STAFF PAPER

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Project	**Leases**		
Paper topic	Lease modifications and contract combinations		
CONTACT(S)	Roberta Ravelli	rravelli@ifrs.org	+44 (0) 20 7246 6935
	Anna Heining	aheining@ifrs.org	+44 (0) 20 7246 6428
	Patrina Buchanan	pbuchanan@ifrs.org	+44 (0) 20 7246 6468
	Scott A. Muir	samuir@fasb.org	+1 (203) 956 3478

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Paper structure

1. This paper discusses two topics:
   (a) Accounting for lease modifications, including:
      (i) How to identify a lease modification;
      (ii) When a lease modification should be accounted for as a separate new lease; and
      (iii) How to account for lease modifications that are not separate new leases.
   (b) Contract combinations (ie when to combine two or more contracts when applying the leases guidance).

Lease modifications

2. This section of the paper discusses the accounting for changes to the contractual terms and conditions of a lease that were not part of the original terms and conditions of the lease ("lease modifications").

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3. Changes to the lease term as a result of exercising an option to extend or terminate the lease and changes to estimates (eg reassessment of options, discount rates and variable lease payments) are not addressed in this paper. Those changes arise for reasons other than a change to the contractual terms and conditions of a lease and, thus, are not lease modifications.

4. This section is structured as follows:
   - (a) Summary of staff recommendations
   - (b) Background
   - (c) Feedback received on the 2013 ED
   - (d) Staff analysis
     - (i) How to identify a lease modification
     - (ii) Accounting for a lease modification—lessee
     - (iii) Accounting for a lease modification—lessor

Summary of staff recommendations

5. The staff recommend the following ((a)-(c) apply equally to lessees and lessors):
   - (a) A lease modification be defined as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease.
   - (b) Clarify that, in determining whether a lease has been modified, an entity would consider the substance of the entire modified contract that is, or contains, a lease.
   - (c) A lease modification be deemed a separate new lease (ie accounted for separately from the original lease) when:
     - (i) The modification grants the lessee an additional right-of-use not included in the original lease; and

(ii) The additional right-of-use is priced commensurate with its standalone price (in the context of that particular contract).

(d) A *lessee* should account for lease modifications that are *not* separate new leases differently based on whether the modification changes:

(i) The scope of the lease (ie whether it changes the original right-of-use or conveys an additional right-of-use); or

(ii) Only the consideration to be paid for the lease.

The table in paragraph 23 of this paper sets out the staff recommendation in this respect.

(e) A *lessor* should account for:

(i) Modifications to a Type B lease as, in effect, a new lease (ie recognizing the modified lease payments prospectively over the remaining lease term), considering any prepaid or accrued lease rentals relating to the original lease as part of the lease payments for the modified lease; and

(ii) Modifications to a Type A lease in accordance with IFRS 9 (IFRS) or Topics 310 (US GAAP).

Background

6. Contract modifications are discussed in paragraph 36 of the 2013 *Leases* Exposure Draft (2013 ED), which states the following:

> If the contractual terms and conditions of a lease are modified, resulting in a substantive change to the existing lease, an entity shall account for the modified contract as a new contract at the date that the modifications become effective. An entity shall recognise any difference between the carrying amounts of the assets and liabilities arising from the previous lease and those arising from any new lease in profit or loss. Examples of a substantive change

arising from a contract modification include changes to the contractual lease term or to the amount of contractual lease payments that were not part of the original terms and conditions of the lease.

Feedback received on the 2013 ED

7. The Boards did not ask a specific question on the accounting for contract modifications in the 2013 ED. Only a handful of constituents commented on the contract modifications proposals.

8. Constituents asked for clarification about the following.

   (a) *How to identify a contract modification*. A few constituents questioned how to identify contract modifications and whether a change would need to be approved in writing. A few constituents questioned whether a change in the contractual lease term should be accounted for as a reassessment of the lease term or as a contract modification.

   (b) *The concept of "substantive change"*. Some constituents questioned whether a "substantive change" proposed in the 2013 ED would be the same as a "substantial modification" under IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* and under ASC Subtopic 470-50, *Debt – Modifications and Extinguishments.* These constituents questioned if the derecognition guidance for financial instruments would be applicable to leases.

   (c) *Timing of recognition of the contract modification*. Some constituents questioned:

      (i) When a contract modification would be considered "effective" (eg at the date of signing the revised agreement or the date when the modification becomes effective); and

      (ii) If a modified contract would be considered "new" from the effective date of the modification or from the original commencement date.

9. A few constituents noted that most lessees would likely recognise a gain if a contract is modified. That results from the carrying amount of the lease liability being larger than the carrying amount of the right-of-use (ROU) asset, which would be the case for most Type A leases. The carrying amount of the lease liability and the ROU asset would also differ for any Type B lease for which the lease payments are not even during the lease term. One of these constituents was concerned about structuring opportunities to recognise a gain from a modification. Another constituent suggested deferring the gain and recognising it over the term of the new lease.

Staff analysis

How to identify a lease modification

10. A lessee and a lessor may renegotiate the terms and conditions of a lease for a variety of reasons. For example, the lessee may wish to extend the lease term or change the asset that it has the right to use. The lessee may consider that the lease is too expensive compared to current market terms and conditions and look to renegotiate, or both parties could agree to renegotiate the terms and conditions if the lessee is in financial difficulty or if tax rates change.

11. The 2013 ED did not include a definition of a contract modification. Instead, the ED included the following examples of a substantive change arising from a modification: changes to the contractual lease term or to the amount of the contractual lease payments that were not part of the original terms and conditions of the lease.

12. In light of the feedback received, the staff think that the modifications guidance included in the 2013 ED could be improved by stating that a lease modification is any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease. The staff think that this would clarify differences between scenarios resulting in a lease reassessment (eg a change in lease term resulting from the exercise of an option to extend the lease

when that option was included in the contact at inception) and those resulting in a lease modification (eg a change in the lease term resulting from changes to the terms and conditions of the original lease).

13. In determining whether a lease has been modified, an entity would consider the substance of the entire modified contract that is, or contains, a lease, and not just the written changes. For example, in a contract that includes lease and non-lease components, the modifications to that contract could be *written* such that any price change would appear to affect only the lease or only the non-lease components, whereas the substance of the transaction, if evaluated objectively, might indicate otherwise.

Accounting for a lease modification—lessee

14. The staff do not think that all modifications should result in accounting for the modified lease as a termination of the original lease and the creation of a new lease. This is because such an approach could be complex to apply, without a corresponding benefit, when the modification does not substantially change the parties' rights and obligations. The staff think that accounting for minor modifications as extinguishments of the original lease could result in the recognition of gains or losses when the lease is substantially the same before and after the modification.

15. In addition, the staff think that a lessee should account for some modifications as new leases, separately from the original lease (ie after the modification, the lessee would have two leases – the original lease and a new lease). In some outreach meetings, including those with lease software providers, it was noted that the ability to account for some lease modifications as separate leases, rather than as modifications of existing leases, may simplify the accounting as compared to having to treat every substantive lease modification as a termination of the original lease.

Accounting for a lease modification as a separate new lease

16. The staff think that a lessee should account for a lease modification as a new lease, separately from the original lease, when the following occur:

    (a) A modification grants the lessee an additional right-of-use (eg the right to use an *additional* underlying asset or the right to use the same underlying asset for an additional period of time not contemplated by a renewal option in the original lease); and

    (b) The additional right-of-use is priced commensurate with its standalone price (in the context of that particular contract).

17. In this case, the lease modification is, in effect, a new lease that is separate from the original lease—it is not a modification of the original lease. A lessee should account for the new lease in accordance with the proposals.

18. The staff think that this would be appropriate for *any* lease modification that meets the criteria set out above, regardless of the approach taken for lease modifications that do not meet the criteria set out above (which is discussed in the next section).

Example 1 – Modification that is a separate new lease

A lessee enters into a 10-year lease for 10,000 square feet of office space. At the beginning of Year 6, the lessee and the lessor agree to amend the original lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building. The increase in total lease consideration is commensurate with the current market rate for the new 10,000 square feet of office space.

The lessee accounts for the modification as a new lease, separate from the original 10-year lease. This is because the modification grants the lessee an additional right-of-use as compared to the original lease, and the increase in lease consideration is commensurate with the standalone price of the additional right-of-use. Accordingly, from the effective date of the modification, the lessee would have two separate leases: the original,

unmodified lease (for 10,000 square feet of office space) and the new lease (for the additional 10,000 square feet of office space). The lessee would not make any adjustments to the accounting for the original lease as a result of this modification.

Accounting for a lease modification that is not a separate new lease

19. The staff recommend accounting for a lease modification that is *not* a separate new lease in accordance with Approach 1 in this paper.

Approach 1 – Changes to the lessee's rights and obligations in the lease

20. Approach 1 focuses on the right-of-use conveyed by the lease to the lessee (ie that which *creates* the lease) and whether the modification affects that right-of-use, or only changes the consideration paid for the right-of-use. Because a lease gives rise to both a ROU asset and a lease liability, a lease modification can affect the lessee's rights (the scope of the lease), the lessee's obligations (the lessee's obligation to make lease payments), or both.

21. Approach 1 would distinguish between lease modifications (ie those modifications that are not a separate new lease based on the criteria set out in the previous section) that:

    (a) *Increase* the scope of the lease by granting the lessee an additional right-of-use. For example:

        (i) Adding the right to use a new standalone underlying asset to the contract or increasing the floor space leased in a property lease; or

        (ii) An extension to the contractual lease term that was not covered by a renewal option in the original contract.

    (b) *Decrease* the scope of the lease. For example:

        (i) Terminating the right to use one or more underlying assets, or a portion thereof; or

(ii) Shortening the period to which a right-of-use relates (eg shortening a lease from 6 years to 4 years).

(c) Result only in a change to the consideration paid for the lease. A change only to the consideration paid for the lease would result from a change to the contractual payments without any corresponding increase or decrease in the scope of the lease.

22. Approach 1 would account for lease modifications that do not result in a separate new lease as follows:

(a) When a modification *increases* the scope of a lease (ie the modification results in an additional right-of-use), a lessee would account for any change to the lease liability as an adjustment to the carrying amount of the ROU asset. The lessee would remeasure the lease liability at the effective date of the modification. The lessee would not consider the original lease to be terminated because the lessee continues to have the right to use the underlying asset identified in the original lease. Consequently, the lessee would not recognise a gain or loss from the modification. The adjustment to the ROU asset would effectively represent the cost of the additional right-of-use acquired as a result of the modification.

Example 2 – Modification that increases the scope of the lease

A lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are CU100,000 per year. The lessee's incremental borrowing rate at lease commencement was 6%. At the beginning of Year 6, the lessee and the lessor agree to amend the original lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building for an annual fixed payment of CU150,000. The increase in total lease consideration is at a discount both to the current market rate for the new 10,000 square feet of office space and in the context of that particular contract.

Because the change in pricing of the lease is not commensurate with the standalone price for the additional right-of-use (in the context of that

particular contract), the lessee *does not* account for the modification as a new lease, separate from the original 10-year lease.

Instead, the lessee remeasures the lease liability based on: (a) a 5-year remaining lease term, (b) annual payments of CU150,000, and (c) the lessee's incremental borrowing rate of 7% at the effective date of the modification, which equals CU615,030. The lessee recognises the difference between the carrying amount of the modified liability and the lease liability immediately before the modification (CU421,236) of CU193,794 as an adjustment to the ROU asset.

(b) When a modification *decreases* the scope of a lease, a lessee would account for the modification as an early termination of the lease (which may be full or partial), adjusting both the ROU asset and the lease liability accordingly. A lessee would recognise any difference between the decrease in the carrying amount of the lease liability resulting from the modification and the proportionate decrease in the carrying amount of the ROU asset in profit or loss. Example 2 below illustrates one way in which a lessee might calculate the proportionate decrease in the carrying amount of the ROU asset.

Example 3 – Modification that decreases the scope of the lease

A lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are CU100,000 per year. The lessee's incremental borrowing rate at lease commencement was 6%. At the beginning of Year 6, the lessee and the lessor agree to amend the original lease for the remaining 5 years to reduce the lease to only 5,000 square feet of the original space for an annual fixed payment of CU60,000.

The lessee remeasures the lease liability based on: (a) a 5-year remaining lease term, (b) annual payments of CU60,000, and (c) the lessee's incremental borrowing rate of 7% at the effective date of the modification, which equals CU246,012. The difference between the pre-modification

liability of CU421,236 and the modified lease liability of CU246,012 is CU175,224. CU175,244 is 41.6% of the pre-modification lease liability.

The lessee determines the proportionate decrease in the carrying amount of the ROU asset based on the decrease in the carrying amount of the lease liability. That decrease of 41.6% comprises both the early termination of the right to use 5,000 square feet of space (50% of the original leased space) and an adjustment to the consideration paid for the lease.

Type A lease

41.6% of the pre-modification ROU asset (CU368,004) is CU153,081. Therefore, the lessee reduces the carrying amount of the ROU asset by CU153,081. The lessee recognises the difference between the adjustment to the lease liability (CU175,224) and the adjustment to the ROU asset (which equals CU22,143) as a gain in profit or loss at the effective date of the modification.

Type B lease

Because the ROU asset would equal the lease liability in this example, the lessee recognises an equal adjustment of CU175,224 to both the ROU asset and the lease liability. Therefore, the lessee would not recognise a gain or loss from this modification.

If the lease were terminated in its entirety, there would be no remaining lease liability or ROU asset. The lessee would recognise any difference between the carrying amounts of the ROU asset and the lease liability as a gain or loss.

(c) When a modification changes only the consideration paid for a lease, a lessee would treat the modification as a continuation of the original lease, remeasuring the lease liability to reflect the new contractual terms and conditions . Use of an updated discount rate in the remeasuring the lease liability reflects the fact that, in modifying the lease, the lessor’s implicit rate, which the discount rate is intended to approximate, changes. When only the consideration changes, the adjustment to the ROU asset would

effectively represent a change to the expected cost of the ROU asset as a result of the modification.

Example 4 – Modification that is a change in consideration only

A lessee enters into a 10-year lease for 10,000 square feet of office space. At the beginning of Year 6, the lessee and the lessor agree to amend the original lease for the remaining 5 years to reduce the price from CU100,000 per year to CU95,000 per year. The original discount rate used by the lessee was 6%.

The lessee remeasures the lease liability based on: (a) a 5-year remaining lease term, (b) annual payments of CU95,000, and (c) the lessee's incremental borrowing rate of 7% at the effective date of the modification, which equals CU389,519. The lessee recognises the difference between the carrying amount of the modified liability and the lease liability immediately before the modification (CU421,236) of CU31,717 as an adjustment to the ROU asset.

23. The following table summarises the proposed accounting under Approach 1 for each type of lease modification that does not result in a separate new lease:

Modification type	Require lease liability re-measurement ? (1)	Discount rate	Adjustment to the ROU asset	Adjustment to the lease liability	P&L effect
Change in scope – increase **(Example 2)**	√	Modification date (2)	Amount of the adjustment to the lease liability	Difference between the modified liability and the liability immediately before the modification	None
Change in scope – decrease **(Example 3)**	√	Modification date (2)	Proportionate decrease to reflect the partial or full termination of the lease	Difference between the modified liability and the liability immediately before the modification	Gain or loss attributable to the partial or full termination of the original lease (3)
Change in consideration **(Example 4)**	√	Modification date (2)	Amount of the adjustment to the lease liability	Difference between the modified liability and the liability immediately before the modification	None

(1) The lease liability remeasurement would reflect the modified contractual payments.

(2) Lessee's incremental borrowing rate (or the rate the lessor charges the lessee if readily determinable) at the effective date of the modification.

(3) Difference between the adjustment to the ROU asset and the adjustment to the lease liability.

Approach 2 - Change to the terms and conditions of the lease that are substantial or non-substantial

24. When considering the most appropriate accounting for lease modifications, the staff also considered an approach that would distinguish between changes to a lease that are substantial and those that are non-substantial. That approach would be similar to the contract modifications proposals in the 2013 ED. Approach 2, like Approach 1, would address only those lease modifications that are *not* separate new leases (as defined based on the criteria set out earlier in this paper).

25. When a change in a lease represents a "substantial" modification, at the date the modification becomes effective, a lessee would:

    (a) Account for the modified lease as a new lease;

    (b) Consider the original lease to be extinguished; and

    (c) Recognise in profit or loss any difference between the carrying amounts of the assets and liabilities arising from the original lease and those arising from any new lease.

26. Under such an approach, a modification could be described as a "substantial modification" if:

    (a) The present value of the remaining cash flows from the lease immediately before the modification is at least 10 per cent different from the present value of the cash flows that would result under the new terms and conditions, both discounted at the original discount rate; or

    (b) A qualitative assessment identifies substantial differences in the terms and conditions that are not captured by the quantitative assessment set out in criterion (a) (eg a change in the currency of the contractual payments).

27. In calculating the difference in cash flows between the original and the modified lease, the cash flows attributable to the modified lease would include all cash flows relating to the lease, including, for example, the lease payments, payments from the lessor to the lessee for lease incentives, direct costs associated with the modification, as well as any other payments between the lessee and the lessor.

28. This approach would propose to distinguish between, and account for, lease modifications in a manner similar to contract modifications relating to financial liabilities within the scope of IFRS 9 *Financial Instruments* and Subtopic 470-50 *Debt - Modification and Extinguishments*. It focuses on the fact that the lease liability is a financial liability. It, therefore, looks to the principle in existing financial instruments guidance relating to financial liabilities in determining how to account for the modification of a lease.

29. IFRS 9 and Subtopic 470-50 state that an entity:

    (a) Derecognises a financial liability when the financial liability is extinguished (ie when the obligation specified in the contract is discharged, cancelled or expires).

    (b) Accounts for a substantial modification of the terms of an existing financial liability or a part of it as an extinguishment of the original financial liability and the recognition of a new financial liability.

    Both IFRS 9 and Subtopic 470-50 provide guidance on what constitutes a substantial modification similar to the guidance set out above.

Modifications that are not substantial

30. If a lease modification is not substantial, a lessee would account for the modified lease as a continuation of the original lease.

Comparison between the two approaches

31. In determining which of the two approaches would be most appropriate for lease modifications, the staff compared the approaches in the following table:

	Approach 1	Approach 2
Type of lease modification	Increase in scope, decrease in scope or change in consideration	Substantial or Non-substantial
Discount rate	Updated discount rate at effective date of modification	Updated discount rate for substantial modification[1]
P&L effect	Gain or loss recognised only for partial or full terminations (ie decreases in scope) – effect limited to that portion of the gain or loss attributable to the terminated portion of the original lease	Gain or loss recognised for all substantial modifications
Judgement	---	Required to: (a) determine the cash flows for the 10 percent test and (b) perform the qualitative assessment when the change in the liability is less than 10 percent
Costs / Complexity	Similar information needed for both. Therefore, no *significant* difference anticipated in the costs and complexity of applying the approaches. However performing the 10 percent test under Approach 2 is likely to add complexity in some scenarios.	
Interaction with other standards	Finance lease liabilities under IFRS are currently subject to the derecognition requirements of IFRS 9. Under this approach, the requirements relating to derecognition of financial liabilities that result from a lease modification would be included in the leases standard, as they are under existing US GAAP (modifications of capital leases are addressed in Topic 840).	---

[1] Approach 2 analogises to the financial instruments guidance. With respect to accounting for a non-substantial modification under Approach 2, US GAAP would use an updated discount rate, unlike IFRS.

32. The following table compares the effects of the two approaches for the examples illustrated above in the section related to Approach 1 (the table assumes all Type A leases because the accounting effect would generally be greater in a Type A lease than in a Type B lease):

	Change in scope – increase (Example 2)		Change in scope – decrease (Example 3)		Change in consideration (Example 4)	
Scope	From 10,000 to 20,000 sq ft		From 10,000 to 5,000 sq ft		10,000 sq ft	
Annual payment	From CU100,000 to CU150,000		From CU100,000 to CU60,000		From CU100,000 to CU95,000	
Original discount rate	6%		6%		6%	
Discount rate at the modification date	7%		7%		7%	
Type of modification under Approach 2	Substantial modification		Substantial modification		Non-substantial modification	
Re-measurement of the lease at the effective date of the modification						
	Approach 1	**Approach 2**	**Approach 1**	**Approach 2**	**Approach 1**	**Approach 2[2]**
Discount rate	**Current 7%**	**Current 7%**	**Current 7%**	**Current 7%**	**Current 7%**	**Original 6%**
Lease liability immediately before the modification	421,236	421,236	421,236	421,236	421,236	421,236
Remeasured lease liability	615,030	615,030	246,012	246,012	389,519	400,175
Adjustment to the lease liability	**193,793**	**193,793**	**(175,225)**	**(175,225)**	**(31,717)**	**(21,062)**
ROU asset immediately before the modification	368,004	368,004	368,004	368,004	368,004	368,004
Adjusted ROU asset	561,798	615,030	214,923	246,012	336,287	346,943
Adjustment to the ROU asset	**193,793**	**247,025**	**(153,081)**	**(121,993)**	**(31,717)**	**(21,062)**
Expense before the modification	553,232	553,232	553,232	553,232	553,232	553,232
Gain at the modification	**-**	**(53,232)**	**(22,143)**	**(53,232)**	**-**	**-**
Expense after the modification	696,768	750,000	268,911	300,000	421,768	421,768
Total expense	**1,250,000**	**1,250,000**	**800,000**	**800,000**	**975,000**	**975,000**

[2]Approach 2 analogises to the financial instruments guidance in accounting for a non-substantial modification. Under US GAAP, the lessee would use the updated discount rate of 7%, unlike under IFRS.

33. The table above illustrates the following:

    (a) When a lease modification is substantial and increases the scope of a lease (Example 2):

        (i) Under Approach 1, a lessee would recognise the change to the carrying amount of the lease liability as an adjustment to the ROU asset (ie no gain or loss would be recognised);

        (ii) Under Approach 2, a lessee would recognise the modified lease as a new lease and recognise the difference between the carrying amounts of the ROU asset and the lease liability immediately before the modification (CU53,232) in profit or loss.

    (b) When a lease modification is substantial and decreases the scope of a lease (Example 3):

        (i) Under Approach 1, a lessee would account for the modification as a partial termination of the lease, recognising a *proportionate* amount of the difference between the carrying amounts of the ROU asset and the lease liability immediately before the modification (CU22,143) in profit or loss;

        (ii) Under Approach 2, a lessee would recognise the modified lease as a new lease and recognise the *entire* difference between the carrying amounts of the ROU asset and the lease liability immediately before the modification (CU53,232) in profit or loss.

    (c) When a lease modification is non-substantial and only changes the consideration paid by the lessee (Example 4), the lessee would account for the lease modification similarly under Approaches 1 and 2 (ie as a continuation of the original lease).

Staff recommendation—lessee

34. The staff think that Approach 1 would provide accounting outcomes that more faithfully represent the substance of lease modifications than Approach 2. This is because a lease gives rise to both a ROU asset and a lease liability. Accordingly, a

lease modification can result in a change to the lessee's rights (ie a change to the ROU asset), a change to the lease liability, or both. Approach 1 would closely align gain or loss recognition with a corresponding change in the lessee's rights and obligations under the lease.

35. The staff think that Approach 2 could result in outcomes that would not faithfully represent the differing nature of each of those changes. This is because it would account for all substantial modifications as the extinguishment of the original lease and the creation of a new lease. Accordingly, there are scenarios when this approach would result in the extinguishment of the original lease (and the recognition of a corresponding gain or loss in profit or loss) when the lessee continues to have all of the rights it had in the original lease after the modification.

36. For example, in Example 2 in this paper, the lessee and the lessor agree to amend the original lease to add an additional right-of-use. The lessee's right to use the original 10,000 square feet of space is unchanged by the modification—the modification simply adds a new right-of-use. In this scenario, the staff think it is inappropriate to account for this modification as a termination of the original lease (and recognise a corresponding gain) when the lessee retains the same right to use the original 10,000 square feet of space after the modification that it had before the modification, which would be the outcome under Approach 2.

37. In contrast, Approach 1 does not treat a modification that increases the scope of a lease as an extinguishment of the original lease—this is consistent with the accounting that would result if the increase in scope is written as a new contract rather than a modification of the original lease. In this scenario, the lessee continues to have the original right-of-use and, thus, the staff think it would better reflect the transaction not to consider the original lease to be extinguished. This is also the case for a modification that decreases the scope of a lease. The staff think that it would better reflect the transaction to account for a modification that decreases the scope of a lease as a partial termination of the lease when the lessee retains at least some of its rights from the original lease.

38. Accordingly, the staff recommend that:

    (a) A lease modification be accounted as a separate new lease when:

        (i) The modification grants the lessee an additional right-of-use not included in the original lease; and

        (ii) The additional right-of-use is priced commensurate with its standalone price (in the context of that particular contract).

    (b) A lease modification that is not a separate new lease should be accounted for in accordance with Approach 1 as set out in this paper.

Accounting for a lease modification—lessor

39. Leasing transactions are fundamentally a revenue-generating activity for most lessors (even if the principal revenue stream is interest) in which they transfer a right to use an underlying asset to the lessee. That right-of-use is the “good” that they transfer in order to generate revenue. Accordingly, evaluating lease modifications in a manner similar to the evaluation of modifications to contracts to deliver other goods or services (within the forthcoming revenue recognition guidance) may be the most appropriate approach.

Accounting for a lease modification as a separate new lease

40. Consistent with the recommendation for lessees, the staff think that a lessor should account for a lease modification as a separate new lease when:

    (a) The lease modification grants the lessee an additional right-of-use not included in the original lease; and

    (b) The additional right-of-use is priced commensurate with its standalone price (in the context of that particular contract).

41. This requirement would be substantially aligned with similar guidance in the forthcoming revenue recognition standard. That guidance requires a seller to account for modifications that add distinct goods or services as separate contracts

if those additional goods or services are priced commensurate with their standalone selling price (as adjusted for circumstances particular to that contract).

Accounting for a lease modification that is not a separate new lease

42. Within this section of the paper, all references to lease modifications exclude lease modifications that a lessor would account for as a separate new lease discussed above.

43. For clarity, based on the Boards' decisions in March 2014:

    (a) Almost all existing operating leases would be Type B leases for a lessor and almost all existing finance (direct finance / sales-type) leases would be Type A leases;

    (b) Type B accounting is similar to existing operating lease accounting and Type A accounting is similar to existing finance (sales-type/direct-financing) lease accounting.

Lessor Type B leases

44. For leases classified as Type B leases before a modification, the staff think that a lessor should account for the modified lease, in effect, as a new lease from the effective date of the modification. A lessor would consider any prepaid or accrued rent relating to the original lease as part of the lease payments for the modified lease. This would be the case regardless of whether the modified lease is classified as Type A or Type B. If the lease remains classified as a Type B lease after the modification, no gain or loss will be recognised as a result of the modification.

45. This approach to lease modifications would align with the contract modifications guidance in the Boards' forthcoming revenue recognition standard when the goods or services that remain to be transferred are distinct from the goods or services already transferred.

46. This approach is premised on the view that each period to which the right-of-use applies (eg each day, month, or year) is distinct from each other period to which it applies. Each period is distinct because:

(a) The lessee can benefit from each period on its own or together with other readily available resources; and

(b) Each period is separable from the other periods in the lease. This is because:

(i) The benefit the lessee can derive from use of the underlying asset each period is not significantly affected by its access to the underlying asset during other periods (ie the periods of access are not highly dependent upon or interrelated with each other);

(ii) No one period of access significantly modifies or customises the lessee's right of use in another period; and

(iii) The periods within the lease term are generally not considered inputs to a combined deliverable that is greater than the sum of its component parts.

47. The staff note that the accounting that results from this approach to lease modifications is *generally* consistent with how lessors account for modifications to operating leases under existing guidance. Accordingly, the approach would be consistent with the Boards' decisions in March 2014 to not fundamentally change existing lessor accounting in the final leases standard.

Example 5 – Lessor Type B lease modification

A lessor enters into a 10-year lease with a lessee for 10,000 square feet of office space. The annual lease payments are CU100,000 in the first year, and CU110,000 in each year thereafter. At the beginning of Year 6, the lessee and the lessor agree to amend the original lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building for an annual fixed payment of CU150,000. The increase in total lease consideration is at a discount both to the current market rate for the new 10,000 square feet of office space, and in the context of that particular contract. The lessor classifies both the original lease and the modified lease as Type B leases. At the effective date of the modification (at the beginning of Year 6), the lessor has an accrued lease rental

asset of CU5,000 (rental income recognised on a straight-line basis of CU545,000 less lease payments for the first 5 years of CU540,000).

Because the change in pricing of the lease is not commensurate with the standalone price for the additional right-of-use (in the context of that particular contract), the lessor *does not* account for the modification as a new lease, separate from the original 10-year lease.

Instead, the lessor would account for the modified lease as a new lease, recognising the lease payments to be made under the modified lease (CU750,000), net of the lessor's accrued rent asset (CU5,000), on a straight-line basis over the remaining 5-year lease term. At the end of the lease, the lessor would have recognised as income the CU1,290,000 in lease payments it has received from the lessee during the 10-year lease term.

Lessor Type A leases

48. For Type A leases, a lessor recognises a financial asset. The staff think that a lessor should apply IFRS 9 (IFRS) or Topic 310, *Receivables* (US GAAP) when accounting for the derecognition and impairment of these financial assets, including when assessing the effect of a lease modification.

49. This would mean no substantive change for IFRS lessors with respect to lease modifications. This is because, under existing IFRS guidance, a lessor would account for any modification to the net investment in a finance lease in accordance with the financial instruments guidance in IFRS 9. The staff understand that, in practice under *existing IFRS*, this generally gets applied in one of two ways:

    (a) Where the criteria for derecognition of the financial asset are met, the modified lease is accounted for by the lessor as if it were a new lease; or

    (b) The lessor adjusts the carrying value of the financial asset using the original discount rate. The offsetting amount to that adjustment is recognised in profit or loss. This application relies on the existing IFRS

financial instruments guidance applicable to a change in cash flows when using the effective interest method.

50. In contrast, this would represent a change for US GAAP lessors. This is because the existing modifications guidance applicable to sales-type/direct-financing leases is contained within Topic 840. The staff note that the modifications guidance in Topic 840 that is applicable to sales-type/direct-financing leases is complex to apply in practice. The staff note that it is often explained in interpretive guidance, such as that from major accounting firms, only by flowchart. Therefore, the staff do not think retaining that guidance, either for US GAAP preparers or for all preparers, is a preferable outcome.

51. The Boards decided in the revenue recognition project to account for the significant financing component (ie a financial asset) in a revenue contract consistently with the principles in the Boards' respective financial instruments guidance. Similarly, the staff think that the Boards' respective financial instruments guidance provides preparers with an appropriate framework to account for the derecognition, impairment, and/or modification of the financial asset resulting from a Type A lease.

Staff recommendation—lessor

52. The staff recommend that a lessor should:

    (a) Consistent with the recommendation for lessees, account for a lease modification as a separate new lease when:

        (i) The lease modification grants the lessee an additional right-of-use not included in the original lease; and

        (ii) The additional right-of-use is priced commensurate with its standalone price (in the context of that particular contract).

    (b) Account for modifications to a Type B lease as, in *effect*, a new lease (ie recognizing the modified lease payments prospectively over the remaining lease term), considering any prepaid or accrued lease rentals relating to the original lease as part of the lease payments for the modified lease.

(c) Account for modifications to a Type A lease in accordance with IFRS 9 (IFRS) or Topic 310 (US GAAP).

Questions 1-4: Lease modifications

Question 1 - Do the Boards agree with the staff recommendation to define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease and that the substance of the modification should govern over its form? If not, what do the Boards prefer?

Question 2 - Do the Boards agree with the staff recommendation that a lease modification should be accounted for as a separate lease when it (a) grants the lessee an additional right-of-use not included in the original lease; and (b) the additional right-of-use is priced commensurate with its standalone price (in the context of that particular contract)? If not, what do the Boards prefer?

Lessee

Question 3 – When there is a modification to a lease that is not accounted for as a separate contract, do the Boards agree with the staff recommendation to adopt Approach 1 to determine the resulting accounting (ie based on whether the modification changes the scope of the lease or only the consideration to be paid for the lease)? If not, what do the Boards prefer?

Lessor

Question 4 – When there is a modification to a lease that is not accounted for as a separate new lease, do the Boards agree with the staff recommendation that the lessor should account for (a) modifications to a Type B lease as, in effect, a new lease (the lease payments for which equal the remaining lease payments for the modified lease, adjusted for any prepaid/accrued rent on the original lease); and (b) modifications to a Type A lease in accordance with IFRS 9 (IFRS) or Topic 310 (US GAAP)? If not, what do the Boards prefer?

Contract combinations

53. This section discusses when it is appropriate to combine two or more contracts when applying the new leases guidance.

54. The staff recommend providing guidance similar to that to be included in the forthcoming revenue recognition standard. Accordingly, an entity would combine two or more contracts entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if either of the following criteria are met:

    (a) The contracts are negotiated as a package with a single commercial objective; or

    (b) The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

55. The 2013 ED did not include any guidance on contract combinations. In the absence of any guidance, an entity is likely to apply the proposed leases requirements on a single contract basis. Although it is usually appropriate to account for contracts individually, the staff think that there is a need to assess the combined effect of contracts that are interdependent. An entity may enter into multiple contracts in contemplation of one another such that the transactions, in substance, form a single arrangement that achieves an overall commercial effect. The financial reporting effect of recognising those contracts separately may be different from the financial reporting effect of recognising those contracts on a combined basis. In such situations, accounting for the contracts independently of each other might not result in a faithful representation of the combined transaction.

56. For example, assume a lessee enters into a one-year lease of an asset with particular characteristics. The lessee also enters into a one-year lease for an asset with those same characteristics starting in one year's time and a similar forward contract starting in two years' time and in three years' time. The terms and conditions of all four contracts are negotiated in contemplation of each other such that the overall economic effect cannot be understood without reference to the

series of transactions as a whole. In effect, the lessee has entered into a four-year lease.

57. In this scenario, the terms and conditions of each lease are likely to be affected by the existence (and terms and conditions) of the other contracts. For example, the lessor may not have agreed to enter into a one-year lease in the absence of the other contracts. Alternatively, even if willing to enter into such a one-year lease, the price charged for that lease is likely to have been more expensive because the lessor would be taking on significantly higher residual asset risk.

58. If each of the contracts were accounted for as separate transactions, the financial statements issued by the lessee would not accurately reflect the lessee's rights and obligations under the lease. In the example described above, the lessee might recognise a ROU asset and lease liability only for one-year (or avoid balance sheet recognition altogether by applying the short-term recognition and measurement exemption). To ensure that such contracts are considered together as a single transaction when applying the leases requirements, the staff recommend including contract combination guidance within the final leases standard.

59. Combining contracts with a single commercial purpose is consistent with the principle in the Boards' respective Conceptual Frameworks that an entity should faithfully represent the economic substance of their transactions.

60. Some might argue that the principles in the Conceptual Frameworks should be sufficient to determine when contracts should be combined. However, the staff think it would be beneficial to add more clarity as to when to combine contracts, in particular, in the context of sale and leaseback transactions and short-term leases. A few respondents to the 2013 ED suggested including guidance on combining contracts for these reasons.

61. The staff also note that any final leases guidance would remove SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* from IFRS guidance. SIC 27 includes a requirement to account for the substance of a transaction involving a lease, which includes the notion of combining two or more contracts when the economics of the arrangement cannot be understood

otherwise. The staff think it may be helpful to include guidance in the final leases standard as to when preparers should combine two or more contracts because the guidance in SIC 27 will be removed. For reference, the relevant extracts from paragraphs 3 and 4 of SIC 27 are as follows:

> 3 A series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and takes place concurrently or in a continuous sequence. (Part A of the accompanying guidance provides illustrations of application of this Interpretation.)
>
> 4 The accounting shall reflect the substance of the arrangement. All aspects and implications of an arrangement shall be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect.

Question 5: Contract combinations

Question 5 – Do the Boards agree with the staff recommendation to include in the final leases standard contract combination guidance that would indicate when two or more contracts should be considered as a single transaction? If not, what do the Boards prefer?