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ACCOUNTING FOR LEASES

I. BACKGROUND AND INTRODUCTION

A. This summary prescribes the accounting treatment for leases in the financial statements of lessees and lessors as it stands as of mid-2014. Relevant literature affecting accounting for leases includes FRS 17; INT–FRSs 15, 27, 104 and 112; and FRS 1 (revised 2008).

B. Major changes to lease accounting have long been debated by IASB, and a revised exposure draft of a substantially revised new approach was issued in 2013, with a likely outcome being that a new standard will be promulgated in 2014 that will require formal recognition of assets (rights to use) and related liabilities for most leases, including many of those currently treated as operating leases. The proposal will be addressed later in this material, and copious examples will also be provided.

II. SCOPE

A. The existing lease standard is to be applied in accounting for leases other than:

1. Leases to explore for or use non-regenerative resources such as oil, natural gas, and so forth; and

2. Licensing arrangements for motion pictures, video recordings, music, and so on.

B. The existing lease standard is not to be applied in the measurement of:

1. Property held by lessees that is an investment property (addressed by FRS 40);

2. Investment property provided by lessors under operating leases (see also FRS 40);

3. Biological assets held by lessees under finance leases (see FRS 41); or

4. Biological assets provided by lessors under operating leases (see FRS 41).

III. DEFINITIONS OF KEY TERMS (in accordance with FRS 17)

Commencement of term. Date when lessee may first exercise its rights, and when accounting recognition begins.

Contingent rent. The portion of the lease payments that is not fixed but rather is based on value of a factor that changes with passage of time (e.g., percentage of future sales).

Lease. An agreement whereby the lessor conveys to the lessee in return for payment the right to use an asset for an agreed period of time.

Lease term. Non-cancellable period over which use of asset has been contracted, together with any renewal period for which, as of inception date, it is reasonably certain lessee will exercise rights per option.

Economic life. Period of time, or units of production, over which leased asset will be useful for one or more users.

Fair value. The amount for which asset could be acquired in arm's-length transaction.

Finance lease. A lease that transfers substantially all the risks and rewards of ownership of an asset. Title need not necessarily be eventually transferred.
Gross investment in lease. Aggregate of minimum lease payments receivable by lessor and any unguaranteed residual value accruing to lessor.

Guaranteed residual value. For lessee: the portion of residual guaranteed by lessee or party related to lessee. For lessor: the portion guaranteed by lessee or by third party that is financially capable of discharging obligation.

Implicit rate. The discount rate that, at lease inception, equates the minimum lease payments and unguaranteed residual value to the fair value of the leased asset and any lessor initial direct costs.

Inception of lease. Earlier of date of lease arrangement or date of commitment by both parties to principal terms. At this date, lease is classified as either operating or finance lease, and, if the latter, the amounts to be given accounting recognition are determined.

Incremental borrowing rate. The rate of interest the lessee would have to pay on a similar lease or to borrow under similar circumstances the funds needed to purchase the asset.

Initial direct costs. Incremental costs directly attributable to negotiating and arranging a lease, except for costs incurred by manufacturer or dealer lessors.

Operating lease. A lease that is not a finance lease.

Minimum lease payments. The payments over the lease term that are required to be made. For a lessee, this includes any amounts guaranteed to be paid; for a lessor, this includes any residual value guaranteed to the lessor.

Net investment in lease. Gross investment discounted to present value using implicit interest rate in lease.

Non-cancellable lease. A lease cancelable only upon occurrence of a remote contingency, with the permission of lessor, upon agreement by lessee to new lease for same or equivalent asset with same lessor, or upon payment of an amount that, at inception, appears to such that continuation of lease seems assured.

Unearned finance income. The difference between the gross and net investment in the lease.

Unguaranteed residual value. The portion of residual not assured or guaranteed only by party related to lessor.

Useful life. Estimated remaining time, from commencement of lease term, over which economic benefits are expected to be consumed.

A. The definition of a lease includes those contracts for hire of an asset that contain provisions for the hirer to acquire title to the asset upon fulfillment of agreed conditions these are sometimes called hire purchase contracts.

IV. CLASSIFICATION OF LEASES UNDER CURRENT RULES

A. The classification of a lease as either a finance lease or an operating lease is critical, as significantly different accounting treatments are required for the different types of lease. The classification is based on the extent to which risks and rewards of ownership of the leased asset are transferred to the lessee or remain with the lessor. Risks include technological obsolescence, loss from idle capacity, and variations in return. Rewards include rights to sell the asset and gain from its capital value.

B. A lease is classified as a finance lease if it transfers substantially all the risks and rewards of ownership to the lessee. If it does not, then it is an operating lease. When classifying a lease, it is important to recognize the substance of the agreement and not just its legal form. The commercial reality is important.
Conditions in the lease may indicate that an entity has only a limited exposure to the risks and benefits of the leased asset. However, the substance of the agreement may indicate otherwise. Situations that, individually or in combination, would usually lead to a lease being a finance lease include:

1. Transfer of ownership to the lessee by the end of the lease term.

2. The lessee has the option to purchase the asset at a price that is expected to be lower than its fair value, such that the option is likely to be exercised.

3. The lease term is for a major part of the economic life of the asset, even if title to the asset is not transferred.

4. The present value of the minimum lease payments is equal to substantially all of the fair value of the asset.

5. The leased assets are of a specialized nature such that only the lessee can use them without significant modification.

C. Situations that, individually or in combination, could lead to a lease being deemed a finance lease include:

1. If the lessee can cancel the lease, and the lessor's losses associated with cancellation are borne by the lessee

2. Gains or losses from changes in the fair value of the residual value of the asset accrue to the lessee.

3. The lessee has the option to continue the lease for a secondary term at substantially below-market rent.

D. A large degree of judgment has to be exercised in classifying leases; many lease agreements are likely to demonstrate only a few of the situations listed, some of which are more persuasive than others. In all cases, the substance of the transaction needs to be properly analyzed and understood. Emphasis is placed on the risks that the lessor retains more than the benefits of ownership of the asset. If there is little or no related risk, then the agreement is likely to be a finance lease. If the lessor suffers the risk associated with a movement in the market price of the asset or the use of the asset, then the lease is usually an operating lease.

E. Understanding the purpose of the lease arrangement may help the classification. If there is an option to cancel, and the lessee is likely to exercise such an option, then the lease is likely to be an operating lease.

F. Classifications of leases are to be made at the inception of the lease. The inception of a lease is the earlier of the agreement date and the date of the commitment by the parties to the principal provisions of the lease. If the lease terms are subsequently altered to such a degree that the lease would have had a different classification at its inception, it will be concluded that a new lease has been entered into. Changes in estimates such as the residual value of an asset are not deemed to be the basis for a change in classification.

G. Leases of land and buildings need to be treated separately, as often the land lease is an operating lease and the building lease is a finance lease.

1. Difficulties arise because the minimum lease payments need to be allocated between the land and the building element in proportion to their relative fair values of the leasehold interests at the beginning of the lease.
2. If the allocation cannot be made reliably, then both leases are treated as finance leases or as operating leases, depending on which classification the arrangement more clearly follows.

3. If the lessee is to classify the land and buildings as investment property, as permitted under FRS 40, it must be treated as a finance lease and the fair value model must be adopted. In such case, separate measurement is not required.

V. LEASES IN THE FINANCIAL STATEMENTS OF LESSEES UNDER CURRENT RULES

A. Finance leases.

1. At the commencement of the lease term, the lessee is to recognize an asset and a liability at the fair value of the leased asset or, if lower, at the present value of the minimum lease payments. The appropriate discount rate in the present value calculation is the rate implicit in the finance lease – i.e., that rate which discounts the lease payments to the fair value of the asset plus any initial direct costs of the lessor.

2. The impact of this treatment is to reflect the economic substance of the transaction. The lessee has acquired an asset for the substantial part of its useful life and expects to obtain substantially all the benefits from its use. In other words, the lease arrangement is merely a financing vehicle for the acquisition of an asset.

3. Subsequent to initial recognition, the lease payments are apportioned between the repayment of the outstanding liability and the finance charge so as to reflect a constant periodic rate of interest on the liability. Methods of calculation vary and include sum of the digits, which is a rough approximation, as well as more complex amortization models.

4. The asset needs to be depreciated over its expected useful life under FRS 16, using methods employed for similar, owned assets. However, if there is no reasonable certainty that ownership will transfer to the lessee, then the shorter of the lease term and the useful life should be used.

B. Disclosures for finance leases.

The following disclosures for finance leases are required, in addition to those required by the financial instruments disclosure standard (FRS 107):

1. For each class of asset, the net carrying value at the date of the statement of financial position;

2. A reconciliation between the total of the minimum lease payments and their present value;

3. The total of the future minimum lease payments analyzed as to:
   a. Amounts due in not more than one year;
   b. Amounts due more than one year but not later than five years hence; and
   c. Amounts due more than five years hence.

4. Contingent rents;

5. Total future minimum lease payments expected to be received under non-cancelable sub-leases; and

6. A general description of the lessee’s material leasing arrangements.
C. Operating leases.

1. Lease payments under operating leases are to be recognized as an expense on a straight-line basis over the lease term, unless another basis is more representative of the pattern of the user’s benefit, even if the payments follow a different pattern.

2. It is important to recognize the impact of incentives in operating leases. Often, incentives to enter into operating leases take the form of up-front payments from the lessor, rent-free periods, and the like. These need to be appropriately recognized over the lease term from commencement. Thus, a rent-free period does not mean that the lessee avoids a rent charge in its income statement; rather, it has to apportion the rent for the entire lease over the entire period, resulting in a reduced annual charge.

D. Disclosures for operating leases.

In addition to the disclosures required by the financial instruments standard, FRS 107, these disclosures are required:

1. Total future minimum lease payments under non-cancelable operating leases for each of the following:
   a. Amounts due in not more than one year;
   b. Amounts due more than one year and not later than five years hence; and
   c. Amounts due more than five years hence.
2. Total future minimum lease payments expected to be received under non-cancelable sub-leases.
3. Lease and sublease payments and contingent rents recognized as an expense in the period.
4. A general description of the significant leasing arrangements.

VI. LEASES IN THE FINANCIAL STATEMENTS OF LESSORS UNDER CURRENT RULES

A. Finance leases.

1. Lessors are to recognize assets held under finance leases as a receivable equal to the net investment in the lease. The net investment in the lease is the aggregate of the minimum lease payments and any unguaranteed residual value (together, the “gross investment”) discounted at the rate implicit in the lease.

2. Due to the definition of the interest rate implicit in the lease – i.e., that rate which discounts the lease payments to the fair value of the asset plus the initial direct costs of the lessor – the initial direct costs of the lessor are automatically included in the receivable. The direct costs of the lessor are those incremental costs directly attributable to negotiating and arranging a lease.

3. Subsequent to initial recognition, finance income is recognized based on a pattern reflecting a constant rate of return on the net investment in the lease. Receipts under the finance lease are apportioned to the gross investment, as a reduction in the receivable, and to the finance income element.

4. Lessors who are manufacturers or dealers should recognize profit on the transaction in the same way as for normal sales of the entity. Thus a finance lease will create a profit or loss from the sale of the
asset at normal selling prices and a finance income over the lease term. If artificially low rates of interest are quoted, profit is calculated using market interest rates.

B. Disclosures for finance leases.

In addition to the requirements of the financial instruments disclosure standard, FRS 107, these disclosures are required:

1. A reconciliation between the gross carrying amount of the investment in the lease and the present value of the future minimum lease payments receivable.

2. The gross investment in the lease and the future minimum lease payments for each of the following:
   a. Amounts due in not more than one year;
   b. Amounts due in more than one year but not later than five years hence; and
   c. Amounts due more than five years hence.

3. Unearned finance income.

4. Unguaranteed residual value.

5. Doubtful recoverable lease payments.

6. Contingent rents recognized as income.

7. A general description of the significant leasing arrangements.

C. Operating Leases.

1. Lessors are to report assets subject to operating leases in the financial statement in accordance with the nature of the asset—e.g., as motor vehicles, plant and equipment, and so on.

2. Lease income from operating leases is to be recognized in the income statement on a straight-line basis over the lease term unless another basis reflects better the nature of the benefit received. Any incentives should be considered.

3. Depreciation on the asset subject to a lease is recognized as an expense and should be determined in the same manner as similar assets of the lessor. Additionally, the lessor should apply the principles of FRS 16, 36, and 38, as appropriate.

4. Initial direct costs of negotiating and arranging the lease shall be added to the cost of the asset and expensed over the lease term in the same pattern as the income is recognized.

D. Disclosures for operating leases.

In addition to the requirements of the financial instruments disclosure standard, FRS 107, these disclosures are required:

1. The future minimum lease payments under non-cancelable operating leases for each of the following:
2. Amounts due in not more than one year;
3. Amounts due in more than one year but not later than five years hence; and
4. Amounts due more than five years hence.
5. Contingent rents recognized as income.
6. A general description of the significant leasing arrangements.

VII. SALE AND LEASEBACK TRANSACTIONS AND OTHER TRANSACTIONS INVOLVING THE LEGAL FORM OF A LEASE UNDER CURRENT RULES

A. Very often, entities enter into complex financing arrangements involving lease-like arrangements. Careful analysis of such arrangements needs to be undertaken to ensure that the substance of the transaction, not just the legal form, is properly reflected.

B. A common financing transaction is a sale and leaseback, whereby the owner of an asset sells it to a financier who then leases the asset back to the original owner. Analysis is required to determine whether the leaseback is a finance lease or an operating lease.
   1. A finance leaseback results in the seller-lessee having to defer any profit on disposal, to be recognized ratably over the lease term.
   2. If the leaseback is an operating lease and the entire transaction is at fair value, gain or loss on disposal is recognized immediately.

C. Other, more complex transactions need to be analyzed for their substance and often involve a series of transactions involving leases. On occasion, just tax benefits arise; sometimes there is no real transaction when the series of transactions is viewed in its entirety. In such cases, the substance needs to be clearly reflected in the financial statements.

D. In the case of an operating lease, if the sale price is below fair value and the loss is compensated by future lease payments at below market price, then the loss should be deferred and amortized in proportion to the lease payments over the useful life of the asset.

E. If the loss is not compensated by future lease payments, it should be recognized immediately.

F. If the sale price is above fair value and the rentals are above the normal market rates, the excess over fair value should be deferred and amortized over the useful life of the asset.

VIII. NEW MODEL FOR LEASE ACCOUNTING – THE REVISED (2013) EXPOSURE DRAFT

A. There has been longstanding displeasure with lease accounting as prescribed by IAS 17 and related standards. These are seen as permitting opportunistic structuring to obtain off-balance sheet treatment of debt obligations; fostering a lack of cross-entity comparability; and being excessively rules-based (to a great extent, even under otherwise largely principles-based IFRS).

B. A joint project with FASB began in 2006; a discussion paper was issued in 2009; an exposure draft in 2010; with re-deliberations taking several more years, and a substantially revised exposure draft issued in 2013, with further re-deliberations now occurring in 2014. In as much as fundamental disagreements
exist between IASB and FASB preferences on several issues, but both bodies committed to a converged standard, timing of a final standard cannot be accurately predicted.

C. If adopted as currently proposed, IFRS will require that most (but still not all) leases be given balance sheet recognition as intangible “rights-of-use” property, with corresponding debt obligations, in the manner of current finance/capital leases under IFRS and other GAAP standards.

1. However, depending on the specifics (see below), some leases will still result in “straight-line” expense recognition (for lessees), similar to how operating leases currently impact income.

2. Other leases will be accounted for similar to the manner in which finance leases are presently treated, i.e., with front-loading of expense recognition (for lessees) comprising amortization plus interest on the implied debt obligation, calculated by a constant rate on a declining balance.


D. Key concepts and requirements of the proposed standard.

1. For lessees, some leases that previously were accounted for as operating leases will be capitalized as right-of-use assets and associated debt obligations.

2. Accounting for periodic expense associated with the right-of-use assets will depend upon whether the lease is determined to be a Type A or a Type B lease (see below), with the difference being in the pattern of expense recognition to be employed.

3. For lessors, some leases previously classed as operating would be accounted for as transfers of rights-of-use and the creation of two distinct assets: the lease receivable and a residual asset (if applicable).

4. For lessors, accounting for Type B leases (see below) would essentially follow current operating lease treatment. Thus, lessee and lessor accounting for some of the same transactions would diverge.

E. Identifying leases.

1. Leases must involve contractual rights to use assets (the “underlying assets”) for a period of time, in exchange for consideration.

2. Fulfillment of the contracts has to depend on the use of identified assets:

   a. Commonly, the assets will be identified in the contract, satisfying this requirement.

   b. However, if the lessor has a substantive right to substitute the asset throughout the term of the contract, this criterion will not be met. Substantive right to substitute will be indicated if:

      i) The supplier can substitute alternative assets without requiring the customer’s consent; and

      ii) There are no economic or other barriers that would prevent such substitution during the term of the contract. Examples of such barriers include high costs associated with substituting the asset and operational barriers, such as lack of availability, that would prevent or deter the supplier from substituting the asset.

   c. Even if a specific asset is not identified in the contract, however, absence of right to substitute may imply identification of an asset sufficient to satisfy this requirement.
d. A physically distinct part of an asset (e.g., a floor of a building) can serve as an identified asset, but a capacity portion (e.g., 50% of the floor space of the building, without designation of unique areas) generally would not qualify as being an identified asset.

3. To qualify as a lease, the contract must convey the right to control the use of an identified asset for a period of time in exchange for consideration:

   a. The ability to control is demonstrated by the presence of both:
      i) The ability to direct the use of the identified asset, and
      ii) The ability to derive benefits from the use of the identified asset.

   b. Regarding the ability to direct use,
      i) The user (lessee) must have the right to make decisions (e.g., how the asset is operated, who operates it) regarding the asset's use that will most significantly affect the benefits to be derived from such use over the term of the lease.
      ii) The substantive decisions may precede the commencement date, e.g., by designing the configuration of the assets or terms of the lease contract, and these control the use over the lease term to meet this threshold criterion.
      iii) The incorporation of protective rights for the lessor (e.g., maximum number of operating hours per month) that secure residual value for the lessor does not necessarily prevent the ability to control use of the leased asset.
      iv) The right to specify output from the asset does not necessarily imply the lessee's ability to control use of the asset.

   c. Concerning the ability to derive benefits from the asset's use,
      i) The lessee should be able to obtain essentially all the benefits from the use of the asset over the lease term.
         a) These can be derived in various direct and indirect ways, such as by using, consuming or holding the asset, or by engaging in a commercial transaction with a third party.
      ii) The ability to derive benefits does not exist if both:
         a) The lessee can obtain the benefits only if the asset is used in conjunction with additional goods or services provided by the lessor and not otherwise separately available from other suppliers, and
         b) The asset is incidental to the delivery of services because the asset is designed to function only with the additional goods or services provided by the lessor.

F. Distinguishing between Type A and Type B leases under the proposed standard.

   1. For leases of “property,” including land and building (whether all or part thereof), would be deemed to be Type B leases unless the lease covers a major portion of the underlying property's remaining economic life, or the present value of the fixed lease payments accounts for substantially all of the fair value of the underlying assets.
a. These criteria are reminiscent of U.S. GAAP’s “75% of useful life” and “90% of fair value” criteria (the third and fourth of the four tests for capital leases under SFAS 13) threshold tests, but use qualitative descriptors (“major part” and “substantially all”), consistent with IFRS’s inclination to be principles-based, in contradistinction to U.S. GAAP’s presumed bias toward rules.

b. If either of these criteria are met, the lease would be deemed a Type A lease, with accounting ramifications as set forth below.

c. As a practical matter, the result will likely be that leases of land and buildings will generally be Type B for purposes of accounting under the new lease standard.

2. For leases “other than for property” (as defined, see below), classification would be as a Type A lease, unless the lease term were for an insignificant portion of the underlying asset’s economic life, or if the present value of the fixed lease payments were insignificant relative to the fair value of the underlying asset.

a. These criteria are again reminiscent of the U.S. GAAP criteria cited above, but again use qualitative descriptors (“insignificant portion” and “insignificant”) rather than quantitative threshold identifiers.

b. As a practical matter, the result will likely be that leases for “other than property,” as defined, will generally be considered to be Type A for purposes of accounting under the new lease standard.

3. Both Type A and Type B leases will result in on-balance sheet presentation of assets (rights-of-use) and corresponding liabilities for lessees, and thus have effects similar to finance leases under IAS 17, with corollary impacts on debt/equity ratios and other important financial measures.

a. However, the pattern of expense recognition in the income statements will vary, with Type B leases having impact similar to that of operating (i.e., off-balance sheet) leases; thus, the accounting for Type B leases can be seen as being a hybrid.

b. As a practical matter, the result will likely be that leases for “other than property,” as defined, will generally be Type A for purposes of accounting under the new lease standard.

4. “Property” as used in the proposed standard implies real estate (i.e., land and buildings). “Other than property” includes such items as equipment, aircraft, automobiles, trucks, etc. (i.e., personal property).

5. If a lease component contains both land and building, the economic life of the building is gauged by the life of the underlying asset for purposes of ascertaining classification.

6. There will be an optional exemption for short-term (under one year) leases, which, if invoked, avoids balance sheet recognition of right-of-use assets and related obligations.

7. Notwithstanding the criteria above, if a lessee has a significant economic incentive to purchase the underlying asset under terms of an option, it is to be classified as a Type A lease.

G. Measuring the right-of-use asset.

1. The right-of-use asset and corresponding liability (for the lessee in the case of either Type A or Type B leases) and the lease receivable (for the lessor in the case of Type A leases) would be computed with reference to the lease’s non-cancelable period, 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” to not exercise the option.

2. The right-of-use asset and corresponding liability (for the lessee) and the lease receivable (for the lessor) would furthermore take into account both the fixed lease payments and those variable payments that are based on an index or rate (e.g., market interest rates, an inflation index), but would exclude any other variable payments unless in-substance those are fixed.

a. If variable lease payments are included in the initial determination of right-of-use or lease receivable assets, these would be based on the index or rate effective on the lease commencement date.

3. The lessee would reassess the lease obligation, and the lessor would reassess the lease receivable, if either of these events later occurs:

a. Relevant factors (affecting either the incentive to extend or the incentive to terminate, as for example the costs of negotiating a new lease or locating a suitable replacement right-of-use) change, causing a change in the lease term; or

b. The index or rate used to determine variable lease payments changes.

H. Contracts that contain or are leases are to be separated into component leases if both –

1. The lessee can benefit from the use of the component asset either separately or in conjunction with other resources readily available from other sources, and

2. The underlying asset is neither dependent on, nor highly interrelated with, the other underlying component assets in the lease contract.

3. Lessee accounting for separate components depends upon whether there are observable stand-alone prices for each component, where prices mean either similar lease terms offered by other lessors or for the good or service sold on a stand-alone basis by vendors.

a. If there are prices for each component, the relative stand-alone prices are used to allocate consideration among them.

b. If there are stand-alone prices for some components, these are used to allocate consideration among them, with the residual assigned to the component not having a stand-alone price; if several components lack prices, these are combined into one reportable lease component.

c. If no components have stand-alone prices, these are all treated as part of a single lease.

I. Accounting for Type A leases by lessees under the proposed standard.

1. A right-of-use asset and a lease liability would be recognized in the statement of financial position, initially measured at the present value of future lease payments.

a. The present value is computed using the rate charged by the lessor, if that can be determined; otherwise, the lessee’s incremental borrowing rate is used.
b. The right-of-use asset is initially measured by reference to:
   
   i) The initial measurement of the lease liability, above;
   
   ii) Any lease payments made at or before the commencement date, less any incentives provided
       by the lessor; and
   
   iii) Any initial direct costs incurred by the lessee (such as commissions, fees, payments to existing
       tenants, and other incremental costs).

c. The lease liability consists of all these elements (if relevant):
   
   i) Fixed payments, less any incentives receivable from the lessor;
   
   ii) Variable lease payments that are governed by indexes or rates, initially given by those at the
       commencement date of the lease;
   
   iii) Any variable payments that are in-substance fixed payments;
   
   iv) Amounts expected to be due under a residual value guarantee;
   
   v) The exercise price of a purchase option if the lease offers significant economic incentive for
      its exercise; and
   
   vi) Lease termination penalty payments, if the term was defined to include early termination.

2. The unwinding (i.e., amortization) of the discount on the lease liability would be recognized separately
   from the amortization of the right-of-use asset. The unwinding of the discount (interest expense)
   would be computed as a constant rate on a declining loan balance, as with normal mortgage-type
   amortization (i.e., using the effective interest rate method).

3. Since the interest component would be front-end loaded, total expense would be heavier in early
   years, lesser in later years, even if the right-of-use asset were being amortized straight-line.

4. Amortization of the right-of-use asset would be by a systematic process consistent with the pattern by
   which the lessee expects to consume the asset’s future economic benefits. This mirrors the logic and
   general requirement regarding amortization of other long-lived assets under Singapore FRS (FRS 16 for
   tangible assets, FRS 38 for intangibles). Straight-line amortization would appear to be the expected
   norm, but accelerated amortization could also be rationalized.
   
   a. The right-of-use asset would be amortized over the lesser of the lease term or the expected useful
      economic life of the asset, unless the lessee has a significant economic incentive to exercise the
      purchase option.
   
   b. If the lessee has a significant incentive to exercise the purchase option, amortization over the
      right-of-use asset’s useful life is prescribed.

5. Impairment of the right-of-use asset would be recognized, as required, consistent with accounting for
   other long-lived assets under IFRS.

6. The lease liability would be adjusted if the lease term, factors pertaining to the incentives to exercise a
   purchase option, amounts due under residual value guarantees, or the index or rate used to determine
   variable lease payments change.
a. In general, changes recorded for the lease liability would also be reflected by changes to the right-of-use asset.

b. However, re-measurement triggered by a change in an index or rate that is attributable to the current period would be reflected immediately in income, and not by an adjustment to the carrying value of the right-of-use asset.

c. If adjustments to the lease obligation and the concomitant adjustments to the right-of-use asset result in the carrying value of the asset being reduced to zero, any further adjustments would be reflected in current income (i.e., the carrying value of the asset cannot be reduced below zero).

7. The discount rate is to be reassessed if there is a change in the lease term, in factors indicating that the economic incentive to exercise a purchase option has dissipated, or in a reference interest rate if relevant to the variable lease payments to be made.

a. If the interest rate is reassessed, it is to be the rate the lessor would charge the lessee as of the date of the reassessment, if known, or the then-extant lessee’s incremental borrowing rate, if not.

J. Accounting for Type B leases by lessees under the proposed standard.

1. A right-of-use asset and a lease liability would be recognized initially measured at the present value of future lease payments (see above discussion).

2. A single periodic lease cost would be recognized, combining the unwinding of the discount with the amortization of the right-of-use asset, on a straight-line basis.

3. Thus, the impact on the income statement would be straight-line over the entire lease term.

4. If the unwinding of the discount on the lease receivable were computed (as would seem logical) by employing the effective interest rate method, this would necessitate that the amortization of the right-of-use asset be calculated by an increasing-charge method, in order to make the sum of these parts be equal each period.

K. Accounting for Type A leases by lessors under the proposed standard.

1. The underlying leased asset would be derecognized as if it had been sold.

2. Two assets would be recognized:

   a. A lease receivable, measured by the present value of future fixed lease payments, discounted using the implicit lease interest rate, plus any initial direct costs, inclusive of –

      i) Fixed payments, net of any incentive payments to be made to the lessee;

      ii) Variable lease payments that depend on an index or a rate;

      iii) Variable lease payments that are in-substance fixed payments;

      iv) Lease payments structured as residual value guarantees;

      v) The exercise price of any purchase option, if the lessee has a significant economic incentive to exercise it; and
vi) Termination penalty payments, if the lease term is predicated on the termination option being exercised.

and

b. A separate residual asset, representing rights the lessor retained to the underlying asset, including expected variable rental payments, with the residual asset being measured with reference to –

i) The present value of the amount expected to be derived from the underlying asset after the lease term ends, plus

ii) The present value of variable lease payments (if not included in the lease receivable), less

iii) Any earned profit (described immediately below).

3. Any profit relating to the lease (the spread between the carrying value of the underlying asset being derecognized and its fair value at lease commencement) would be allocated between that reported in earnings at the inception of the lease and that added to the residual asset.

a. The portion recognized in income would be determined by multiplying the spread between carrying value and fair value by the present value of lease payments to be received, divided by the fair value of the underlying asset.

b. The portion recognized as part of the residual asset would be determined by reducing the spread between carrying value and fair value by amount reported in income at commencement of the lease.

4. The lessor under a Type A lease will re-measure the lease receivable and/or the residual asset under certain circumstances, as follows:

a. If there is a change in lease term, or in the assessment of whether the lessee has a significant economic incentive to exercise the purchase option, the carrying amount of the residual asset is to be adjusted, with gain or loss recognized in income.

b. If there is a change in lease term, or factors affecting the incentive to exercise the purchase option, the lease receivable is to be revised.

c. A change in the index or rate used to drive the variable payments, the lease receivable will be revised.

d. The discount rate used to determine the present value of lease payments will be revised if there are changes in the lease term, changes in factors affecting the incentive to exercise the purchase option, or changes to the reference interest rate, if variable payments are affected by such changes.

5. The carrying amount of the residual asset is to be accreted using the implicit rate in the lease.

6. If variable payments were included in the initial amount of the residual asset, the periodic amounts earned are removed from the residual asset and recognized in expense, using a cumulative computation at each reporting date.
7. If the lease receivable and/or residual asset is determined to become impaired, the impairment is to be recognized currently consistent with IAS 39 (unless this is altered by the IASB’s project on recognition of expected credit losses).
   a. The value of any collateral held by the lessor would be given consideration in such computation of the value of the lease receivable (exclusive of cash flows pertaining to the value of the residual asset).

8. At the end of the lease term, the residual asset would be reclassified to the appropriate category of long-lived asset, valued at the carrying amount of the residual asset at that date.

9. In the event of an early termination, the lessor under a Type A lease would have to –
   a. Test the lease receivable for impairment under IAS 39 and recognize any impairment;
   b. Reclassify the lease receivable and residual asset to appropriate categories, using the carrying values at that date; and
   c. Account for the underlying asset as required under IFRS.

L. Accounting for Type B leases by lessors under the proposed standard.
   1. The underlying property asset would continue to be recognized on the lessor’s balance sheet.
   2. Lease income would be recognized over the lease term, probably on a straight-line basis, together with any initial direct costs deferred.
      a. Variable payments are recognized in income as earned.
   3. The lessor thus reports the underlying (tangible, usually) asset on its balance sheet, and the lessee simultaneously reports the right-of-use asset regarding that same item on its balance sheet.

M. If contract terms are later modified, with substantive change to the existing lease, the modified lease is to be accounted for as a new lease as of the date the modifications become effective.
   1. Any difference between the then-carrying amounts of pertinent assets and liabilities from the predecessor lease and the corresponding amounts for the new lease is to be recognized in income immediately.
   2. Changes could involve lease term, or amounts of contractual payments.

N. If the right-of-use asset qualifies as investment property under IAS 40, it may alternatively be measured in accordance with the fair value model set forth by that standard.

O. Proposed presentation requirements for the lessee are as follow.
   1. A lessee will either present in the statement of financial position or disclose in the notes all of the following:
      a. The right-of-use assets separately from other assets;
      b. The lease liabilities separately from other liabilities;
c. The right-of-use assets arising from Type A leases separately from right-of-use assets arising from Type B leases and right-of-use assets measured at revalued amounts; and

d. The lease liabilities arising from Type A leases separately from lease liabilities arising from Type B leases.

2. If a lessee does not present right-of-use assets and lease liabilities separately in the statement of financial position, it must do both of the following:

   a. Present right-of-use assets within the same line item as the corresponding underlying assets would be presented if they were owned; and

   b. Disclose which line items in the statement of financial position include right-of-use assets and lease liabilities.

3. In the statement of profit or loss and other comprehensive income, a lessee is to present both of the following:

   a. For Type A leases, the unwinding (amortization) of the discount on the lease liability must be presented separately from the amortization of the right-of-use asset.

   b. For Type B leases, the unwinding of the discount on the lease liability is reported together with the amortization of the right-of-use asset.

4. In the statement of cash flows, a lessee is to classify lease items as follows:

   a. Repayments of the principal portion of the lease liability arising from Type A leases is presented within financing activities;

   b. The unwinding of the discount on the lease liability arising from Type A leases is to be reported in accordance with the requirements relating to interest paid in IAS 7, Statement of Cash Flows (which permits either operating or financing classification);

   c. Payments arising from Type B leases are to be reported within operating activities; and

   d. Variable lease payments and short-term lease payments not included in the lease liability are to be reported within operating activities.

P. Proposed presentation requirements for the lessor are as follow.

1. The lessor is to present lease assets (i.e., the sum of the carrying amounts of lease receivables and residual assets) separately from other assets in the statement of financial position.

2. The lessor is also to 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.

3. A lessor will either present in the statement of profit or loss and other comprehensive income or disclose in the notes income arising from leases.

   a. If a lessor does not present lease income in the statement of profit or loss and other comprehensive income, the lessor is to disclose which line items include the income in the statement of profit or loss and other comprehensive income.
4. The lessor is to present any profit or loss on the lease recognized at the commencement date in a manner that best reflects the lessor’s business model(s), such as by the following:

a. If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor should present 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.

b. If a lessor uses leases for the purposes of providing finance, it will present the profit or loss in a single line item.

5. In the statement of cash flows, a lessor is to classify cash receipts from lease payments within operating activities.

6. For a lessor having Type B leases, lease payments are to be reported as lease income in income 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.

a. The lessor is to recognize initial direct costs as an expense over the lease term on the same basis as lease income.

b. A lessor is to recognize variable lease payments in income in the period in which that income is earned.

c. A lessor is to continue to measure and present the underlying asset subject to a Type B lease in its balance sheet accordance with other applicable Standards.

d. In the statement of cash flows, a lessor is to classify cash receipts from Type B lease payments within operating activities.

Q. Proposed disclosure requirements applicable to lessee financial reporting are as follow.

1. The objective of the disclosure requirements is to enable users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases. To do so, a lessee is to disclose qualitative and quantitative information about all of the following:

a. Its leases (general characteristics and natures, including those that have yet to commence);

b. The significant judgments made in applying the [draft] Standard to those leases (e.g., discount rates, terms); and

c. The amounts recognized in the financial statements relating to those leases.

2. A lessee will be required to consider what level of detail will be necessary to satisfy the disclosure objective, and how much emphasis to place on each of the various requirements.

a. Aggregation or disaggregation of disclosures is to be optimized so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.
3. A lessee will be required to disclose the following:

   a. Information about the nature of its leases, with appropriate identification of any sub-leases incorporated, including:
      i) A general description of those leases;
      ii) The basis, and terms and conditions, on which variable lease payments are determined;
      iii) The existence, and terms and conditions, of options to extend or terminate the lease; narrative disclosure should be included about the options that are recognized as part of the right-of-use asset and lease liability and those that are not;
      iv) The existence, and terms and conditions, of residual value guarantees provided by the lessee; and
      v) The restrictions or covenants imposed by leases, e.g., those relating to dividends or incurring additional financial obligations.

   b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee.

   c. Information about significant assumptions and judgments made in applying the [draft] Standard, which may include the following:
      i) The determination of whether a contract contains a lease;
      ii) The allocation of the consideration in a contract between lease and non-lease components; and
      iii) The determination of the discount rate.

4. A lessee will have to disclose a reconciliation of opening and closing balances of right-of-use assets by class of underlying asset – separately for Type A leases, Type B leases, and right-of-use assets measured at revalued amounts – setting forth items that are useful in understanding the change in the carrying amount of right-of-use assets, e.g.:

   a. Additions due to leases commencing or being extended;
   b. Reclassifications when a lessee exercises a purchase option;
   c. Reductions due to lease terminations;
   d. Re-measurements relating to a change in an index or a rate used to determine lease payments;
   e. Amortization;
   f. Effects of business combinations; and
   g. Impairment.
5. A lessee that measures its right-of-use assets arising from leased investment property in accordance with the fair value model in FRS 40 may elect not to provide the preceding disclosures for those right-of-use assets.

6. If a lessee measures right-of-use assets at revalued amounts, the lessee is to disclose:
   a. The effective date of the revaluation; and
   b. The amount of the revaluation surplus that relates to right-of-use assets at the beginning and the end of the reporting period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders.

7. A lessee is to disclose a reconciliation of opening and closing balances of the lease liability separately for Type A leases and Type B leases, to include the periodic unwinding of the discount on the lease liability and other items that are useful in understanding the change in the carrying amount of the lease liability, e.g.:
   a. Liabilities created due to leases commencing or being extended;
   b. Liabilities extinguished due to leases being terminated;
   c. Remeasurements relating to a change in an index or a rate used to determine lease payments;
   d. Cash paid;
   e. Foreign currency exchange differences; and
   f. The effects of business combinations.

8. A lessee is furthermore to disclose costs that are recognized in the period relating to variable lease payments not included in the lease liability.

9. A lessee must also disclose 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 (per FRS 7).

10. In lieu of the maturity analyses required by FRS 107, Financial Instruments: Disclosures, a lessee is to disclose a maturity analysis of the lease liability, 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. The undiscounted cash flows are to be reconciled to the lease liability recognized in the statement of financial position.

R. Proposed disclosure requirements applicable to lessor financial reporting are as follow.

1. The objective of the disclosure requirements is to enable users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases, which is achieved by presenting qualitative and quantitative information about all of the following:
   a. Its leases;
   b. The significant judgments made in applying the [draft] Standard to those leases; and
c. The amounts recognized in the financial statements relating to those leases.

2. A lessor is to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements.

a. The lessor should aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

3. A lessor is to disclose the following:

a. Information about the nature of its leases, including:
   i) A general description of those leases;
   ii) The basis, and terms and conditions, on which variable lease payments are determined;
   iii) The existence, and terms and conditions, of options to extend or terminate the lease; and
   iv) The existence, and terms and conditions, of options for a lessee to purchase the underlying asset.

b. Information about significant assumptions and judgments made in applying the [draft] Standard, which may include the following:
   i) The determination of whether a contract contains a lease;
   ii) The allocation of the consideration in a contract between lease and non-lease components; and
   iii) The initial measurement of the residual asset.

4. A lessor is also to disclose lease income recognized in the reporting period, in a tabular format, to include the following:

a. For Type A leases:
   i) Profit or loss recognized at the commencement date (gross or net);
   ii) The unwinding of the discount on the lease receivable; and
   iii) The unwinding of the discount on the gross residual asset;

b. For Type B leases, lease income relating to lease payments;

c. Lease income relating to variable lease payments not included in the measurement of the lease receivable; and

d. Short-term lease income.
5. Specific additional disclosures applicable to Type A leases by lessors are as follow:

a. A lessor will have to disclose a reconciliation of the opening and closing balances of the lease receivable, including such items as:

   i) Additions due to leases commencing or being extended;
   ii) Receivables derecognized due to leases being terminated;
   iii) Cash received;
   iv) The unwinding of the discount on the lease receivable;
   v) Foreign currency exchange differences;
   vi) Effects of business combinations; and
   vii) Changes to the loss allowance.

b. A lessor will also have to disclose a reconciliation of the opening and closing balances of the residual asset, citing items such as:

   i) Additions due to leases commencing;
   ii) Deductions due to leases being extended;
   iii) Reclassifications at expiry or termination of a lease;
   iv) The unwinding of the discount on the gross residual asset;
   v) The effects of business combinations; and
   vi) Impairment.

c. Except as described in the immediately following point, a lessor is to disclose information relating to risks arising from leases, as required by FRS 107.

d. In place of the maturity analyses required by FRS 107, a lessor will have to disclose 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.

   i) The lessor will be required to reconcile the undiscounted cash flows to the lease receivable recognized in the statement of financial position.

e. The lessor will need to disclose information about how it manages its risk associated with residual assets. In particular, a lessor is to disclose all of the following:

   i) Its risk management strategy for residual assets;
   ii) The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor; and
iii) Any other means by which the lessor reduces its residual asset risk (e.g., buy-back agreements or variable lease payments for use in excess of specified limits).

6. Specific additional disclosures relating to Type B leases by lessors are as follow:

a. 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 of the amounts for the remaining years, separately from the maturity analysis required for Type A leases.

5. Proposed accounting for sale/leaseback transactions per the 2013 draft Standard.

1. Sale/leaseback transactions accounting will depend on whether the sale leg of the arrangement qualifies as a sale under the new (anticipated) IFRS on revenue recognition. (See separate explanation of the proposed new revenue accounting standard.)

2. The existence of a leaseback (i.e., the transferor’s right to use the asset for a period of time) does not, per se, prevent the transferee from obtaining control of the asset.

a. 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.

b. 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 either of the following occurs:

   i) The lease term is for the major part of the remaining economic life of the asset; or

   ii) The present value of the lease payments accounts for substantially all of the fair value of the asset.

3. If a transferee obtains control of the asset in accordance with the requirements for determining when a performance obligation is satisfied under the proposed revenue recognition standard, then:

a. The transferor (lessor) will account for a sale in accordance with applicable Standards and for the lease in accordance with lessee accounting in the new lease standard.

b. The transferee (lessee) will account for a purchase in accordance with applicable Standards and for the lease in accordance with lessor accounting in the [draft] standard.

c. If the consideration for the sale of an asset is not at fair value or the lease payments are not at market rates, the reporting entity will have to make the following adjustments to recognize the sale at fair value:

   i) The transferor will measure 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 will subsequently account for the lease to reflect those current market rates.

   ii) The transferee will measure 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 will subsequently account for the lease to reflect those current market rates.
4. If the transferee does not obtain control of the asset in accordance with the requirements for determining when a performance obligation is satisfied in the proposed new revenue recognition standards, then:

a. The transferor will not derecognize the transferred asset and will have to account for any amounts received as a financial liability in accordance with applicable Standards; and

b. The transferee will not recognize the transferred asset and will account for the amounts paid as a receivable in accordance with applicable Standards.

5. Regarding disclosure of sale/leaseback transactions, if a transferor or a transferee enters into a sale and leaseback transaction that meets new revenue recognition criteria, it will provide the disclosures required by the proposed lease accounting standards.

6. In addition to the required lease accounting disclosures, a transferor that enters into a sale and leaseback transaction will also disclose both of the following:

a. The main terms and conditions of that transaction, and

b. Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

T. Proposed accounting for short-term leases per 2013 draft Standard.

1. A lessee may elect, as an accounting policy, not to apply the requirements of the proposed standard to short-term leases, but may instead recognize the lease payments in profit or loss on a straight-line basis over the lease term.

2. A lessor may elect, as an accounting policy, not to apply the requirements of the proposed standard to short-term leases, but may instead recognize 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.

3. The accounting policy election for short-term leases will have to be made by class of underlying asset to which the right of use relates. If an entity accounts for short-term leases in accordance with these elective options, it must disclose that fact.

U. Current project status and expected progress.

1. This was one of the key convergence standards projects, under which IASB and FASB were to construct essentially identical solutions for adoption by the respective regimes.

2. However, FASB and IASB have reached an impasse on certain issues, although continuing efforts to resolve differences.

3. The remaining issues and the respective Boards’ positions are as follow:

a. The 2013 draft, discussed in detail above, conceives of two diverse income statement treatments for lessees, with Type A leases (applicable for most equipment leases) having finance lease-type expense recognition (decreasing interest charge from period to period, and primarily straight-line amortization of the right-of-use asset), whereas for Type B leases (mainly for “property” real estate assets) a straight-line total periodic expense would be recognized, implying decreasing charges for amortization from period to period.
i) FASB continues to support this differential approach, based on asset type.

ii) IASB prefers to eliminate the differential treatment, and to apply finance lease treatment to all leases, thus requiring reporting declining interest charges and mostly straight-line asset amortization over the lease term.

iii) Each Board is strongly arguing its respective position, so outcome is unclear, with possibly divergent standards emerging.

b. A less critical difference exists regarding lessor accounting.

i) FASB favors a method in which lessors would not be able to recognize profit on a lease contract unless they transfer control of a leased asset to the lessee; this would be consistent with the just-issued (converged) standard on revenue recognition.

ii) IASB does not want to establish a control concept for lessors in the leasing standard.

c. Finally, there is disagreement regarding the need for, and validity of, a “small ticket” exemption from the proposed rules.

i) FASB opposes having any such exemption to the general rules.

ii) IASB would prefer a “small ticket” exemption, although the desired threshold amount for any such exemption is not clear.

**Leases – Examples From 2013 IASB Exposure Draft**

**Examples #1 — Identifying a Lease: Contract for Rail Cars**

**Example 1A**

**Terms of the arrangement:**

- A contract between Customer and a freight carrier (Carrier) provides Customer with the use of 10 rail cars of a particular specification owned by Carrier for five years.

- The contract specifies the type of car. Customer determines when, where and which goods are to be transported using the cars.

- When the cars are not in use, they are kept at Customer’s premises. Customer can use the cars for another purpose (for example, storage) if it so chooses.

- If a particular car needs to be serviced or repaired, Carrier is required to substitute an equivalent car of the same type.

- Otherwise, and other than on default by Customer, Carrier cannot retrieve the cars during the five-year period.

- The contract also requires Carrier to provide an engine and a driver when requested by Customer and stipulates that, if Carrier is unable to do so, Customer has the right to hire an engine and a driver from other suppliers.
• Carrier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods. Carrier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers (i.e., if other customers require the transport of goods to destinations close to the destination requested by Customer and within a similar timeframe, Carrier can choose to attach up to 100 rail cars to the engine).

Analysis:
The contract contains a lease of rail cars. Customer has the right to use 10 rail cars for five years.
• Fulfillment of the contract depends on the use of 10 identified cars. Once delivered to Customer, Carrier can substitute the cars only when they are not operating properly.
• Customer has the right to control the use of the cars because of both of the following:
  (a) Customer has the ability to direct the use of the cars. Customer determines how, when and for what purpose the cars are used, not only when they are being used to transport Customer's goods but throughout the term of the contract.
  (b) Customer has the ability to derive the benefits from use of the cars. The cars are available for Customer's use throughout the term of the contract, including when they are not being used to transport Customer's goods.
• The contract also contains a non-lease (service) component that relates to the use of an engine and a driver. The contract does not convey the right to use an identified engine.

Example 1B
Terms of arrangement:
• The contract between Customer and Carrier requires Carrier to transport a specified quantity of goods in accordance with a stated timetable for a period of five years.
• The timetable and quantity of goods specified is equivalent to Customer having the use of 10 rail cars for five years. Carrier provides the rail cars, driver and engine as part of the contract.
• The contract states the nature and quantity of the goods to be transported but does not include specific details about the cars or engine to be used to transport Customer's goods. Although transporting the goods identified in the contract requires cars similar to those identified immediately preceding example, Carrier has a large pool of similar cars that can be used to transport Customer's goods.
• Similarly, Carrier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers.
• The cars and engines are stored in Carrier's premises when not being used to transport goods.

Analysis:
The contract does not contain a lease. The reasoning is as follows:
• Fulfillment of the contract does not depend on the use of 10 identified rail cars or an identified engine because Carrier has substantive substitution rights.
• Carrier can choose the cars and engine without Customer’s consent.

• There are also no economic barriers that prevent Carrier from using any car within the pool of cars of a particular specification, and any one of a number of engines.

**Example 1C**

**Terms of the arrangement:**

• Assume the same facts as in immediately preceding example, except that Carrier has only 10 rail cars of the specification required to transport Customer’s goods.

• Carrier can also use those cars to fulfill other contracts if those cars are not being used to transport Customer’s goods, and Carrier could decide to expand its fleet of cars during the term of the contract.

• Cars of the specification required to transport Customer’s goods can be purchased from rail car suppliers and are readily available to Carrier.

**Analysis:**
The contract does not contain a lease. The reasoning is as follows:

• Although the 10 rail cars owned by Carrier are identified at the commencement of the contract, Customer does not have the right to control their use throughout the term of the contract.

• Carrier controls the use of the rail cars. Carrier makes the substantive decisions about how the rail cars are used to deliver goods including, for example, whether to use the rail cars to fulfill other contracts.

• Carrier could fulfill the contract with Customer using rail cars other than those owned at the commencement of the contract if, for example, Carrier were to decide to expand its fleet of rail cars during the term of the contract.

• Specifying the quantity of goods to be transported and the timetable for delivery, means, in effect, that Customer specifies the output from the use of rail cars but it does not give Customer the right to use the 10 rail cars for five years.

**Example #2 — Identifying a Lease: Contract for Coffee Service**

**Terms of arrangement:**

• Customer enters into a contract for coffee services for two years.

• Supplier puts 25 coffee machines in Customer’s premises that are tailored for use with coffee consumables provided by Supplier. The coffee machines function only with the consumables provided by Supplier, and have no use to Customer other than when they are used in conjunction with those consumables.

• Supplier is responsible for repairs and maintenance of the coffee machines.

• Customer’s staff operate the machines (ie they select the coffee they wish to drink and the machines deliver the coffee).
Analysis:

The contract does not contain a lease. The reasoning is as follows:

- Although fulfillment of the contract may depend on the use of the machines, the contract does not give Customer the right to control the use of those machines. That is because Customer does not have the ability to derive the benefits from use of the machines on their own; the machines function only with the consumables that are supplied by Supplier.

- Accordingly, the machines have no use or value to Customer without the consumables.

- The machines are incidental to the delivery of the coffee services. The machines and the consumables combine to deliver coffee services to Customer over the two-year term of the contract.

Example #3 — Identifying a Lease: Contract for Medical Equipment

Terms of arrangement:

- Customer enters into a contract for medical equipment for three years.

- Supplier puts 10 items of patient-monitoring equipment in Customer's premises that require the use of disposable consumables that connect the monitoring equipment to the patient.

- Although the contract requires Customer to purchase the consumables from Supplier, consumables that function with the monitoring equipment are readily available from other suppliers.

- Supplier carries out repairs and maintenance of the monitoring equipment when needed and can replace the equipment without the consent of Customer (although, because of the costs associated with replacing the equipment, Supplier would replace the equipment only if it is not operating properly).

- Customer determines how and when the equipment is used, and operates the equipment to monitor patients.

Analysis:

The contract contains a lease of the patient-monitoring equipment. The reasoning is as follows:

- Although the terms of the contract require Customer to use Supplier's consumables, consumables that function with the patient-monitoring equipment are readily available from other suppliers. Accordingly, Customer would be able to derive the benefits from use of the monitoring equipment on its own without Supplier's consumables.

- In addition, although the terms of the contract require Customer to use Supplier for repairs and maintenance, this is a non-lease (service) component of the contract that does not change the conclusion that Customer has the right to use the equipment. Consequently, the contract has three separate components: the right to use the equipment, the supply of consumables, and the maintenance of the equipment.

- The contract conveys the right to use the patient-monitoring equipment to Customer for the following reasons:

  (a) Fulfillment of the contract depends on the use of the equipment. Supplier's substitution rights are not substantive because the costs of replacing the equipment create an economic barrier that prevents Supplier from replacing the equipment other than when it is not operating properly.
(b) Customer has the right to control the use of the equipment because of the following:

(i) Customer has the ability to direct the use of the equipment. Customer determines how and when the equipment is used and it operates the equipment. Accordingly, Customer makes decisions about the use of the equipment that most significantly affect the economic benefits derived from use throughout the term of the contract.

(ii) Customer has the ability to derive the benefits from use of the equipment. The equipment is available solely for Customer's use throughout the three-year term of the contract.

Examples #4 — Identifying a Lease: Contract for Energy/Power

Example 4A
Terms of arrangement:

• Customer enters into a contract to purchase substantially all of the energy produced by a new power plant for 20 years.

• The power plant is owned by Supplier and the energy cannot be provided from another plant.

• Supplier and Customer were both involved in designing the plant before it was constructed.

• Customer has the right to either operate and maintain the plant itself, or appoint another party to operate and maintain the plant, in accordance with industry-approved operating practices.

Analysis:
The contract contains a lease. Customer has the right to use the power plant for 20 years.

• Fulfillment of the contract depends on the use of the power plant. The energy cannot be supplied from another plant.

• Customer has the right to control the use of the power plant because of the following:

(a) Customer has the ability to direct the use of the power plant. Customer has determined how the plant will be operated by both being involved in designing the plant and appointing the party that operates and maintains the plant. Customer's decision-making rights about the design and maintenance of the plant have given it the ability to make decisions about the use of the plant that most significantly affect the economic benefits derived from use throughout the term of the contract. Although another party might operate the plant on a daily basis, that party would be implementing decisions made by Customer about the use of the plant.

(b) Customer has the ability to derive the benefits from use of the plant. Customer has the right to obtain substantially all of the energy produced by the plant throughout the 20-year term of the contract.

Example 4B
Terms of arrangement:

• An electricity provider (Customer) enters into a contract to purchase substantially all of the power produced by a power plant for three years.

• The power plant is owned and operated by a utility company (Supplier).
• Supplier cannot provide power from another plant.

• Supplier designed the power plant when it was constructed some years before entering into the contract with Customer – Customer had no involvement in that design.

• Customer issues dispatch instructions to Supplier. Those instructions detail the quantity and timing of delivery of power to Customer.

• Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Customer and Supplier agree to the plant’s maintenance plan at the start of the contract.

• Customer’s only decision-making authority relates to the dispatch instructions.

• Supplier is able to sell the power not taken by Customer to other customers.

Analysis:

The contract does not contain a lease. The rationale is as follows:

• Although fulfillment of the contract depends on the use of the power plant, Customer does not have the right to control its use because it does not have the ability to direct the use of the plant. Supplier has that ability.

• Supplier has made (and will make) all decisions about how the plant operates.

• Customer’s ability to determine when power is produced, in effect, gives it the ability to specify the output from the plant. However, without any other decision-making authority, Customer has no ability to direct the use of the plant that is used to make the power.

Example #5 — Allocation of Consideration to Components of a Lease

Terms of arrangement:

• Customer enters into a five-year contract with Supplier for a total consideration of S$200,000, payable annually in five amounts of S$40,000.

• The contract has two components:

  Component 1—lease of equipment for five years;

  Component 2—maintenance of the equipment by Supplier for five years.

• The contract does not specify prices for the individual components.

• The manufacturer of the equipment requires that all lessors of the equipment include maintenance services as part of the contract with the lessee. Accordingly, Supplier cannot lease the equipment without also requiring the lessee to purchase maintenance services that relate to the equipment.

• The contract is priced as a package, and Customer is unable to obtain an observable stand-alone price for the lease component.

• Customer is, however, able to obtain an observable stand-alone price for the service component on the basis of information that is available from other suppliers. Several other suppliers provide
maintenance services that relate to similar equipment over a five-year period at a stand-alone price of S$10,000 per year.

Analysis:
- Because Customer has an observable stand-alone price for one component, but not both, it first allocates consideration to the component with an observable price and then allocates the remaining consideration to the component without an observable price.
- Customer concludes that the consideration for the lease component is S$30,000 per year (S$40,000 per year – S$10,000 per year allocated to the service component of the contract).

Example #6 — Lease Components and Identifying Primary Asset: Lease of Retail Space

Terms of arrangement:
- A lessee enters into a lease of retail space together with the surrounding land that is used for parking and deliveries.
- Because of the location of the retail space, a retailer would not lease the building without the surrounding land.
- The lessee is a retailer that intends to use the building for its retail operations.

Analysis:
The contract contains one lease component.
- The retail space is dependent on the land for parking and deliveries. The lessee would be unable to access the benefits from use of the retail space without the surrounding land for parking and deliveries. Accordingly, the lessee cannot benefit from use of the retail space without also using the surrounding land that is part of the contract.
- The primary asset is the retail building because it is the predominant asset for which the lessee has contracted for the right to use. The main purpose of the surrounding land for parking and deliveries is to facilitate the lessee obtaining benefits from use of the retail space.

Example #7 — Lease Components and Identifying Primary Asset: Lease of Manufacturing Plant

Terms of arrangement:
- A lessee leases a manufacturing plant together with a large item of equipment that is installed within the plant.
- The lessor does not lease or sell the equipment separately but other suppliers do.
- The plant is not tailored for use only with that item of equipment, and the equipment could be used for a different manufacturing process within another plant.

Analysis:
The contract contains two lease components—a lease of the manufacturing building (together with the land on which the building is situated) and a lease of an item of manufacturing equipment.
- The item of equipment is neither dependent on, nor highly interrelated with, the plant and vice versa; i.e., both the plant and the equipment could be used for other purposes together with other assets.
Accordingly, the lessee can benefit from use of the plant together with other resources that are readily available to it.

The lessee also can benefit from use of the equipment together with other resources that are readily available to it.

**Example #8 — Lease Components and Identifying Primary Asset: Lease of Turbine Plant**

**Terms of arrangement:**
- A lessee leases a turbine plant, which consists of a large turbine housed within a building, together with the land on which the turbine is situated.
- The building was designed specifically to house the turbine and the life of the building is directly linked to the life of the turbine (i.e., when the turbine can no longer be used and is dismantled, the building will be demolished or substantially rebuilt).

**Analysis:**
The contract contains one lease component.
- The building and the land on which the turbine is situated are highly interrelated with the turbine. Accordingly, the lessee cannot benefit from use of the building or the land without also using the turbine. Similarly, the lessee could not benefit from use of the turbine if it were not housed within the building.
- The primary asset is the turbine because it is the predominant asset for which the lessee has contracted for the right to use. The main purpose of the building (and the land on which the turbine is situated) is to facilitate the lessee obtaining benefits from use of the turbine. The land and building would have little, if any, use or value to the lessee without the turbine.

**Example #9 — Determining if Lease Qualifies for Short-Term Lease Exception**

A lessee has made an accounting policy election not to recognize a right-of-use asset and a lease liability that arise from short-term leases for any class of underlying asset.

**Terms of arrangement:**
- The lessee enters into a 12-month lease of a vehicle, with an option to extend for another 12 months.
- The lessee does not have a significant economic incentive to exercise the option to extend.

**Analysis:**
The arrangement is not a short-term lease within the meaning of the proposed standard.
- The lease does not meet the definition of a short-term lease because the maximum possible term under the contract is longer than 12 months (i.e., the maximum possible term under the contract is two years).
- Consequently, the lessee recognizes a right-of-use asset and a lease liability.
- Because there is no significant economic incentive to exercise the option to extend, the lessee determines the lease term to be 12 months and measures the right-of-use asset and the lease liability accordingly.
Example #10 — Determining Lease Classification: Equipment Lease

Terms of arrangement:

- A lessee enters into a two-year lease of an item of equipment, which has a total economic life of 12 years.
- The lease payments are S$9,000 per year, the present value of which is S$16,700 calculated using the rate the lessor charges the lessee.
- The fair value of the equipment at the commencement date is S$60,000.

Analysis:
The lessee determines that the lease is a Type A lease because of the following:

- The underlying asset is not property;
- The lease term is for more than an insignificant part of the total economic life of the equipment; and
- The present value of the lease payments is more than insignificant relative to the fair value of the equipment at the commencement date.

Example #11 — Determining Lease Classification: Commercial Property Lease

Terms of arrangement:

- A lessee enters into a 15-year lease of an office building, which has a remaining economic life of 40 years at the commencement date.
- The lease payments are S$30,000 per year, the present value of which is S$300,000, calculated using the lessee’s incremental borrowing rate (because the rate the lessor charges the lessee is not readily determinable to the lessee).
- The fair value of the property at the commencement date is S$400,000.

Analysis:
The lessee determines that the lease is a Type B lease because of the following:

- The underlying asset is property;
- The lease term is not for a major part of the remaining economic life of the property; and
- The present value of the lease payments does not account for substantially all of the fair value of the property.

Example #12 — Initial and Subsequent Measurement by Lessee with Change in Term

Part 1 – Initial and subsequent measurement of the right-of-use asset and the lease liability

Terms of arrangement:

- A lessee enters into a 10-year lease of an asset, with an option to extend for five years.
- Lease payments are S$50,000 per year during the initial term and S$55,000 per year during the optional period, all payable at the beginning of each year.
• The lessee incurs initial direct costs of S$15,000.

• At the commencement date, the lessee concludes that it does not have a significant economic incentive to exercise the option to extend and therefore determines the lease term to be 10 years.

• The rate that the lessor charges the lessee is not readily determinable. The lessee’s incremental borrowing rate is 5.87%, which reflects the fixed rate at which the lessee could borrow a similar amount in the same currency, for the same term, and with similar collateral as in the lease.

• At the commencement date, the lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining nine payments of S$50,000, discounted at the rate of 5.87%, which is S$342,017.

Analysis:
The lessee recognizes lease assets and liabilities as follows.

<table>
<thead>
<tr>
<th>Right-of-use asset</th>
<th>S$407,017 (= S$342,017 + S$50,000 + S$15,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>S$342,017</td>
</tr>
<tr>
<td>Cash (lease payment for first year)</td>
<td>S$50,000</td>
</tr>
<tr>
<td>Cash (initial direct costs)</td>
<td>S$15,000</td>
</tr>
</tbody>
</table>

During the first year of the lease, the lessee recognizes lease expenses as follows, depending on how the lease is classified.

If the lease is classified as a Type A lease:
The lessee expects to consume the right-of-use asset’s future economic benefits evenly over the lease term and, thus, amortizes the right-of-use asset on a straight-line basis.

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>S$20,076 (= 5.87% x S$342,017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>S$20,076</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>S$40,702 (= S$407,017 ÷ 10)</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>S$40,702</td>
</tr>
</tbody>
</table>

At the end of the first year of the lease, the carrying amount of the lessee’s right-of-use asset is S$366,315 (S$407,017 – S$40,702).

If the lease is classified as a Type B lease:
The lessee determines the cost of the lease to be the sum of S$500,000 (sum of the lease payments for the lease term) plus S$15,000 (initial direct costs incurred by the lessee). The annual lease expense to be recognized is therefore S$51,500 (= S$515,000 ÷ 10 years).

<table>
<thead>
<tr>
<th>Lease expense</th>
<th>S$51,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>S$20,076  (= 5.87% x S$342,017)</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>S$31,424 (= S$51,500 – S$20,076)</td>
</tr>
</tbody>
</table>

At the end of the first year of the lease, the carrying amount of the lessee’s right-of-use asset is S$375,593 (= S$407,017 – S$31,424).

At the end of the first year of the lease, the lessee’s lease liability is S$362,093 (= S$342,017 + S$20,076), regardless of how the lease is classified.

At the beginning of the second year of the lease, the lessee makes the payment for that year, recognized as follows.

<table>
<thead>
<tr>
<th>Lease liability</th>
<th>S$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>S$50,000</td>
</tr>
</tbody>
</table>
Part 2 – Accounting for a change in the lease term

In the sixth year of the lease, the lessee makes significant leasehold improvements. Those improvements are expected to have significant economic value for the lessee at the end of the original non-cancelable period of 10 years. That is because the improvements result in the underlying asset having greater utility to the lessee than alternative assets that could be leased for a similar amount.

Consequently, at the end of Year 6, the lessee concludes that it has a significant economic incentive to exercise the option to extend the lease. The lessee’s incremental borrowing rate at the end of Year 6, taking into consideration the extended remaining lease term, is 7.83%. Although the lease term changes, the lessee does not reassess the lease classification.

At the end of the sixth year, before accounting for the change in the lease term, the lease liability is S$183,972 (present value of four remaining payments of S$50,000, discounted at the rate of 5.87%).

The lessee’s right-of-use asset is S$162,806 if the lease is classified as a Type A lease or S$189,971 if the lease is classified as a Type B lease.

The lessee remeasures the lease liability, which is now equal to the present value of four payments of S$50,000 followed by five payments of S$55,000, all discounted at the rate of 7.83%, which is S$355,189.

The lessee increases the lease liability by S$171,217 representing the difference between the remeasured liability of S$355,189 and its current carrying amount of S$183,972. The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional rights, recognized as follows.

<table>
<thead>
<tr>
<th>Right-of-use asset</th>
<th>S$171,217</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>S$171,217</td>
</tr>
</tbody>
</table>

Following the adjustment, the carrying amount of the lessee’s right-of-use asset is S$334,023 if the lease is a Type A lease (= S$162,806 + S$171,217) or S$361,188 if the lease is a Type B lease (= S$189,971 + S$171,217).

The lessee then makes the lease payment for Year 7, recognized as follows.

<table>
<thead>
<tr>
<th>Lease liability</th>
<th>S$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>S$50,000</td>
</tr>
</tbody>
</table>

Following this payment, the lessee’s lease liability is S$305,189 (= S$355,189 – S$50,000), regardless of how the lease is classified.

The lessee recognizes lease expense in Year 7 as follows, depending on how the lease had been classified at the commencement date.

If the lease is classified as a Type A lease at the commencement date:

The lessee expects to consume the right-of-use asset’s future economic benefits evenly over the remaining lease term and amortizes the right-of-use asset on a straight-line basis.

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>S$23,896 (= 7.83% x S$305,189)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>S$23,896</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>S$37,114 (= S$334,023 ÷ 9)</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>S$37,114</td>
</tr>
</tbody>
</table>

If the lease is classified as a Type B lease at the commencement date:

The lessee determines the remaining cost of the lease as follows:

- (a) the sum of S$500,000 (ten payments of S$50,000 during the initial lease term) plus S$275,000 (five
payments of S$55,000 during lease extension) plus S$15,000 (initial direct costs incurred by lessee); less

(b) the cost of the lease already recognized as an expense of S$309,000 (annual lease expense of S$51,500 recognized during the first six years of the lease).

= (S$790,000 – S$309,000 = S$481,000

Consequently, the lessee determines that the annual expense to be recognized is S$53,444 (S$481,000 ÷ remaining lease term of nine years). The annual entries will be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense</td>
<td>S$53,444</td>
</tr>
<tr>
<td>Lease liability</td>
<td>S$23,896</td>
</tr>
<tr>
<td>(7.83% x S$305,189)</td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>S$29,548</td>
</tr>
<tr>
<td>(S$53,444 – S$23,896)</td>
<td></td>
</tr>
</tbody>
</table>

Example #13 — Termination Penalty

Terms of arrangement:

- A lessee enters into a 10-year lease of an asset, which it can terminate at the end of each year once the lease enters its sixth year.
- Lease payments are S$50,000 per year during the 10-year term, payable at the beginning of each year.
- If the lessee terminates the lease at the end of Year 6, the lessee must pay a penalty to the lessor of S$20,000.
- The termination penalty decreases by S$5,000 in each successive year.
- At the commencement date, the lessee concludes that it does not have a significant economic incentive not to exercise the termination option in Year 6 (i.e., it does not have a significant economic incentive to continue to use the underlying asset after Year 6), having considered all factors including the termination penalties and the lease payments during the remaining years of the lease.
- Accordingly, the lessee determines that the lease term is six years.

Analysis:

- At the commencement date, the lessee measures the lease liability on the basis of lease payments of S$50,000 for six years plus the penalty of S$20,000 payable at the end of Year 6.

Example #14 — Purchase Option

Terms of arrangement:

- A lessee enters into a five-year lease of equipment with annual lease payments of S$59,000, payable at the end of each year. (This example ignores any initial direct costs.)
- At the end of Year 5, the lessee has an option to purchase the equipment for S$5,000.
- The residual value of the equipment in five years is S$75,000.
- Consequently, the lessee concludes that it has a significant economic incentive to exercise the
purchase option.

- The fair value of the equipment at the commencement date is S$250,000, and its useful life is seven years.

- The rate that the lessor charges the lessee in this example is the rate implicit in the lease, which is 6.33%. That is the rate that causes the present value of lease payments, including the exercise price of the purchase option, to equal the fair value of the equipment at the commencement date.

Analysis:

- The lessee classifies the lease as a Type A lease.

- The lessee measures the lease liability at the commencement date at S$250,000 (the present value of five payments of S$59,000 plus the present value of the purchase option payment of S$5,000).

- At the commencement date, the lessee recognizes lease assets and liabilities as follows:

  Right-of-use asset  S$250,000
  Lease liability   S$250,000

- The lessee amortizes the right-of-use asset over the useful life of the equipment of seven years, and not over the lease term of five years, because the lessee has a significant economic incentive to exercise the purchase option. The lessee expects to consume the asset’s future economic benefits evenly over the seven years and, thus, amortizes the asset on a straight-line basis.

- During the first year of the lease, the lessee recognizes interest on the lease liability and amortization of the right-of-use asset as follows.

  Interest expense  S$15,825 (= 6.33% × S$250,000)
  Lease liability   S$15,825
  Amortization expense  S$35,714 (= S$250,000 ÷ 7)
  Right-of-use asset   S$35,714

- At the end of Year 1, the right-of-use asset is S$214,286 (= S$250,000 – S$35,714) and the lease liability is S$206,825 (S$250,000 + S$15,825 – S$59,000).

- At the end of Year 5, the lessee has amortized the right-of-use asset to S$71,430 (= S$250,000 – S$35,714 x 5) and has a liability of S$5,000 relating to the purchase option. The lessee exercises the option to purchase the equipment and settles the remaining liability. The lessee then reclassifies the right-of-use asset and recognizes the item of equipment as follows.

  Lease liability  S$5,000
  Cash          S$5,000
  Property, plant and equipment  S$71,430
  Right-of-use asset(a)   S$71,430

(a) The lessee could choose to present the right-of-use asset as part of property, plant and equipment during the five-year term of the lease; alternatively, the lessee could choose to present the right-of-use asset separately from property, plant and equipment.
Examples #15 — Variable Lease Payments in Substance Fixed

Example 15A
Terms of arrangement:
• A lessee enters into a five-year lease of property, with annual payments determined as 2% of the lessee’s sales generated from the leased property. The annual lease payment must be at least S$100,000 in each year of the lease.

Analysis:
• At the commencement date, the lessee measures the lease liability on the basis of annual fixed payments of S$100,000. The lessee is required to make payments of at least S$100,000 in each year, regardless of the level of sales from the property.
• Those payments are in-substance fixed lease payments.

Example 15B
Terms of arrangement:
• A lessee enters into a five-year lease of property, with an initial annual payment of S$100,000.

• The contract includes an escalation clause specifying that the lease payment for each year (excluding the first year of the lease) will increase by the higher of the annual increase in the Consumer Price Index for the preceding 12 months, or 2%.

Analysis:
• At the commencement date, the lessee measures the lease liability on the basis of fixed lease payments of S$100,000 in Year 1, S$102,000 in Year 2, S$104,040 in Year 3, S$106,121 in Year 4 and S$108,243 in Year 5.

• The lessee is required to make payments of at least those amounts in each year during the lease term, regardless of the movement in the Consumer Price Index. Accordingly, those payments are in-substance fixed lease payments.

Example 15C
Terms of arrangement:
• A lessee enters into a 10-year lease of property, with annual fixed lease payments of S$100,000 and variable lease payments that are determined as 3% of the lessee’s sales from the property.

• At the end of the 10-year period, if sales from the property are at least S$1,000,000 in each of the 10 years, the lessee has the option to purchase the property for S$375,000.

• At the commencement date, the lessee determines that it does not have a significant economic incentive to exercise the purchase option. However, if sales from the property are less than S$1,000,000 in any of the 10 years of the lease, the lessee is required to purchase the property for S$375,000 at the end of the 10-year period.
Analysis:

- At the commencement date, the lessee measures the lease liability at the present value of either of the following:

  (a) yearly payments of S$130,000 (the S$100,000 annual fixed payment plus S$30,000 variable payment assuming sales are S$1,000,000); or

  (b) fixed annual payments of S$100,000 plus the S$375,000 purchase price payable at the end of Year 10.

- The exercise price of the purchase option of S$375,000, or the annual payments of S$30,000 for 10 years, are considered to be in-substance fixed payments because the lessee is required to pay at least the lower of those two amounts, regardless of the level of sales during the 10-year lease term.

Example #16 — Lessor Accounting for Type A Leases: Underlying Asset BV = FV

Terms of arrangement:

- A lessor leases a vehicle for three years for lease payments of S$2,400, payable annually at the end of each year, and incurs initial direct costs of S$200.

- At the commencement date, the carrying amount and fair value of the vehicle is S$10,000 and the amount the lessor expects to derive from the vehicle following the end of three years is S$4,500.

- The lessee has an option to purchase the vehicle at the end of the initial lease term at a market price or to extend the lease for two years for the same annual payment of S$2,400. The economic life of the vehicle is seven years.

Analysis:

- The lessor concludes that the lessee does not have a significant economic incentive to extend the lease or exercise the purchase option and therefore determines the lease term to be three years.

- The lessor also determines that the lease is a Type A lease.

- The rate that the lessor charges the lessee is the rate implicit in the lease, which is 6.87% (that is the rate that causes the present value of the lease payments and the estimated value of the vehicle at the end of the lease term to equal the fair value of the vehicle at the commencement date).

- The lessor measures the lease receivable at S$6,513, which is the present value of three payments of S$2,400, discounted at 6.87%, plus the initial direct costs of S$200.

- The lessor measures the gross residual asset at S$3,687, which is the present value of the amount the lessor expects to derive from the vehicle following the end of the lease term of S$4,500, discounted at 6.87%.

- Because there is no difference between the carrying amount and the fair value of the vehicle at the commencement date, the lessor does not recognize any profit at that date or any unearned profit relating to the residual asset. The lessor therefore recognizes the residual asset at S$3,687.
• At the commencement date, the lessor derecognizes the vehicle and recognizes the lease receivable and residual asset as follows.

Lease receivable $6,513
Residual asset $3,687
Vehicle $10,000
Cash/payable for initial direct costs $200

• The lessor also may present revenue and cost of goods sold at $6,313 at the commencement date, depending on the lessor's business model.

• Because the initial direct costs are included in the receivable, the lessor determines the imputed rate that will reduce the balance of the lease receivable to $0 at the end of the lease term. The imputed rate for the lease is 5.18%. The imputed rate is used to determine the interest income on the lease receivable in each year of the lease.

• At the end of Year 1, the lessor recognizes the receipt of a lease payment, interest on the lease receivable, and interest on the residual asset as follows.

Cash $2,400
Lease receivable $2,400
Lease receivable $338 (= 5.18% x $6,513)
Residual asset $253 (= 6.87% x $3,687)
Interest income $591 (= $338 + $253)

• Following those entries, the carrying amount of the lease receivable is $4,451 (= $6,513 – $2,400 + $338), and the carrying amount of the residual asset is $3,940 (= $3,687 + $253).

• The lessor accounts for the lease during the remainder of the lease term as shown below.

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Statement of profit or loss and other comprehensive income</th>
</tr>
</thead>
<tbody>
<tr>
<td>End of Year</td>
<td>Lease receivable</td>
</tr>
<tr>
<td>1</td>
<td>4,451</td>
</tr>
<tr>
<td>2</td>
<td>2,282</td>
</tr>
<tr>
<td>3</td>
<td>–</td>
</tr>
</tbody>
</table>

At the end of the lease term, the lessor reclassifies the residual asset to, for example, inventory. That entry would be as follows:

Inventory $4,500
Residual asset $4,500

The vehicle is then sold for an assumed $5,000, and the lessor recognizes the sale.

Cash/accounts receivable $5,000
Inventory $4,500
Gain on sale of inventory $500
Example #17 — Lessor Accounting for Type A Leases: Underlying Asset BV < FV

Terms of arrangement:

- Assume the same facts as in the immediately preceding example, except that the carrying amount of the vehicle at the commencement date is S$7,500 and any initial direct costs are ignored in this example.

Analysis:

- The lessor measures the lease receivable in the same way as in preceding example, except that this example ignores initial direct costs (= S$200); i.e., the lease receivable at the commencement date is S$6,313 (= S$6,513 – S$200).

- The lessor measures the gross residual asset in the same way as in preceding example (i.e., at the present value of the amount the lessor expects to derive from the vehicle following the end of the lease term), which is S$3,687.

- To calculate both the recognized and the unearned profit, the lessor first determines the difference between the fair value and the carrying amount of the vehicle to be S$2,500 (= S$10,000 – S$7,500).

- The lessor calculates the profit recognized at the commencement date on the basis of the present value of the lease payments as a proportion of the fair value of the vehicle as S$1,578 ((= S$10,000 – S$7,500) x (S$6,313 ÷ S$10,000)).

- Accordingly, the lessor calculates the unearned profit on the residual asset as S$922 (= S$2,500 – S$1,578).

- At the commencement date, the lessor derecognizes the vehicle and recognizes the lease receivable, gross residual asset and unearned profit on the residual asset, as well as profit on the lease as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (S$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>6,313</td>
</tr>
<tr>
<td>Revenue (a)</td>
<td>6,313</td>
</tr>
<tr>
<td>Gross residual asset (b)</td>
<td>3,687</td>
</tr>
<tr>
<td>Cost of goods sold (c)</td>
<td>4,735</td>
</tr>
<tr>
<td>Unearned profit on the residual asset (b)</td>
<td>922</td>
</tr>
<tr>
<td>Vehicle</td>
<td>7,500</td>
</tr>
</tbody>
</table>

- At the end of Year 1, the lessor recognizes the receipt of a lease payment, interest on the lease receivable, and interest on the gross residual asset as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (S$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,400</td>
</tr>
<tr>
<td>Lease receivable</td>
<td>2,400</td>
</tr>
<tr>
<td>Lease receivable</td>
<td>434 (= 6.87% × 6,313)</td>
</tr>
<tr>
<td>Residual asset</td>
<td>253 (= 6.87% × 3,687)</td>
</tr>
<tr>
<td>Interest income</td>
<td>687 (= 434 + 253)</td>
</tr>
</tbody>
</table>

- Following those entries, the carrying amount of the lease receivable is S$4,347 (= S$6,313 – S$2,400 + S$434), and the carrying amount of the net residual asset is S$3,018 (= S$3,687 – S$922 + S$253).
The lessor accounts for the lease during the remainder of the lease term as shown on the following page.

### Statement of financial position

<table>
<thead>
<tr>
<th>End of Year</th>
<th>Lease receivable</th>
<th>Gross residual asset</th>
<th>Unearned profit on residual asset</th>
<th>Carrying amount of residual asset</th>
<th>Interest on lease receivable</th>
<th>Interest on residual asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>4,347</td>
<td>3,940</td>
<td>(922)</td>
<td>3,018</td>
<td>434</td>
<td>253</td>
</tr>
<tr>
<td>2</td>
<td>2,246</td>
<td>4,211</td>
<td>(922)</td>
<td>3,289</td>
<td>299</td>
<td>271</td>
</tr>
<tr>
<td>3</td>
<td>–</td>
<td>4,500</td>
<td>(922)</td>
<td>3,578</td>
<td>154</td>
<td>289</td>
</tr>
</tbody>
</table>

- At the end of the lease term, the lessor reclassifies the residual asset to, for example, inventory.
  
  Inventory | S$3,578  
  Unearned profit | S$922  
  Residual asset | S$4,500

The vehicle is then sold for S$5,000, and the lessor recognizes the sale.

Cash/accounts receivable | S$5,000  
Cost of sales | S$3,578  
  Inventory | S$3,578  
  Revenue | S$5,000

(a) This example illustrates a gross presentation of profit on the lease at the commencement date. If a net presentation best reflects the lessor’s business model, the lessor would present a gain of S$1,578 (= S$6,313 – S$4,735) instead of separately presenting revenue and cost of goods sold.

(b) Not required to be presented or disclosed as two amounts but only required to be presented on a net basis.

(c) This rate is different from the rate applied to the lease receivable in the preceding example because the lease receivable in this example does not include any initial direct costs.

### Examples #18 — Lessor Accounting for Type A Leases: Residual Value Guarantee

#### Example 18A

**Terms of arrangement:**

- Assume the same facts as Example 16, above, and, in addition, assume that the lessee guarantees the residual value of the vehicle.

- According to the residual value guarantee, if the market value of the vehicle at the end of the lease term is lower than S$4,500, the lessee will compensate the lessor for the difference. The lessor will obtain the benefits if the market value is in excess of S$4,500.

**Analysis:**

- At the commencement date, the lessor does not recognize the residual value guarantee as part of the lease receivable.
• If, during the lease term, the amount the lessor expects to derive from the vehicle following the end of the lease term falls below the original estimate of S$4,500, the lessor would not recognize any impairment of the residual asset (assuming no deterioration in the lessee's credit standing). That is because the original amount expected to be derived from the vehicle of S$4,500 will be recovered through the residual value guarantee.

Example 18B

Terms of arrangement:
In addition to the guarantee provided by the lessee in Example 18A, the contract also states that, if the vehicle is sold for more than S$4,500, after the end of the lease the lessor will pay the difference between the selling price and S$4,500 to the lessee.

Analysis:
In this example, S$4,500 is considered to be a fixed lease payment structured as a residual value guarantee. Accordingly, the lessor includes S$4,500, discounted using the rate implicit in the lease, as part of the lease receivable at the commencement date.

Example #19 — Lessor Accounting for Type A Leases: Impairment of Lease Receivable

Part 1: Impairment of the lease receivable

This example illustrates the measurement of any impairment loss and allowance for expected credit losses but does not consider the timing of recognition of impairment of the lease receivable.

The timing of recognition would be determined in accordance with the requirements for financial instruments. For the purpose of this example, it is assumed that the lessor is required to recognize an impairment allowance equal to the full amount of expected credit losses for the lease receivable at the end of Year 2 of the lease. The lessor may have already recognized an impairment allowance before this date in accordance with the requirements for financial instruments, which is ignored in this example.

A lessor leases a vehicle for three years for lease payments of S$2,400, payable annually at the beginning of each year. At the commencement date, the carrying amount of the vehicle is S$7,500, the fair value of the vehicle is S$10,000, and the amount the lessor expects to derive from the vehicle following the end of three years is S$4,500. The rate implicit in the lease is 9.64 per cent.

At the start of the lease, the lessor would expect to account for the lease as follows before accounting for expected credit losses.

<table>
<thead>
<tr>
<th>End of Year</th>
<th>Lease receivable</th>
<th>Gross residual asset</th>
<th>Unearned profit on residual asset</th>
<th>Carrying amount of residual asset</th>
<th>Interest on lease receivable and residual asset</th>
<th>Profit on the lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>6,586</td>
<td>3,414</td>
<td>(854)</td>
<td>2,560</td>
<td>–</td>
<td>1,646</td>
</tr>
<tr>
<td>1</td>
<td>4,589</td>
<td>3,744</td>
<td>(854)</td>
<td>2,890</td>
<td>733</td>
<td>–</td>
</tr>
<tr>
<td>2</td>
<td>2,400</td>
<td>4,104</td>
<td>(854)</td>
<td>3,250</td>
<td>571</td>
<td>–</td>
</tr>
<tr>
<td>3</td>
<td>–</td>
<td>4,500</td>
<td>(854)</td>
<td>3,646</td>
<td>396</td>
<td>–</td>
</tr>
</tbody>
</table>

At the end of Year 2, the lessor measures the allowance for expected credit losses on the lease receivable.
in accordance with the requirements for financial instruments.

In accordance with the terms and conditions of the lease agreement, the lessor is entitled to retrieve the vehicle if the lessee fails to make the final lease payment at the beginning of Year 3, i.e., the vehicle provides collateral against the receivable.

At the end of Year 2, the lessor estimates that it would be able to sell the vehicle for S$5,500 if the vehicle were to be retrieved at the beginning of Year 3. The amount the lessor expects to derive from the vehicle following the end of the lease term remains unchanged at S$4,500.

When measuring the impairment allowance, the lessor allocates the expected cash flows from the sale of the collateral between the lease receivable and the residual asset. The portion of the collateral allocated to the residual asset represents the cash flows that the lessor expects to derive from the vehicle following the end of the lease term (i.e., S$4,104, representing the present value of S$4,500), and the portion allocated to the lease receivable represents the cash flows that the lessor expects to derive during the remaining lease term (i.e., S$1,396, calculated as S$5,500 less S$4,104).

Accordingly, at the end of Year 2 the lessor recognizes an impairment allowance on the lease receivable of S$1,004 (i.e., S$2,400, the carrying amount of the lease receivable less S$1,396, the portion of the collateral allocated to the lease receivable). The amount of impairment recognized in profit or loss would represent the difference between the impairment allowance of S$1,004 at the end of Year 2 and the amount of the impairment allowance already recognized in accordance with the requirements for financial instruments. The lessor does not recognize any impairment on the residual asset because the lessor expects to derive economic benefits from the residual asset that exceed the carrying amount of that asset.

Part 2: Return of the underlying asset

The lessee fails to pay the final lease payment at the beginning of Year 3. The lessor retrieves the vehicle from the lessee and sells it for S$5,500.

The lessor recognizes the vehicle at S$4,646, i.e., the carrying amount of the lease receivable (S$1,396) and the residual asset (S$3,250).

| Inventory | S$4,646 |
| Lease receivable | S$1,396 |
| Residual asset | S$3,250 |

The vehicle is then sold for S$5,500, and the lessor recognizes the sale:

| Cash/accounts receivable | S$5,500 |
| Inventory | S$4,646 |
| Gain on sale of inventory | S$854 |

Both the FASB Proposed Update, Accounting for Credit Losses on Certain Financial Instruments, and the IASB Exposure Draft, Financial Instruments: Expected Credit Losses, propose that existing recognition thresholds be removed. This means that a lessor would always account for expected credit losses on lease receivables and recognition would no longer be contingent on impairment losses being ‘probable’ or there being objective evidence of impairment. The FASB Proposed Update and the IASB Exposure Draft propose different models that result in the recognition of different loss allowance amounts at different times. For purposes of this example, it is assumed that the lessor is required to recognize an impairment allowance equal to the full expected credit losses on the lease receivable at the end of Year 2.
Example #20 — Sale-Leaseback Transaction

Terms of arrangement:

- An entity (Seller) sells a piece of land to an unrelated entity (Buyer) for cash of S$2,000,000.
- Immediately before the transaction, the land is carried at a cost of S$1,000,000. At the same time, Seller enters into a contract with Buyer for the right to use the land for 10 years, with annual payments of S$120,000 payable at the end of each year.
- The terms and conditions of the transaction are such that Buyer obtains control of the land in accordance with the requirements for determining when a performance obligation is satisfied in the current draft IFRS, Revenue from Contracts with Customers. Accordingly, Seller and Buyer account for the transaction as a sale and leaseback.
- This example ignores any initial direct costs associated with the transaction.
- The market rates for the lease of the land are S$90,000, payable annually at the end of each year.

Analysis:

- Because the consideration for the sale of the land is not at fair value, Seller and Buyer are required to make adjustments to recognize the transaction at fair value.
- The rate the lessor charges the lessee is 5 per cent. This rate is readily determinable by Seller.
- The lease is classified as a Type B lease.
- At the commencement date, Seller accounts for the transaction as follows.

  Leaseback of the land recognized using the market rates for the lease.

  Right-of-use asset  S$694,956
  Lease liability  S$694,956 (10 payments of S$90,000, discounted at 5%)

  Sale of the land (adjusted to account for the lease using market rates):

  Cash  S$2,000,000
  Land  S$1,000,000
  Financial liability  S$231,652 (10 payments of S$30,000, discounted at 5%)
  Gain on sale of land  S$768,348

At the commencement date, Buyer accounts for the transaction as follows.

  Land  S$1,768,348 (= S$2,000,000 – S$231,652)
  Financial asset  S$231,652 (10 payments of S$30,000, discounted at 5%)
  Cash  S$2,000,000

After the commencement date, both Seller and Buyer account for the lease by treating S$90,000 of the annual payments of S$120,000 as lease payments. The remaining S$30,000 of annual payments made
by Seller are accounted for as payments made to settle the financial liability of S$231,652 (recognized by Seller) and payments received to settle the financial asset of S$231,652 (recognized by Buyer).

**Example #21 — Lessee Transitioning from Operating Lease to Type A Lease Treatment**

**Terms of arrangement:**
- A lessee enters into a five-year lease of a vehicle on 1 January 20X1 with annual lease payments payable at the end of each year.
- The lessee originally accounts for the lease as an operating lease.
- On 1 January 20X2 (and before transition adjustments), the lessee has an accrued rent liability of S$1,200 for the lease, reflecting rent that was previously recognized as an expense but was not paid at that date (e.g., because of straight-line recognition of rent holiday at inception).
- Four lease payments remain: one payment of S$31,000 followed by three payments of S$33,000.

**Analysis:**
- 1 January 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessee first applies the requirements in the proposed lease Standard. At the effective date, the lessee’s incremental borrowing rate is 6%. The lessee classifies the lease of the vehicle as a Type A lease.
- On 1 January 20X2, the lessee measures the lease liability at S$112,462, the present value of one payment of S$31,000 and three payments of S$33,000, discounted at 6%.
- The lessee determines the carrying amount of the right-of-use asset at the date of initial application in two steps: the lessee estimates the commencement-date lease liability, and it calculates the right-of-use asset (before adjustment for accrued rent) on the basis of the proportion of the commencement-date lease liability that relates to the remaining lease term.
- The lessee elects not to include initial direct costs in determining the right-of-use asset as permitted by the transition guidance.
- The lessee estimates the commencement-date lease liability on the basis of the average remaining lease payments. The average lease payment for the remaining four years of the lease is S$32,500. The lessee estimates the commencement-date lease liability at S$136,902 (the present value of a S$32,500 annuity for the five-year total term of the lease). Thus, the lessee measures the right-of-use asset before adjustment for accrued rent at S$109,522 (= S$136,902 x four remaining years ÷ five-year lease term).
- The difference between the right-of-use asset and the lease liability on 1 January 20X2 is an adjustment to opening retained earnings at that date.

In summary, on 1 January 20X2, the lessee recognizes the following to reflect the transition of the operating lease to a Type A lease.

<table>
<thead>
<tr>
<th>Right-of-use asset</th>
<th>S$109,522</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>S$ 2,940</td>
</tr>
<tr>
<td>Lease liability</td>
<td>S$112,462</td>
</tr>
</tbody>
</table>
The lessee also makes an adjustment to the right-of-use asset for the amount of the previously recognized accrued rent.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued rent</td>
<td>S$ 1,200</td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td></td>
<td>S$ 1,200</td>
</tr>
</tbody>
</table>

**Example #22 — Lessee Transitioning from Operating Lease to Type B Lease Treatment**

**Terms of arrangement:**
- A lessee enters into a five-year lease of land on 1 January 20X1 with annual lease payments payable at the end of each year.
- The lessee originally accounts for the lease as an operating lease.
- On 1 January 20X2 (and before transition adjustments), the lessee has an accrued rent liability of S$1,200 for the lease, reflecting rent that was previously recognized as an expense but was not paid at that date.
- Four lease payments remain: one payment of S$31,000 followed by three payments of S$33,000.

**Analysis:**
- 1 January 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessee first applies the requirements in the draft lease Standard. At the effective date, the lessee’s incremental borrowing rate is 6%.
- The lessee classifies the lease of land as a Type B lease.
- On 1 January 20X2, the lessee measures the lease liability at S$112,462, the present value of one payment of S$31,000 and three payments of S$33,000, discounted using the rate of 6%.
- The right-of-use asset is equal to the lease liability before adjustment for accrued rent.
- The lessee does not include initial direct costs in determining the right-of-use asset as permitted by the transition guidance.
- In summary, on 1 January 20X2, the lessee recognizes the following to reflect the transition of the operating lease to a Type B lease.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>S$112,462</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>S$112,462</td>
<td></td>
</tr>
</tbody>
</table>

- The lessee also makes an adjustment to the right-of-use asset for the amount of the previously recognized accrued rent.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued rent</td>
<td>S$ 1,200</td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td></td>
<td>S$ 1,200</td>
</tr>
</tbody>
</table>
Example #23 — Lessor Transitioning from Operating Lease to Type A Lease Treatment

Terms of arrangement:

- A lessor leases a vehicle for five years on 1 January 20X1 with annual lease payments receivable at the end of each year.
- The lessor originally accounts for the lease as an operating lease.
- On 1 January 20X2 (and before transition adjustments), the lessor has a rent accrual of S$1,200 for the lease, reflecting rent that was previously recognized as income but was not received at that date.
- Four lease payments remain: one payment of S$31,000 followed by three payments of S$33,000.

Analysis:

- 1 January 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessor first applies the requirements in the draft lease Standard.
- On 1 January 20X2, the lessor classifies the lease of the vehicle as a Type A lease.
- Immediately before 1 January 20X2, the vehicle was recognized in the lessor's financial statements at S$176,000 (historical cost of S$200,000 – depreciation of S$24,000). The lessor also has an asset for accrued rent of S$1,200.
- The rate implicit in the lease at the commencement date is 5.27%. The fair value of the vehicle on 1 January 20X2 is S$180,000, and the expected value of the vehicle at the end of the lease term is S$80,000.
- The present value of one payment of S$31,000 plus 3 payments of S$33,000, discounted using the rate of 5.27%, is S$114,390. The present value of the expected value of the vehicle at the end of the lease term, discounted using the rate of 5.27%, is S$65,147.
- The lessor determines the residual asset on the basis of information available on 1 January 20X2.
- The lessor determines that profit of S$1,779 relates to the lease ((S$180,000 [fair value of the vehicle] – S$177,200 [carrying amount of the vehicle immediately before 1 January 20X2 after adjustment for accrued rent]) x (S$114,390 [the lease receivable] ÷ S$180,000 [the fair value of the vehicle]).
- The lessor determines the unearned profit relating to the residual asset as S$1,021 at 1 January 20X2 (S$180,000 fair value of the vehicle – S$177,200 carrying value of the vehicle after adjustment for accrued rent – S$1,779 profit relating to the lease). The net residual asset of S$64,126 comprises the gross residual asset of S$65,147 and the unearned profit on the residual asset of S$1,021.
- The difference between the assets previously recognized (vehicle of S$176,000 and accrued rent of S$1,200) and the assets recognized at 1 January 20X2 (lease receivable of S$114,390 and net residual asset of S$64,126) is a transition adjustment to opening retained earnings at 1 January 20X2 of S$1,316.
In summary, at 1 January 20X2, the lessor recognizes the following to reflect the transition of the operating lease to a Type A lease.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>S$114,390</td>
</tr>
<tr>
<td>Gross residual asset</td>
<td>S$ 65,147</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>S$ 24,000</td>
</tr>
<tr>
<td>Vehicle</td>
<td>S$200,000</td>
</tr>
<tr>
<td>Unearned profit on the residual asset (a)</td>
<td>S$ 1,021</td>
</tr>
<tr>
<td>Accrued rent</td>
<td>S$ 1,200</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>S$ 1,316</td>
</tr>
</tbody>
</table>

(a) Not required to be presented or disclosed as two amounts but only required to be presented on a net basis.
About ISCA Technical Standards Development and Advisory

The Technical Standards Development and Advisory (TSDA) team is part of the Technical Knowledge Centre and Quality Assurance division of the Institute of Singapore Chartered Accountants (ISCA). It is committed to supporting the Institute in advancing and promoting technical developments within the profession as part of the effort to transform Singapore into a leading global accountancy hub by 2020.

ISCA TSDA engages external stakeholders in soliciting meaningful feedback on accounting and auditing related issues to develop a consistent approach to addressing industry issues identified. It also prescribes auditing and assurance standards that are closely aligned to international best practices, champions thought leadership initiatives with key stakeholders and drives projects in collaboration with various ISCA technical committees.

It actively engages international standard setters and strives to be an advocate of matters pertinent to the development of Singapore’s accountancy profession. Furthermore, it aims to cultivate a mindset change and raises awareness of new and revised standards through the publication of articles authored by the team.

Additionally, ISCA TSDA seeks to empower members and the profession at large to achieve their aspirations by equipping them with relevant technical expertise and this is achieved through the development of a range of resources that they can tap on.

Knowledge sharing with accounting community is facilitated through a variety of print and online channels including the sharing of regular updates and thought leadership articles via in-house publications like the journal, “IS Chartered Accountant”, the E-newsletter, “ISCA Weekly”, and various online knowledge centres and a technical forum. Seminars and workshops are regularly organised and ISCA TSDA also provides value-added technical clarification services to assist the profession in resolving accounting, auditing and ethics related issues.

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