price; (b) significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable; (c) costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset in a contractually specified condition or to a contractually specified location; and (d) the importance of that underlying asset to the lessee’s operations, considering, for example, whether the underlying asset is a specialised asset and the location of the underlying asset.

Example 1

Entity P enters into an arrangement to lease a hotel from its owner for a non-cancellable period of 10 years, paying a yearly fixed lease payment of RM8 million. At the end of year 10, Entity A has an option to extend the lease for another 10 years, with the yearly lease payment being set at the then prevailing market rate at the end of year 10.

Entity P is in the business of hotel management and operations. Its business model is to manage similar leased hotels on a 20-year planning horizon. It expects to incur significant leasehold improvements to the hotel property and these improvements are expected to bring economic benefits for about 20 years.

The amount of lease payment in the optional period, being set at the then prevailing market rate, would not on its own be a significant economic incentive to extend the lease period. However, considering that there is significant economic value of the leasehold improvements at the end of the non-cancellable lease period to Entity P and the importance of the hotel property to its business (i.e. its business model), Entity P would probably conclude that there is significant economic incentive to exercise the option. Hence, the lease term is determined at 20 years (i.e. the non-cancellable lease period of 10 years plus the optional period of 10 years).

6. Classification of Leases

The commencement date of a lease is the date on which a lessor makes an underlying asset available for use by a lessee. This may be different from the inception date, which is the date the lease contract is entered into by the counterparties. At the commencement date, an entity classifies a lease as either a Type A lease or a Type B lease. The (draft) Standard does not permit reassessment of the classification after the commencement date, even if facts and circumstances have changed.

If the underlying asset is not property (defined as land or a building, or part of a building, or both), an entity classifies a lease as a **Type A** lease unless one of the following two criteria is met:

- (a) the lease is for an insignificant part of the total economic life of the underlying asset; or
- (b) the present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type B lease. What is “insignificant” in the above two criteria is not specified or subject to some “bright-line” indicators. It is a matter of judgement although an entity may, by analogy, apply the “12-month or less” period specified for the exemption of short-term leases, or an arbitrary “10% or less” present value rule for the second criterion. For example, a lease of a photo-copying machine for one year may be considered as insignificant and thus accounted for as Type B lease, with rental paid recognised as an expense in profit or loss. The insignificant part criterion is assessed in relation to the total economic life of the underlying asset rather than its remaining economic life. For example, a two-year lease of a manufacturing plant that has a remaining economic life of 10 years may be more than insignificant if assessed in relation to the remaining economic life, but is likely to be insignificant if the total economic life of the plant is 30 years when first constructed by the owner.

If the underlying asset is property, an entity classifies a lease as a **Type B** lease unless one of the following two criteria is met:

- (a) the lease is for the major part of the remaining economic life of the underlying asset; or
- (b) the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified at a Type A lease. What is considered “a major part of the remaining economic life” or what is “substantially all of the fair value” is not specified. These two criteria are similar to the indicators in the current IAS 17, and in practice, some have used an arbitrary 75% rule for the major part criterion and a 90% rule for the fair value criterion. However, these rules are not standards.

These two criteria have a rather high threshold for classification of property leases as a Type A lease, which means that such classification would be restricted to those property leases that are almost equivalent to a purchase of property with borrowings. Thus, most property leases would be classified as a Type B lease even if their lease term is more than insignificant. For example, in a lease of a building that has an economic life of 50 years, a lease term of 25 years would not meet the criterion of a major part of the remaining economic life. The present value of the lease payments may also not account for substantially all of the fair value of the building. A building is a depreciable asset. Notwithstanding that the building’s fair value may increase in the initial years, it would eventually have a nil value at the end of its economic life. If the consumption principle is the basis to classify a lease, it is difficult to justify that in a 25-year lease of a building, the lessee is only consuming an insignificant part of the asset. Thus, the two

criteria for Type A classification of property leases appear to be inconsistent with the consumption principle.

For a leasehold land with a long lease term (for example, a 99-year land lease), the present value of the lease payments is likely to account for substantially all of the fair value of the land. In this case, the leasehold land is classified as a Type A lease. The accounting applied by the lessee and the lessor would thus be similar to accounting for the purchase and sale of the land respectively.

Example 2

Entity M enters into an arrangement to lease a property (land and building) from its owner, Entity N. The primary asset in the arrangement is the building, which has a remaining economic life of 40 years. The current market price of the property is RM100 million. The non-cancellable lease period is 10 years, with an option to extend for another 10 years. Entity M determines that it has significant economic incentive to exercise the option to extend the lease at the end of the non-cancellable lease period. The yearly rental payable in arrears is RM6 million for the first 5 years, thereafter increases at 5% for interval of every five years, including the extended period. The rate the owner charges the lessee is 6%.

The lease term in this case is 20 years and it is assessed not for a major part of the remaining economic life of the building (the primary asset). Discounting the lease payments over the lease term at 6% provides a present value of RM72.87 million, which is assessed not substantially all of the fair value of the property. Hence, the lease is a Type B lease.

Suppose the lease term is extended to 30 years with similar term of lease payments (increase at 5% for each interval of every 5 years). The 30-year lease term may be considered as a major part of the remaining economic life of the building (if a 75%-guide is used internally). Alternatively, the present value of the lease payments discounted at 6% is determined at RM90 million, which may be considered as substantially all of the fair value of the property (if a 90%-guide is used internally). Based on either criterion, and notwithstanding that the underlying asset is property, it is classified as a Type A lease.

Significant Economic Incentive to Exercise Purchase Option

A lease is classified as a Type A lease if the lessee has a significant economic incentive to exercise an option to purchase the underlying asset. For example, in a property lease, if the exercise price is fixed and it is significantly below the expected fair value of the underlying asset at the end of the lease term, it would be reasonably certain at the commencement date that the lessee would exercise the purchase option.

Example 3

Entity P enters into an arrangement to lease a property from a property developer, Entity Q, for five years, paying in advance, a yearly rental of RM80,000. The property has a current market price of RM800,000. The arrangement provides for Entity P an option to purchase the property at the end of Year 5, at an option price of RM655,030. Property prices increase at about 5% per year and the expected market price of the underlying property at the end of Year 5 is RM972,400. The rate that Entity Q charges Entity P is 8%. Because the option price is significantly below the expected fair value of the property, Entity P has a significant economic incentive to exercise the purchase option at the end of Year 5.

Notwithstanding that the underlying asset is property, the lease is classified as a Type A lease. Entity P measures the right-of-use asset and the corresponding lease liability by discounting the lease payments (including payment for the purchase option). Entity Q the lessor, will also account for the transaction as a Type A lease and apply the derecognition model. It treats the transaction as sale with deferred payments. Thus, it recognises revenue and the corresponding cost of sale for the property sold at the commencement date.

Determining the Primary Asset in a Lease

If a lease component contains the right to use more than one asset, an entity determines the nature of the underlying asset on the basis of the nature of the primary asset within the lease component. It regards the economic life of the primary asset to be the economic life of the underlying asset when applying the classification criteria. For example, if a lease component contains both land and a building, the economic life of the building is regarded as the economic life of the underlying asset for lease classification purpose.

Example 4

Entity L leases an empty shopping mall from its owner for 5 years with an option to extend the lease for another 5 years. The yearly lease payment in the non-cancellable lease period is RM10 million. If the option is extended for another 5 years, the yearly lease payment for the extended period is RM15 million. The initial direct costs incurred by Entity L amount to RM1 million. The rate the owner charges Entity L in the lease is 8%.

This shopping mall is on a leasehold land that has a remaining lease period of 80 years. The fair value of the property as a whole is RM200 million. The remaining economic life of the shopping mall is 40 years. The yearly lease payment includes the use of the parking lot adjacent to the shopping mall. Entity L expects to undertake extensive renovations to the empty shopping mall and these are expected to have significant economic value at the end of the non-cancellable lease period of 5 years. Entity L determines the lease term to be 10 years as it expects to exercise the option to extend the lease. The lease includes the right to use the empty shopping mall, the leasehold land and the parking lot.

The primary asset within the lease is the shopping mall that has a remaining life of 40 years. The lease term is 10 years, which is not a major part of the remaining economic life of the building. The present value of the lease payments discounted at 8% is RM80.688 m, which is only about 40% of the fair value of the property. Hence, Entity L accounts for the lease of property as a Type B lease.

6. Contract Modification

If the contractual terms and conditions of a lease are modified, resulting in a substantive change to the existing lease, an entity accounts for the modified contract as a new contract at the date the modifications become effective. Examples may include changes to the contractual lease term or to the amount of contractual lease payments that were not part of the original terms and conditions of the lease. Any difference between the carrying amounts of the assets and liabilities arising from the previous lease and those arising from any new lease is recognised in profit or loss.

7. Lessee Accounting

7.1 Recognition Principles

The revised ED proposes that at the commencement date, a lessee shall recognise a right-of-use asset and a lease liability for all leases with contractual terms of more than 12 months. The lessee can choose to recognise a right-to-use asset and a lease liability for leases of 12 months or less but is not required to do so. The exception is made to address concerns raised in the feedback and discussions about costs and complexity of the requirements on short-term leases.

The term “right-of-use asset” is defined as an asset that represents the lessee’s right to use an underlying asset for the lease term. It is a non-financial asset. Whether or not it should be treated as a tangible (physical) asset or an intangible asset is unclear. If the lease is treated as a Type A lease, it may be argued that the lessee has acquired a part of the physical asset. In that sense, it may be more appropriate to treat the right-of-use asset as a tangible asset. If the lease is a Type B lease, the right-of-use asset is more akin to an intangible asset rather than a physical asset.

7.2 Measurement Principles

7.2.1 Initial Measurement

The (draft) Standard requires that at the commencement date, a lessee measures both of the following:

- (a) a lease liability at the present value of the lease payments discounted using the rate the lessor charges the lessee. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate.
- (b) the right-of-use asset, the cost of which would consist of: (i) the amount of the initial measurement of the lease liability; (ii) any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor; and (iii) any initial direct costs incurred by the lessee.

Determining Lease Payments

The initial measurement of the lease payments included in the lease liability consists of: (a) fixed payments, less any lease incentives receivable from the lessor; (b) variable lease payments that depend on an index or a rate (such as the consumer price index or a market interest rate), initially measured using the index or rate as at the commencement date; (c) variable lease payments that are in-substance fixed payments; (d) amounts expected to be payable by the lessee under residual value guarantees; (e) the exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option; and (f) payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Example 5

On 1 January 20x4, Entity A leases an aircraft from its owner for a non-cancellable lease term of five years and the yearly fixed lease payment is RM5 million, payable at the end of each year. Entity A has the option to extend the lease for another five years, and the yearly lease payment in the extend period is variable, being the higher of RM6 million and RM5 million plus an amount based the increase in the consumer price index between 1 January 20x4 and 31 December 20x8.

If the option to extend the lease term is not exercised, Entity A is required to pay a penalty of RM4 million for terminating the lease. The aircraft has a current market value of RM100 million. Entity A has guaranteed that the fair value of the aircraft at the end of year 5 and year 10 would be at least RM80 million and RM60 million respectively.

Based on the fact that Entity A would incur substantial costs to refurbish the interior of the aircraft and its business model of operating such assets, Entity A determines that the lease term is 10 years (it expects to exercise the option). It also expects to pay a residual value guarantee payment of RM10 million because its estimate of the fair value at the end of year 10 is RM50 million. The initial direct costs incurred in the lease amount to RM2 million.

The rate that the owner charges Entity A is not readily determinable. Entity A's current incremental borrowing cost is 6%.

The lease term in this case is 10 years because there is a significant economic incentive to extend the lease. The lease payments include the variable lease payments because the lessee is required to make a payment of at least RM6 million regardless of the CPI movement. Accordingly, the RM6 million payable is in-substance fixed payment. Also, the expected residual value guarantee payment is included in the lease payments. The present value of these payments discounted at 6% is as follows:

Year	Lease payments RM'm
1	5.00
2	5.00
3	5.00
4	5.00
5	5.00
6	6.00
7	6.00
8	6.00
9	6.00
10	16.00
NPV(6%,y1-y10)	45.53

At the commencement date, Entity A records the following amounts:

	RM'm	RM'm
Dr Right-of-use asset (45.53 + 2)	47.53	
Cr Lease liability		45.53

Cr Cash – initial direct costs - to record lease of an aircraft (Type A lease).
--

2.00

Variable lease payments are payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time. In the original 2010 ED, the proposal was to include all expected variable lease payments in the measurement of lease assets and liabilities, including lease payments payable in the optional renewal periods on a “more likely than not” basis. Many commentators disagreed with this proposal as they were concerned about cost and complexity in the application. In response to those comments, the IASB has changed the proposal to exclude variable lease payments in the measurement of lease assets and lease liabilities unless those payments are in-substance fixed payments or are linked to an index or rate. Hence, if variable lease payments are linked to sales of the output produced from, or to the use of, the underlying asset in the lease, they are excluded in the measurement. Similarly, optional payments (such as a payment for purchase option or payments payable in optional renewal periods) are excluded in the measurement unless the lessee has a significant economic incentive to exercise the option.

Variable lease payment linked to an index (such as a property price index) or a reference interest rate is included in the initial measurement using the index or rate at the commencement date. For example, if the yearly lease payment in a property lease is based on the property price index, an entity determines all of the variable lease payments during the lease term using the current property price index. It does not include probable increases in the property price index in the future years even if that is more likely than not to occur. Consequently, when the property price index increases in the future years, the entity needs to perform a remeasurement of the lease liability and right-of-use asset.

The concept of in-substance fixed payment is not defined or clarified in the revised ED. The application of this new concept is likely to be subjective and hence requires judgement. For example, if variable lease payments increase at a fixed per cent per year, they are in-substance fixed payments as the amount in each future year is clearly determinable. However, if variable lease payment in each subsequent year is the higher of a specified amount (a base amount) and a per cent of sales, the specified amount is in-substance fixed payment even if it is highly probable that a higher amount based on sales will occur. The Illustrative Examples that accompany the revised ED seem to suggest that when there are both specified minimum payment plus other variable (extra) payments, an entity uses the specified minimum amount as in-substance fixed payment without regards to the probable extra payment (for example, those linked to sales).

In some contracts that convey a right to use an asset and the lease payments are substantially linked to sales or use, the proposed requirement could potentially lead to an understatement of the lease liabilities and the right-of-use assets. For example, if a lease contains a base payment (minimum payment) plus a per cent of sales, the base payment is in-substance fixed payment. An entity excludes the extra payment linked to sales. If the base payment is set at a very low amount or if there is no base payment (for example, in a lease of slot machines in a casino operation where payments to the lessor are based entirely on a per cent of machine revenue), the variable lease payments linked to sales would be excluded in the measurement and this could result in an understatement of the lease liability, which may not represent the probable cash outflows. It is unclear in the (draft) Standard whether an entity is allowed, in such cases, to include an extra payment based on expected or probable sales and deem that as in-substance fixed payment.

Determining the Discount Rate

The discount rate used to determine the present value of the lease payments for a lessor is the rate the lessor charges the lessee. This rate takes into account the nature of the transaction as well as the terms and conditions of the lease. The rate the lessor charges the lessee could be the rate implicit in the lease or the property yield in a lease of property. An entity uses the rate implicit in the lease as the rate the lessor charges the lessee whenever that rate is available.

The rate implicit in the lease is the rate of interest that, at a given date, causes the sum of the present value of lease payments made by a lessee for the right to use an underlying asset and the present value of the amount a lessor expects to derive from the underlying asset following the end of the lease term to equal the fair value of the underlying asset.

For example, if an underlying asset in a five-year lease has a fair value of RM1,000,000. The yearly lease payment, payable at the end of each year, is RM180,000. The lessor expects to recover RM400,000 from the underlying asset at the end of the lease term. The implicit interest rate in the lease is determined as follows:

$$1,000,000 = PVIFA(r, 5) \times 180,000 + PVIF(r, 5) \times 400,000$$

Where: PVIFA is the present value interest factor of an annuity;

PVIF is the present value interest factor; and

“r” is the implicit interest rate. The rate is 7.71% which can be derived using an Excel program.

If the rate the lessor charges the lessee is not readily determinable (such as when there are variable lease payments or when the lessee is unable to determine either the fair value of the underlying asset or the amount the lessor expects to recover from the underlying asset at the end of the lease term), the lessee uses its incremental borrowing rate, which is the rate of interest it would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

7.2.2 Subsequent Measurement

The (draft) Standard uses a cost-based model for the subsequent measurement of lease liabilities and right-of-use assets. A lease liability is subsequently measured using a method similar to the amortised cost effective interest method (i.e. the amount that reflects the unwinding of the discount and the lease payments during the period so as to *produce a constant periodic discount rate* on the remaining balance of the liability). This is similar but not identical to the amortised cost effective interest method used for debt instruments in IFRS 9 because the rate used in the discounting may not be the implicit rate of interest in the lease. The right-of-use asset is subsequently carried at cost less any accumulated amortisation and any accumulated impairment losses (similar to the depreciated cost method used for property, plant and equipment in IAS 16).

For the statement of profit or loss and other comprehensive income, the (draft) Standard requires that a lessee recognises expenses in profit or loss (unless the costs are included in the carrying amount of another asset in accordance with other applicable Standards). For Type A leases, these would include both the unwinding of the discount on the lease liability as interest and the amortisation of the right-of-use asset. For Type B leases, a lessee recognises a single lease cost, combining the unwinding of the discount on the lease liability with the amortisation of the right-of-use asset, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis. However, the periodic lease cost shall not be less than the periodic unwinding of the discount on the lease liability. Any variable lease payments not included in the lease liability measurement (for example, variable payments based on sales) would be recognised as an expense in the period in which the obligation for those payments is incurred.

Example 6

On 1 January 20x4, a lessee enters into a contract to lease an asset from a lessor for a lease term of 5 years, with yearly fixed lease payment of RM1,000,000, payable at the end of each year. In addition, the lessee needs to pay 5% of any sales of goods produced by the asset in excess of RM10 million. The rate the lessor charges the lessee cannot be determined readily. The lessee's incremental borrowing cost is 8%. In year 1, the extra payment for the excess sales made is RM200,000.

The fixed lease payments over the five years are discounted at 8% as follows:

Year	Lease Payment RM'000
1	1,000
2	1,000
3	1,000
4	1,000
5	1,000
NPV(8%, y1-y5)	3,993

The lessee records the right-of-use asset and the lease liability at RM3,993,000 at the commencement date.

If the lease asset is a Type A lease, the interest expense and the amortisation of the right-of-use asset would be as follows:

Type A lease						
Year	Opening liability RM'000	Interest at 8% RM'000	Lease payment RM'000	Closing liability RM'000	Amortisation RM'000	Total expense RM'000
1	3,993	319	(1,000)	3,312	799	1,118
2	3,312	265	(1,000)	2,577	799	1,064
3	2,577	206	(1,000)	1,783	799	1,005
4	1,783	143	(1,000)	926	798	941
5	926	74	(1,000)	(0)	798	872
		1,007	(5,000)		3,993	5,000

If the lease asset is a Type B lease, the lease cost is constant and the interest expense and the amortisation of the right-of-use asset would be as follows:

Type B lease						
Year	Opening liability RM'000	Interest at 8% RM'000	Lease payment RM'000	Closing liability RM'000	Amortisation RM'000	Total expense RM'000
1	3,993	319	(1,000)	3,312	681	1,000
2	3,312	265	(1,000)	2,577	735	1,000
3	2,577	206	(1,000)	1,783	794	1,000
4	1,783	143	(1,000)	926	857	1,000
5	926	74	(1,000)	(0)	926	1,000
		1,007	(5,000)		3,993	5,000

In both cases, the variable lease payment of RM200,000 not included in the measurement is recognised as an expense in the year it is incurred.

The example above shows that although the total expense recognised in profit or loss is the same for both Type A and Type B leases over the five-year lease term, its recognition is faster in the initial years of the lease than in the later years for a Type A lease, compared to a constant lease cost for a Type B lease. It has been advanced that for leases of equipment and vehicles, faster expense recognition is justifiable because such assets tend to be consumed or used up must faster in the earlier years of a lease. However, for a lease of property, faster expense recognition is not justifiable because the lessee merely pays for the use of the asset rather than consuming a significant portion of the asset. The constant lease cost represents a payment to the lessor to enable it to earn a return on its investment in the property, not a recovery of part of that investment.

7.2.3 Reassessment of the Lease Liability

After the commencement date, lease payments may change due to a change in the lease term, the relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise a purchase option, the amounts expected to be payable under residual value guarantee, or an index or rate used to determine the lease payments during the reporting period. Similarly, a lessee needs to reassess the discount rate if there is a change in the lease term, the relevant factors used in determining significant economic incentive to exercise purchase option or a reference interest rate, if variable lease payments are determined using that rate.

A lessee remeasures the lease liability to reflect changes to the lease payments and changes to the discount rate. It recognises the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset, except for: (a) the amount of the remeasurement arising from a change in an index or a rate that is attributable to the current period is recognised in profit or loss; and (b) if the carrying amount of the right-of-use asset is reduced to zero, any remaining amount of the remeasurement is recognised in profit or loss.

The requirement for reassessment of the lease liability is similar to remeasurement of financial liabilities carried at amortised cost in IAS 39 whenever there are changes to the expected cash flows. However, if variable lease payments are included in the initial measurement based on a reference index or rate at the commencement date, and that index or rate changes frequently (such as a consumer price index that increases yearly), an entity would need to perform a continuous (e.g. yearly) reassessment over the lease term and make the necessary adjustments to the lease liability, the right-of-use asset and a portion to profit or loss. This requirement can be onerous and costly to apply. A simpler approach would be to include variable lease payments based on the expected or projected indices or rates over the lease term in the initial measurement. If this suggested approach is applied, it would reduce the frequency of reassessment required (probably limited to circumstances when there is a material change to the expected or projected indices or rates).

7.2.4 Amortisation and Impairment of the Right-of-Use Asset

For Type A leases, a lessee amortises the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. For Type B leases, a lessee determines the amortisation of the right-of-use asset for the period as the difference between (a) the periodic lease cost (which generally is on a straight line basis) and (b) the periodic unwinding of the discount on the lease liability.

Amortisation begins from the commencement date to the earlier of the end of the useful life of the right-of-use asset and the end of the lease term. However, if the lessee has a significant economic incentive to exercise a purchase option, it amortises the right-of-use asset to the end of the useful life of the underlying asset.

A lessee applies IAS 36 *Impairment of Assets* to determine and recognise any impairment loss of the right-of-use asset.

7.2.5 Alternative Measurement Bases for the Right-of-Use Asset

The (draft) Standard proposes to allow a lessee to measure right-of-use assets arising from leased property in accordance with the fair value model of IAS 40 if the leased property meets the definition of investment property and the lessee elects the fair value model in IAS 40 as an accounting policy. If this alternative measurement is availed, amortisation would be redundant and the lessee accounts for the changes in fair value of the right-of-use asset through profit or loss.

Similarly, a lessee may measure right-of-use assets relating to a class of property, plant and equipment at a revalued amount in accordance with IAS 16 if the lessee revalues all assets within that class of property, plant and equipment. For a Type A lease, the revalued amount of the right-of-use asset is the new base for amortisation. However, for a Type B lease, the lease cost over the remaining lease term

(which is generally on the straight-line basis) needs to include the revaluation surplus so that the “balancing” amortisation of the right-of-use asset includes that revaluation surplus.

7.3 Presentation

A lessee presents either in the statement of financial position or discloses in the notes: (a) right-of-use assets separately from other assets; (b) lease liabilities separately from other liabilities; (c) right-of-use assets arising from Type A leases separately from right-of-use assets arising from Type B leases; (d) right-of-use assets measured at revalued amounts; and (e) lease liabilities arising from Type A leases separately from lease liabilities arising from Type B leases.

In the statement of profit or loss and other comprehensive income, a lessee presents: (a) for Type A leases, the unwinding of the discount on the lease liability separately from the amortisation of the right-of-use asset; and (b) for Type B leases, the unwinding of the discount on the lease liability together with the amortisation of the right-of-use asset i.e. as a single lease cost.

In the statement of cash flows, a lessee classifies: (a) repayments of the principal portion of the lease liability arising from Type A leases within financing activities; (b) the unwinding of the discount on the lease liability arising from Type A leases in accordance with the requirements relating to interest paid in IAS 7 *Statement of Cash Flows*; (c) payments arising from Type B leases within operating activities; and (d) variable lease payments and short-term lease payments not included in the lease liability within operating activities.

7.4 Disclosure

The proposed disclosure requirements focus on users’ understanding of the amount, timing and uncertainty of cash flows arising from leases. A lessee discloses both qualitative and quantitative information about its leases, significant judgements applied and the amounts recognised in the financial statements.

Detailed information to be disclosed by a lessee includes:

- (a) *nature* of its leases, such as a general description of those leases; basis, terms and conditions of variable lease payments; existence, terms and options to extend or terminate the lease; residual value guarantees provided; and restrictions or covenants imposed by leases;
- (b) information about *subleases*;
- (c) leases that have *not yet commenced* but that create significant rights and obligations;
- (d) significant *assumptions and judgements* made in determining whether a contract contains a lease, allocation of consideration to components of a contract, and in determining the discount rate;
- (e) a *reconciliation* of the opening and closing balances of right-of-use assets by class of underlying asset separately for Type A leases and Type B leases and right-of-use assets measured at revalued amounts, including additions, reclassifications, reductions, remeasurement, amortisation, impairment and effects of business combinations;
- (f) if the right-of-use assets are measured at *revalued amounts*, the effective date of the revaluation, the revaluation surplus, changes during the period and any restriction on distribution of the surplus;
- (g) a *reconciliation* of opening and closing balances of lease liabilities separately for Type A leases and Type B leases, including liabilities created from new leases, liabilities extinguished or terminated, effects of remeasurements, cash paid, unwinding of discount, foreign currency exchange differences and effects of business combinations.
- (h) *costs* recognised in the period relating to variable lease payments not included in the lease liability;
- (i) information about the acquisition of right-of-use assets in exchange for lease liabilities arising from both Type A leases and Type B leases as a supplemental *non-cash transaction* disclosure in IAS 7; and
- (j) a *maturity analysis* of lease liabilities, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee

must also show the reconciliation of the undiscounted cash flows to the lease liabilities in the statement of financial position

8. Lessor Accounting

8.1 Type A Leases

Application of the Derecognition Approach

The revised ED retains the derecognition approach for lessor accounting proposed in the original 2010 ED for leases of equipment and vehicles (Type A leases). This approach is premised on the notion that if a lessor has conveyed to a lessee a right to use an underlying asset for a specified period (but not the entire remaining life of the underlying asset) and for future payments (the present value of which is not insignificant relative to the fair value of the underlying asset), it has, in substance, “sold” a portion of the underlying asset to the lessee and “retained” an interest in the portion not sold. Accordingly, the portion of the underlying asset sold is derecognised.

Applying this notion would require that the underlying asset be bifurcated, one part that is sold for which a gain or loss is recognised in profit or loss, and the other part that is retained, classified as a residual asset. Unlike the original ED which did not permit subsequent remeasurement of the residual asset, the revised ED proposes an amortised cost measurement and other requirements on the remeasurement of the residual asset after initial recognition.

Concerns were raised whether the part retained meets the definition of an asset in the Conceptual Framework when control of the underlying asset has already passed to the lessee. The IASB concluded that the part retained meets the definition of an asset because the lessor has a retained interest in the underlying asset which brings in future economic benefits and it has a share in the control over the underlying asset (such as title or ownership). The part retained i.e. the residual asset must have significant economic value relative to the fair value of the underlying asset as a whole. For example, if an item of equipment in a lease has a total economic life of 8 years and the lease term is 3 years, the asset would have significant economic value to the lessor at the end of the lease term. If the lease term is for the entire remaining life of the asset or the present value of the lease payments is equal to the fair value of the underlying asset, then there will be no economic value to the residual asset. In this case, the entire asset is transferred or “sold” to the lessee without any retained economic interest.

The (draft) Standard does not apply to transactions for which control of the underlying asset is transferred to the lessee, without any retained economic interest. For such arrangements, the accounting for leases that are economically similar to the sale of the underlying asset would be accounted for in a similar way to the sale of that asset. Thus, when a lease is such that the lessee would consume substantially all of the underlying asset, the lessee would account for it similar to the purchase of an asset that is financed, and the lessor would account for it similar to the sale of an asset with deferred payments. Examples of such arrangements in Malaysia include hire purchase transactions on vehicles and straight finance leases of equipment where a lessor recovers all of its investment in the asset from one lessee.

8.1.1 Recognition Principles

The (draft) Standard requires that at the commencement date of a Type A lease, a lessor shall: (a) derecognise the carrying amount of the underlying asset (if previously recognised); (b) recognise a lease receivable; (c) recognise a residual asset; and (d) recognise any resulting profit or loss on the lease in profit or loss.

8.1.2 Measurement Principles

Initial Measurement

At commencement date, a lessor measures: (a) the lease receivable at the present value of the lease payments, discounted using the rate the lessor charges the lessee, plus any initial direct costs; and (b) the residual asset as prescribed in the (draft) Standard.

Initial Measurement of Lease Receivable

Initial measurement of the lease payments included in the lease receivable consists of: (a) fixed payments, less any lease incentives payable to the lessee; (b) variable lease payments that depend on an index or a rate (such as the consumer price index or rate) at the commencement date; (c) variable lease payments that are in-substance fixed payments; (c) lease payments structured as residual value guarantees; (d) the exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option; and (e) payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

The components of lease payments for a lessor are the same as those for a lessee except for lease payments structured as residual value guarantees. In addition to a residual value guarantee provided by a lessee, the lessor may receive from, or pay to, a counterparty (not necessarily the lessee) the difference between the selling price or fair value of the underlying asset and the specified amount at the end of the lease term. These guarantees, whether provided by a lesser or another counterparty, are lease payments for a lessor.

Initial Measurement of the Residual Asset

At the commencement date, a lessor measures the residual asset as follows:

A + B – C, where:

A = the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term, discounted using the rate the lessor charges the lessee (gross residual asset).

B = the present value of the expected variable lease payments not included in lease receivable.

C = any unearned profit.

If a lessor reflects an expectation of variable lease payments in determining the rate the lessor charges the lessee and those payments are not included in the lease receivable (for example, variable lease payments linked to sales), the lessor includes in the initial measurement of the residual asset the present value of the variable lease payments expected to be earned during the lease term, discounted using the rate the lessor charges the lessee.

For example, if the present value of the amount the lessor expects to recover from the underlying asset at the end of the lease term is RM10 million, the present value of the expected variable lease payments not included in lease receivable is RM2 million and the unearned profit is RM4 million, the initial measurement of the residual asset is = 10m + 2m – 4m = RM8 million

Allocating Profit between Parts

If the fair value of the underlying asset is greater than its carrying amount immediately before the commencement date, a lessor allocates that difference between profit relating to the lease, which the lessor recognises at the commencement date, and unearned profit, which is included in the initial measurement of the residual asset. The allocation is applied using the following formulae:

$$\text{Profit earned} = D \times \text{PV}/\text{FV}$$

Where: D is the difference between the fair value and carrying amount of the underlying asset.

PV is the present value of lease payments.

FV is the fair value of the underlying asset.

$$\text{Unearned profit} = D - \text{profit earned.}$$

For example, the fair value and the carrying amount of an underlying asset in a lease are RM30m and RM20m respectively. The present value of the lease payments is RM18m. The present value of the amount the lessor expects to recover from the underlying asset at the end of the lease term is RM12m.

The difference in fair value and carrying amount is RM10m and this amount is allocated to profit relating to the lease at $10m \times 18m/30m = RM6m$.

The unearned profit included in the initial measurement of the residual asset is $10m - 6m = RM4m$.

The journal entries at initial recognition would be as follows:

Dr Lease receivable	18m	
Dr Residual asset (12m – 4m)	8m	
Cr Underlying asset		20m
Cr Profit on lease in profit or loss		6m

Subsequent Measurement

The (draft) Standard uses a cost-based model for the subsequent measurement of lease receivable and residual asset. The lease receivable is carried at amortised cost that reflects the unwinding of the discount and the lease payments received during the period so as to *produce a constant periodic discount rate* on the remaining balance of the lease receivable (a mirror image of the corresponding lessee's lease liability). Similarly, the residual asset is carried at amortised cost that includes accretion for the unwinding of the discount.

A lessor recognises in profit or loss: (a) the unwinding of the discount on the lease receivable as interest income; (b) the unwinding of the discount on the gross residual asset as interest income; and (c) variable lease payments that are not included in the lease receivable in the periods in which that income is earned.

A lease receivable it is a financial asset, and hence, the subsequent measurement is similar to the amortised cost effective interest method prescribed for debt instruments in IAS 39. However, the residual asset is a non-financial asset. Recognising interest income on a non-financial asset is something new. The rationale is probably because a lessor in a Type A lease needs to price the lease to provide a return on its investment in the underlying asset, not just on the lease receivable. Thus, a residual asset is treated as if it is a financial asset in the subsequent measurement.

Example 7

At 1 January 20x5, a lessor owns an equipment with a carrying book value of RM800,000. The fair value of the equipment on this date is RM1,000,000. The remaining economic life of the equipment is 8 years. On this date, the lessor leases the equipment to a lessee for a lease term of four years. The yearly fixed lease payment, payable in advance (at the beginning of each year) is RM200,000. The lessor expects to recover RM400,000 from the underlying asset at the end of the lease term. The rate the lessor charges the lessee is 9.88%

The present value of the lease payments and the present value of the amount the lessor expects to recover from the underlying asset at the end of the lease term discounted at 9.88% are computed (using an Excel program) as follows:

Year	Lease payments RM	Year	Recoverable amount RM
0	200,000		
1	200,000	1	-
2	200,000	2	-
3	200,000	3	400,000
NPV(9.88%,y1-y3)	498,457		
Total present value	698,457		301,543

The difference of RM200,000 between the fair value of the equipment and its carrying amount is allocated as follows:

To the part sold = $200,000 \times 698,457/1,000,000 = \text{RM}139,691$. The balance of RM60,309 is the unearned profit attributable to the part retained (part of the residual asset).

At the commencement date, the lessor records the following amounts:

	RM	RM
Dr Lease receivable	698,457	
Dr Residual asset (301,543 – 60,309)	241,234	
Cr Carrying amount of equipment		800,000
Cr Gain in profit or loss*		139,691

- to record Type A lease of equipment.

Note: if the lessor's nature of business is selling similar equipment, it records revenue of RM698,457 and cost of sales of RM558,766 so that the gain of RM139,691 represents the gross profit from sale.*

Dr Cash	200,000	
Cr Lease receivable		200,000

- to record first lease payment received in advance.

The balance in the lease receivable is RM498,457 being the present value of the future lease payments not yet received.

After initial recognition, both the lease receivable and the gross residual asset would be measured at the amortised cost effective interest method. The effective rate in the unwinding of interest is 9.88%, the rate used to discount both the cash flows, as shown below:

Lease Receivable				
Year	Opening receivable	Interest income	Lease payment	Closing receivable
	RM	RM	RM	RM
0	698,457	-	(200,000)	498,457
1	498,457	49,228	(200,000)	347,685
2	347,685	34,338	(200,000)	182,023
3	182,023	17,977	(200,000)	-
		101,543	(800,000)	

At the end of Year 1, the lessor recognises interest income as follows:

	RM	RM
Dr Lease receivable	49,228	
Cr Interest income		49,228

- to recognise interest income on the lease receivable.

Dr Cash	200,000	
Cr Lease receivable		200,000

- to record lease payment received.

The balance in the lease receivable at the end of Year 1 is RM347,685. The above entries would be repeated in the subsequent years.

Gross Residual Asset					Net
Year	Openig asset	Interest income	Closing asset	Unearned profit	residual asset
	RM	RM	RM	RM	RM
1	301,543	29,781	331,324	(60,309)	271,015
2	331,324	32,722	364,046	(60,309)	303,738
3	364,046	35,954	400,000	(60,309)	339,691
		98,457			

At the end of year 1, the lessor recognises interest income on the gross residual asset as follows:

	RM	RM
Dr Gross residual asset	29,781	
Cr Interest income		29,781

- to recognise interest income on residual asset.

Reassessment of the Lease Receivable

After the commencement date, the lease payments receivable by a lessor may change due to a change in the lease term, the relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise a purchase option, or an index or a rate used to determine the lease payments during the reporting period. Similarly, a lessor reassesses the discount rate if there is a change in the lease term, the relevant factors for determining significant economic incentive to exercise or not to exercise a purchase option, or a reference interest rate, if variable lease payments are determined using that rate.

A lessor remeasures the lease receivable to reflect changes to the lease payments and changes to the discount rate. It adjusts the carrying amount of the residual asset to reflect the amount the lessor expects to derive from the underlying asset following the end of the revised lease term, if there is a change in the lease term or in the assessment of whether the lessee has or no longer has a significant economic incentive to exercise a purchase option; and recognise any difference between the carrying amounts of the lease receivable and residual asset before and after the remeasurement in profit or loss.

Subsequent Measurement of the Residual Asset

After the commencement date, a lessor increases the carrying amount of the residual asset in each period to account for the unwinding of the discount on the gross residual asset as an interest income, using the rate the lessor charges the lessee.

If a lessor includes variable lease payments in the initial measurement of the residual asset, it derecognises a portion of the carrying amount of the residual asset and recognises a corresponding expense in profit or loss. This is the portion of the residual asset that relates to the variable lease payments expected to be received during the lease term. And when those variable payments are received during the lease term, they are recognised as lease income separately. Without derecognising a corresponding portion of the residual asset during the lease term would result in an overstatement of profit, and the residual asset could possibly be impaired.

In principle, a lessor would be required to update its expectations of variable lease payments at the end of each reporting period and recalculate the adjustments to be made to the residual asset. However, the IASB is not proposing such an approach because it would be extremely complex to apply for possibly little benefit. Thus, a lessor determines the portion to derecognise on the basis of the variable lease payments expected to be earned in each period at the commencement date only. Changes in estimates relating to variable lease payments do not affect the carrying amount of the residual asset and accordingly, the amounts to be derecognised by the lessor in each period. The difference between expected and actual variable lease payments is recognised in profit or loss in the reporting period it arises.

The Application Guidance clarifies that a lessor calculates the portion of the residual asset to derecognise in each period, using the following formula:

$$A/B \times C \times D/E$$

Where: A = the amount of variable lease payments expected to be earned in a current period;
 B = the total variable lease payments expected to be earned during the lease term reflect in the discount rate;
 C = the present value of variable lease payments expected to be earned during the lease term;
 D = the carrying amount of the underlying asset immediately before the commencement date;
 and
 E = the fair value of the underlying asset at the commencement date.

The formula above seems odd as it includes a “D/E” adjustment, which may cause the C factor, which is the present value of the variable lease payments included in the initial measurement, not fully derecognised at the end of the lease term if the fair value of the underlying asset (the E factor) is higher than its carrying amount (the D factor).

For example, an underlying asset in a lease has a carrying amount and fair value of RM8m and RM10m respectively. The fixed lease payment is RM1.5m per year for 5 years. The amount the lessor expects to recover from the underlying asset at the end of the lease term is RM5m. The rate the lessor charges the lessee is 9.17% and this rate reflects variable lease payments linked to sales of RM0.25m per year for 5 years.

The present value of the fixed lease payments discounted at 9.17% is RM5.81m; the present value of the recoverable amount of the underlying asset at the end of the lease term is RM3.22m; and the present value of the variable lease payments reflected in the rate the lessor charges the lessee is RM0.97m.

The profit in the lease at the commencement date = $RM2m \times 5.81m/10m = RM1.16m$. The unearned profit is = $RM2m - RM1.16m = RM0.84m$. The initial measurement of the residual asset = $3.22m + 0.97m - 0.84m = RM3.35m$.

At the commencement date, the lessor records the following:

	RM'm	RM'm
Dr Lease receivable	5.81	
Dr Residual asset	3.35	
Cr Carrying amount of the underlying asset		8.00
Cr Profit on lease in profit or loss		1.16

The initial amount of the gross residual asset of RM3.22m will accrete at the rate of 9.17% to RM5m at the end of the lease term. As the expected variable lease payment per year is constant, the amount to be derecognised in each year is = $.25/1.25 \times .97m \times 8m/10m = RM0.15m$. At the end of the lease term, there is still a balance of RM0.22m attributable to the variable lease payments not derecognised. What this amount represents at the end of lease term is unclear. A simpler approach would have been to exclude the D/E adjustment in the above formula.

Impairment of the Lease Receivable and the Residual Asset

The lease receivable is similar to a financial asset in IAS 39. Thus, a lessor applies IAS 39 to test and recognise any impairment loss for the lease receivable. When determining the loss allowance for a lease receivable, a lessor takes into consideration the collateral relating to the receivable. This represents the cash flows that the lessor expects to derive from the underlying asset during the remaining lease term, which exclude the cash flows that the lessor expects to derive from the underlying asset following the end of the lease term. For the residual asset, a lessor applies IAS 36 to test for impairment, taking into consideration any residual value guarantees relating to the underlying asset.

Accounting for the Underlying Asset at the End of the Lease Term or on Termination

At the end of the lease term, a lessor reclassifies the residual asset to the appropriate category of asset (e.g. property, plant and equipment) in accordance with applicable Standards, measured at the carrying amount of the residual asset. If a lease is terminated before the end of the lease term, a lessor needs to test the lease receivable for impairment in accordance with IAS 39, reclassify the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset to the appropriate category of

asset in accordance with the applicable IFRS, measured at the sum of the carrying amounts of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset; and account for the asset that was the subject of the lease in accordance with the applicable IFRS.

8.1.3 Presentation

A lessor presents lease assets (i.e. the sum of the carrying amount of lease receivables and residual assets) separately from other assets. It can either present in the statement of financial position or disclose in the notes, the carrying amount of lease receivables and the carrying amount of residual assets.

In the statement of profit or loss and other comprehensive income, or in the notes, a lessor presents income arising from leases.

A lessor presents any profit or loss on the lease recognised at the commencement date in a manner that best reflects the lessor's business model(s). For example, if a lessor uses leases as an alternative means of realising value from the goods that it could otherwise sell, the lessor presents revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently. However, if a lessor uses leases for the purposes of providing finance, the lessor presents the profit or loss in a single line item

In the statement of cash flows, a lessor classifies cash receipts from lease payments within operating activities.

8.2 Type B Leases

For leases of property, the lessor accounting is unchanged when compared with the current IAS 17 requirements on operating leases. There is no derecognition of the underlying asset in the lease. A lessor recognises lease payments as lease income in profit or loss over the lease term on either a straight-line basis or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset (for example, a property yield basis if the underlying property is managed on a fair value basis).

The other proposed requirements for Type B leases include: (a) initial direct costs are recognised as an expense over the lease term on the same basis as lease income; (b) variable lease payments are recognised in profit or loss in the period in which that income is earned; and (c) the lessor continues to measure and present the underlying asset in accordance with other applicable Standards.

In the statement of cash flows, a lessor classifies cash receipts from lease payments within operating activities.

8.3 Disclosures (for both Type A and Type B Leases)

The disclosure requirements focus on users' understanding of the amount, timing and uncertainty of cash flows arising from leases. They include both qualitative and quantitative information such as a lessor's leases; significant judgements made about whether a contract contains a lease; allocation of consideration to components; initial measurement of the residual asset; and amounts recognised in the financial statements relating to those leases.

Detailed information to be disclosed by a lessor includes:

- (a) The *nature* of its leases, including a general description; basis, terms and conditions of variable lease payments; existence, terms and conditions of option to extend or terminate the lease; and of purchase options.
- (b) Lease income is to be disclosed in a *tabular format*, including: for Type A leases, the profit or loss recognised on commencement date, the unwinding of discount on the lease receivable and the unwinding of discount on the gross residual asset.
- (c) For Type A leases, a *reconciliation* of the opening and closing balances of the lease receivable, including movements such as additions, receivables derecognised, cash received, unwinding of

discount, foreign currency exchange difference, effects of business combinations and loss allowance.

- (d) For Type A leases, a *reconciliation* of the opening and closing balances of the residual asset, showing the movements due to additions, reductions, reclassification at expiry or termination of a lease, unwinding of discount, effects of business combinations and impairment.
- (e) For Type A leases, a *maturity analysis* of the lease receivable, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. The total undiscounted amount should be reconciled to the lease receivable recognised in the statement of financial position.
- (f) For Type A leases, information about how it *manages its risk* associated with residual assets, including its risk management strategy, carrying amount covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor); and other means by which the lessor reduces its residual asset risk (for example buy-back agreements or variable lease payments for use in excess of specified limits).
- (g) For Type B leases, a lessor discloses a *maturity analysis* of lease payments showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total for the amounts for the remaining years. This is presented separately from the maturity analysis for Type A leases.

9. Sale and Leaseback Transactions

In the current IAS 17, the accounting for sale and leaseback transactions is dependent mainly on whether the leaseback is a finance lease or an operating lease. In this revised ED, the accounting for such transactions depends on whether the transfer of the asset is a sale or not a sale, rather than on the nature of the leaseback.

An entity, whether a transferor or a transferee, determines whether the transfer of an asset is accounted for as a sale of the asset by determining when a performance obligation is satisfied in accordance with (draft) IFRS on *Revenue from Contracts with Customers*. The critical determinant is who has control of the underlying asset. The existence of the leaseback (i.e. the transferor's right to use the asset for a period of time) does not, in isolation, prevent the transferee from obtaining control of the asset. However, if the leaseback provides the transferor with the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, then the transferee does not obtain control of the asset and the transfer is not a sale.

The transferor is considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, if: (a) the lease term is for the major part of the remaining economic life of the asset; or (b) the present value of the lease payments accounts for substantially all of the fair value of the asset. The application of these two criteria (which are similar to those in IAS 17) requires judgement as there are no "bright-lines" provided on what is considered as "major part of the economic life" or "substantially all of the fair value". As in past practices, some arbitrary thresholds may be used as a guide, such as a 75% rule for the major part of remaining economic life criterion and 90% rule for the present value criterion, but these are not standards.

If the consideration for the sale of an asset is not at fair value or the lease payments are not at market rates, an entity makes adjustments to recognise the sale at fair value. For a transferor, it measures the right-of-use asset and the gain or loss on disposal of the underlying asset to reflect current market rates for lease payments for that asset. The transferor subsequently accounts for the lease to reflect those current market rates. For a transferee, it measures the lease receivable and the residual asset for Type A leases, or the underlying asset for Type B leases, to reflect current market rates for lease payments for that asset. The transferee subsequently accounts for the lease to reflect those current market rates.

If the transferee does not obtain control of the asset, the transfer is not a sale. Hence, the transferor does not derecognise the transferred asset and shall account for any amount received as a financial

liability; whilst the transferee does not recognise the transferred asset and shall account for the amounts paid as a receivable (i.e. a financial asset).

10. Exemptions for Short-Term Leases - Lessees and Lessors

Some respondents had commented that the recognition and measurement requirements can be cumbersome and costly to apply for short-term leases but with little benefit because the effect in profit or loss is about the same as the current expense or income treatment for operating leases.

The revised ED proposes to provide exemptions to the requirements for short term leases. For a lessee, it may elect, as an accounting policy, not to apply the recognition and measurement requirements to short-term leases. Instead, a lessee may recognise the lease payments in profit or loss on a straight-line basis over the lease term. Similarly, a lessor may elect, as an accounting policy, not to apply the recognition and measurement requirements to short-term leases. Instead, a lessor may recognise the lease payments in profit or loss over the lease term on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which income is earned from the underlying asset. The accounting policy election for short-term leases would be made by class of underlying asset to which the right of use relates. An entity that avails this exemption discloses that fact.

The revised ED proposes that short-term leases should be defined as leases that, at the commencement date, have a maximum contractual term, including all options to extend, of 12 months or less. Thus, if a lease arrangement has a contractual term of one year with an option to extend for another year, the exemption does not apply even if the lessee or the lessor determines the lease term to be one year. In the IASB's view using lease term as a basis could lead to abuses because a longer contractual term could be structured in a series of one-year renewal options to obtain the benefit of short-term lease accounting. Also, any lease that contains a purchase option is not a short-term lease.

11. Sublease Arrangements

A sublease is within the scope of the (draft) IFRS and it is defined as a transaction in which an underlying asset is re-leased by the original lessee (or intermediate lessor) to a third party, and the lease agreement (or head lease) between the original lessor and the lessee remains in effect. The lessee in the original head lease becomes an intermediate lessor in the sublease. The head lease and the sublease are therefore two separate contracts.

The accounting requirements of the proposed standard apply to each party. The original lessor in the head lease accounts for the head lease using the appropriate approach i.e. whether it is a Type A lease or Type B lease. The lessee in the sublease accounts for it using the requirements prescribed for lessees. However, the intermediate lessor has to account for two separate arrangements: (a) as a lessee in the original head lease, and (b) as a lessor in the sublease.

When classifying a sublease, an entity evaluates the lease with reference to the underlying asset, rather than the right-of-use asset arising from the head lease. This is because a lessee in a sublease may not know the terms and conditions of the head lease and, accordingly, the proposed approach would be easier to apply than referring to the right-of-use asset arising from the head lease.

12. Potential Issues

The classification of a lease in the (draft) Standard is based on the consumption principle. The rationale for a constant expense or income recognition for property leases is premised on the notion that the lessee is not expected to consume more than an *insignificant* amount of the underlying asset and that the lessor prices the lease to earn a return on its investment in the property rather than to recover part of the property consumed or used up by the lessee. However, the criteria applied in the proposal for lessor accounting use a much higher threshold (either a major part of the remaining economic life or substantially all of the fair value) which is not consistent with the "insignificant" threshold of consumption. For example, a 25-year lease of a building that has a remaining economic life of 50 years would be classified as a Type B

lease (it is unlikely to meet any of the two criteria for a Type A lease classification). A building is a depreciable asset regardless of its measurement model. If the lease term is 25 years, it is difficult to justify that the lessee would only be consuming an insignificant part of the building over the lease term. Similarly, the lessor would probably price the lease to include a recovery of part of the asset consumed by the lessee over the lease term. There is a need to reconsider the criteria or thresholds proposed in the (draft) Standard, such as lower thresholds for classification of property as a Type A lease if a lessor prices a lease that includes recovery or consumption of part of the property. Using an entity's business model approach may be a better alternative for classification of property leases.

The proposals in the revised ED for the measurement of lease payments have removed most of the concerns about cost and complexity of measurement in the original 2010 ED. However, the exclusion of variable lease payments (except those linked to an index or rate and those that are in-substance fixed lease payments) may potentially lead to an understatement of lease liabilities and assets if those payments are a significant feature of a lease. For example, in a lease that is structured with lease payments entirely or substantially linked to sales, there are little or no fixed lease payments. For the lessee, the measurement of the lease liability would be understated as it is unlikely to reflect the probable outflows of future economic benefits. For the lessor, the lease receivable will also be understated, although those variable lease payments may be reflected in the initial measurement of the residual asset. It would also be inconsistent if a lessee excludes variable lease payments but the lessor includes them in the measurement of the residual asset. Including probable variable lease payments in the measurement may overcome this issue, but is it unclear whether a probable variable lease payment can be deemed as in-substance a fixed lease payment. There is a need to reconsider the proposals on variable lease payments to accord them more closely to the definitions of assets and liabilities in the Conceptual Framework.

The proposal to include variable lease payments based on an index or rate at the commencement date would simplify the initial measurement to address concern on the complexity of measurement in the 2010 ED. However, the requirement for reassessment when the index or rate changes is equally, if not more complex, and can be onerous if that index or rate changes frequently (e.g. a consumer price index that increases every year due to inflation). Also, additional guidance may be required on the assessment of "expected" payments under residual value guarantees. It is unclear whether the "expectation" should be based on a quantitative probability-weighted estimate of occurrence or most likely outcome, or some qualitative assessments of market-based and contract-based factors, such as the past trend of market prices or a price index of the underlying asset in a lease.

The requirement that the measurement of the residual asset includes variable lease payments (those not included in the measurement of the lease receivable) that the lessor factors in when pricing the lease is conceptually sound but difficult to apply. In principle, the return to the lessor should include those variable lease payments that have been factored in the pricing and when those payments are received after the initial recognition, a portion of the residual asset relating to those variable payments is derecognised as an expense. However, the calculation of the amount to be derecognised is complex as it requires estimates of those variable lease payments over the lease term and those in a period. These variable lease payments may be linked to sales or use of the asset and estimates are likely to be subjective. Hence, a simpler way of calculating the portion to be derecognised (such as a straight-line basis) should be considered. The proposal in the (draft) Standard is only marginally more accurate than a straight-line basis, but it may not justify the costs that would be incurred.

13. Implications and Conclusions

The revised ED would correct the weaknesses and deficiencies that are apparent in the current IAS 17. The proposed right-of-use model for lessee accounting would resolve the long-debated concern on off-balance sheet financing. Rights and obligations, regardless of the form or legal structure, would be reflected as assets and liabilities if they meet the definitions of assets and liabilities in the *Conceptual Framework*. This would affect the current practice of many entities. For example, airline entities that

currently treat rental of airplanes as operating leases would be required to recognise the airplanes as right-of-use assets and corresponding lease liabilities in the statement of financial position. Similarly, a utility entity that purchases power or energy in a concession arrangement would be required to recognise a right-of-use asset on the power plant or the network infrastructure and a corresponding lease liability. Their financial leverage or gearing would probably increase by these new requirements, and this may affect their credit ratings, covenants in borrowings, etc.

The scope of the (draft) Standard is wide as it covers any contract that conveys a right to use an asset. A reporting entity would need to reassess all its contracts with counterparties to determine whether the contracts contain an embedded lease component (similar to the assessment of embedded derivatives in financial and non-financial contracts in IAS 39). These may include sale or purchase contracts that contain a right to use an asset. They may also include manufacturing, construction or service contracts that have multiple components, including a lease component.

For lessee accounting, apart from the requirement to recognise all assets and liabilities under leases, the impact on profit or loss would depend on the classification of a lease. If the lease is a Type A lease, there will be faster recognition of expenses in profit or loss (compared to an even recognition of rental expense for current operating leases). However, for a Type B lease, recognition of a straight-line lease cost in profit or loss would be about the same as the straight-line rental expense for current operating leases.

The proposals for lessor accounting have been simplified when compared to the proposals in the original 2010 ED. There were many adverse comments on the performance obligation approach in the original 2010 ED and this approach has been removed. There is generally no change to the lessor accounting for current finance leases. For leases of property (Type B leases), the lessor accounting is similar to the current operating leases in that a lessor recognises rental income on a straight line basis. There is no derecognition of the underlying asset. However, for leases of equipment and vehicles (Type A leases) a derecognition approach is applied in that a portion of the underlying asset is deemed as sold, with any profit attributable to that portion recognised in profit or loss. The residual asset is recognised separately. For current operating leases of equipment and vehicles, there will be a deferral of profit (the unearned profit attributable to the residual asset) but the interest income (on both the lease receivable and the residual asset) recognised in profit or loss would be faster in the earlier years of a lease, compared to the straight-line basis of rental income in the current IAS 17.

The revised ED also introduces some new concepts and criteria or thresholds, such as “significant economic incentive” “in-substance fixed payments”, “a major part of the remaining economic life”, “substantially of all the fair value” and “insignificant” consumption. The application of these concepts and criteria invariably requires judgements because they are qualitative factors rather than quantitative bright-lines. An entity would need to assess these qualitative factors and document its assessment to minimise subjectivity in the application.

Also, many more items would be within the scope of lease accounting and these may include medium-term rental of equipment, property tenancy agreement and other medium-term arrangements that convey a right to use an asset for a consideration. It would also include leases of land regardless of the lease period. In Malaysia, the tax treatment for leases (whether finance or operating leases) is generally based on rentals paid. Bringing in more assets and liabilities in the statement of financial position under the new lease accounting models would also require additional deferred tax assets and deferred tax liabilities. The tax consequences of the changes would require a careful and detailed analysis for all lease transactions.

References:

1. ED/2010/9, *Leases*, August 2010, IASB.
2. ED/2013/6, *Leases*, May 2013, IASB.
3. IAS 17, *Leases*, September 1982, IASC.
4. IASB *Leases – Basis for Conclusions*, May 2013, IASB,
5. IASB Staff Paper, *Effects of board redeliberations on Exposure Draft Leases*, June 2011, IASB.
6. IFRIC 4, *Determining whether an Arrangement contains a Lease*, December 2004, IFRIC.

7. Snapshot – Leases, May 2013, IASB.

Tan Liong Tong currently serves as a Project Manager of the Consolidation Project in MASB. He was previously an Associate Professor with the Graduate School of Management, Universiti Putra Malaysia. The views expressed in this article are those of the author and not the official views of the MASB.

Appendix – A Case on Lease Accounting

At the beginning of Year 1, Entity K, a hotel owner, enters into an arrangement to convey to Entity L, a hotel operator, the right to use the hotel property. The carrying amount of the property in the books of Entity K is RM100 million, measured on the depreciated cost basis. The property has a remaining economic life of 30 years. However, the property's current market value on this date is assessed at RM250 million.

The details of the arrangement are as follows:

- (a) A non-cancellable period of 10 years:
 - (i) Rental for the first five years is fixed at RM16 million per year, payable in advance at the beginning of Year 1 and thereafter at the end of each preceding year (for example, year 2 rental is payable at the end of Year 1).
 - (ii) Rental for the years 6-10 is determined at the higher of RM19.5 million and RM16 million plus an adjustment to reflect the property price index in the preceding five-year period. The rentals are payable in advance at the end of each preceding year of the years 5-9 (for example, Year 6 rental is payable at the end of Year 5).
- (b) An option to extend the lease for another 5 years at the end of Year 10.
 - (i) If the option is exercised, rental for the years 11-15 is determined at the then market rate prevailing at the end of Year 10.
 - (ii) If the option is not exercised, a penalty payment of RM8 million is imposed as compensation for the owner to seek a new operator.
 - (iii) Upon termination of the arrangement at the end of Year 10, the guaranteed residual value is RM100 million. If the market value drops below RM100 million at end of Year 10, the difference in value is the payment of residual value guarantee.
- (c) Notwithstanding clause (b) above, the arrangement will terminate at the end of Year 15. Any option to extend the lease thereafter will be renegotiated on a willing-buyer willing-seller basis, giving first priority of renewal to the operator.
- (d) Contingent rentals – If at the end of Year 5 or Year 10, whichever is applicable, the benchmark Klibor has increased in the preceding 5-year period, additional rental becomes payable as follows:
 - (i) Klibor increases by 100 basis point – RM2 million.
 - (ii) Klibor increases by 200 basis points – RM3.5 million.
 - (iii) For every further increase of 100 basis points an additional amount of RM0.5 million.
- (e) The operator has an option at the end of Year 10 or Year 15, whichever is applicable, to purchase the hotel property at the prevailing market value at the date the purchase option is exercised.

The implicit rate of interest that Entity K charges Entity L is 5% per annum. Market rates for rental of similar properties have, in past years, moved in tandem with the property price index with an average increase of 4% per year. The current Klibor is 4%. Entity K estimates that the Klibor will increase by 100 basis points every 5 years.

Entity L's business model for leasing similar hotels is based on a 10-year forecast. It expects to lease newer and more modern hotels every 10 years. It expects to incur refurbishment costs on the hotel and these are expected to last about 5 years. No significant economic value is expected from these refurbishment costs at the end the non-cancellable lease period. The market value of the hotel at the end of Year 10 is estimated at RM90 million. Entity L expects to pay a residual value guarantee of RM10 million.

Both the lessor and lessee incur initial direct costs of RM2 million.

Required:

Explain and show the lessee accounting and the lessor accounting in the above case.

Solution:

Determining the lease term:

The lease term in this case is 10 years. There is no significant economic incentive to exercise the option to extend the lease period after 10 years because Entity L's business model is to operate such leases on a 10-year planning horizon. The leasehold improvements (i.e. the hotel refurbishments) are not expected to have significant economic value, and rentals in the optional period would be priced at the then prevailing market rate.

Estimating the lease payments (relevant cash flows):

- (a) Rental payment for the first 5 years is fixed at RM16m per year payable in advance.
- (b) Rental payment for each year in years 6-10 is RM19.5m because this variable payment is in-substance, fixed payments (regardless of the movement in the property price index, this amount is payable in the non-cancellable lease period).
- (c) Contingent rental is expected to be payable in each of the years 6-10 at RM2m based on the expected increase in Klibor, a market interest rate.
- (d) The purchase option at the end of Year 10 is not relevant because there is no significant economic incentive to exercise the option if the option is set at the then prevailing market value.
- (e) Term option penalty of RM8m is expected to be payable at end of Year 10 (using a lease term of 10 years implies that the option to extend will not be exercised).
- (f) Payment of residual value guarantee at the end of year 10 = 100m – 90m = RM10m.

Discounting the estimated cash flows:

Using the rate that Entity K charges Entity L, the lease payments (the relevant cash flows above) are discounted at 5%. The calculation of the present value is shown below:

Year	Variable rental RM'm	Contingent rental RM'm	Penalty & guarantee RM'm	Lease payments RM'm
0	16.00			16.00
1	16.00			16.00
2	16.00			16.00
3	16.00			16.00
4	16.00			16.00
5	19.50	2.00		21.50
6	19.50	2.00		21.50
7	19.50	2.00		21.50
8	19.50	2.00		21.50
9	19.50	2.00		21.50
10	-	-	18.00	18.00
Net present value =				160.37

Classification of the Lease

The underlying asset in the lease is a hotel property (land and building). It is classified as Type B lease.

Entity L – Lessee's Accounting

Recording the lease arrangement

Entity L adds the initial direct costs of RM2m to the right-of-use asset. The journal entry for the recognition at the commencement date would be as follows:

	RM'm	RM'm
Dr Right-of-use asset	162.37	
Cr Lease liability		160.37
Cr Bank – initial direct costs incurred		2.00
Dr Lease liability	16.00	
Cr Bank – payment in advance		16.00

The total lease cost (sum of the undiscounted lease payments) is RM205.5 million. On a straight-line basis, the lease cost recognised as an expense in each year is RM20.55 million.

The lease liability is carried at the amortised cost effective interest method. The effective rate in the liability is the 5% used in the present value calculation, and this is the rate that interest expense should be recognised each year over the 10-year lease term. For example, the journal entry at the end of Year 1 would be as follows:

	RM'm	RM'm
Dr Interest expense (5% x 144.37)	7.22	
Dr Lease liability	8.78	
Cr Bank – rental paid		16.00

The difference between the lease cost and the interest expense of RM13.33 million is the amortisation expense of the right-of-use asset in Year 1.

The carrying amount of the lease liability, interest expense and lease payments, lease cost and amortisation made in each year in the lease period would be as follows:

Year	Opening liability	Interest expense	Lease payment	Closing liability	Lease cost	Amortisation expense
	RM'm	RM'm	RM'm	RM'm	RM'm	RM'm
0	160.37	-	(16.00)	144.37		
1	144.37	7.22	(16.00)	135.59	20.55	13.33
2	135.59	6.78	(16.00)	126.37	20.55	13.77
3	126.37	6.32	(16.00)	116.69	20.55	14.23
4	116.69	5.83	(16.00)	106.52	20.55	14.72
5	106.52	5.33	(21.50)	90.35	20.55	15.22
6	90.35	4.52	(21.50)	73.36	20.55	16.03
7	73.36	3.67	(21.50)	55.53	20.55	16.88
8	55.53	2.78	(21.50)	36.81	20.55	17.77
9	36.81	1.84	(21.50)	17.15	20.55	18.71
10	17.15	0.85	(18.00)	(0.00)	20.55	19.70
Total		45.13	(205.50)		205.50	160.37

Entity K – Lessor's Accounting

The underlying asset is a Type B lease. Entity K, the lessor, does not derecognise the hotel property. Rental income is recognised on the straight-line basis (or another systematic basis). For example, on the straight-line basis, it may recognise rental income of RM20.55 million in each year of the 10-year lease term. The initial direct costs of RM2 million is also recognised as an expense on the straight-line basis over the 10-year lease term.