International
Accounting Standards
Board

Financial Accounting
Standards Board

INFORMATION FOR OBSERVERS

Leases Working Group Meeting
Tuesday 7 October 2008
Agenda Paper - Draft IASB Invitation to Comment – IASB discussion paper on Leases

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Leases discussion paper

Attached is a staff draft of the Leases discussion paper.

The purpose of this staff draft is to:

(a) summarise the proposed approach to a new lease accounting standard
(b) provide preliminary views on how various issues will be addressed in an exposure draft
(c) discuss other issues that will need to be addressed prior to the publication of an exposure draft
(d) seek the views of constituents on all of these areas.

Please note that this is a **staff draft** and **has not been approved for issue** by either the IASB or FASB.

Purpose of the working group meeting

The purpose of this meeting is to help the staff ensure that the discussion paper is complete and understandable.

Specifically, the staff will ask the working group members:

- to identify any additional issues that should be included in the discussion paper (and to explain why those issues should be included)
- to suggest any additional analysis of the issues covered in the discussion paper
- to identify any structural changes that would make the discussion paper easier to understand
- to highlight any sections or paragraphs that are difficult to understand and to propose drafting changes that would improve clarity.

The staff will also ask for comments and suggestions on the proposed questions. For example:

- whether the proposed questions are appropriate (given the objective of the discussion paper)
- whether the proposed questions are understandable. If not, how those proposed questions could be changed.
- whether there are any additional questions that should be included.

Contents

Invitation to comment and summary

Introduction

IN1 This discussion paper presents the preliminary views of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on the main components of an accounting model for lessees.

IN2 It is designed to gather information to assist the FASB and the IASB (the boards) in developing a new principles-based standard on lease accounting for lessees.

Summary of the discussion paper

IN3 [A summary of each chapter and any preliminary views reached will be included here]

The Leases Working Group

IN4 In 2006 the boards set up a joint lease accounting working group that includes users, preparers and auditors of both lessee and lessor financial statements. The group met in February 2007 and provided valuable comments on the early proposals for lease accounting. Since that meeting, members of the working group have continued to contribute to the project on an informal basis and, at a meeting in October 2008, provided feedback on this discussion paper.

IN5 The boards greatly appreciate the time and energy participants have devoted to this process. Their comments and insights have been very helpful.

Next steps

IN6 Following publication of this discussion paper, the boards intend to start work on an exposure draft. In developing the exposure draft, the boards will review the responses to this paper and decide whether to modify, confirm or develop their preliminary views. The boards will pay particular attention to the need for users of financial statements to receive relevant and reliable information, at a reasonable cost to preparers.

IN7 The boards expect the work on lease accounting to proceed in parallel with other projects (including the conceptual framework, revenue recognition, derecognition and financial instruments projects) but they will not necessarily wait for the outcome of those projects. In addition, the work on lease accounting may provide useful input to other projects.

IN8 This discussion paper deals with lease accounting for lessees only. In developing this paper, the boards decided to defer consideration of lessor accounting until further progress has been made on a number of other projects (in particular, derecognition and revenue recognition). However, the boards want to ensure they have considered all possible consequences of this decision.

Invitation to comment

IN9 The boards invite comments on all matters in this paper. Chapters 1 – 8 include questions for respondents. Appendix A lists all the questions. Comments are most helpful if they:

(a) comment on the questions as stated

(b) indicate the specific paragraph or paragraphs to which the comments relate

(c) contain a clear rationale

(d) describe any alternative the boards should consider.

IN10 Respondents need not comment on all the questions and are encouraged to comment on any additional issues.

IN11 The boards will consider all comments received in writing by [**Date**].

Chapter 1 Background

Purpose of this discussion paper

1.1 In July 2006, the boards decided to add to their agendas a joint project on lease accounting. In April 2008, the boards stated their intention to produce a revised standard for lessees by mid-2011. This discussion paper is the first step towards that goal.

1.2 The purpose of this discussion paper is to:

(a) summarise the proposed approach to a new lease accounting standard

(b) provide preliminary views on how various lease accounting issues will be addressed in the final standard

(c) discuss other issues that will need to be addressed before a lease accounting standard is finalised

(d) seek the views of constituents on all of these areas.

Problems with the existing lease accounting standards

1.3 The boards decided to add lease accounting to their agendas following criticism of the existing accounting model for leases.

Description of the existing accounting model

1.4 Current lease accounting standards require lessees to classify their lease contracts as finance (capital[1]) leases or operating leases. Finance leases are defined as those leases that transfer substantially all the risks and rewards incidental to ownership of the leased asset to the lessee. All other leases are operating leases.

1.5 Leases classified as finance leases are treated as similar to a purchase of the underlying asset. Consequently, the lessee recognises the leased item in its statement of financial position and an obligation to pay rentals. The lessee depreciates the leased item and apportions lease payments between a finance

[1] US GAAP uses the term capital lease rather than finance lease. To avoid repetition this document uses the term finance lease.

change and a reduction of the outstanding liability. No similar assets or liabilities are recognised when the lease is classified as an operating lease. The lessee recognises lease payments under an operating lease as an expense on a straight-line basis over the lease term.

Criticisms of the existing accounting model for lessees

1.6 The following criticisms have been made of the existing accounting model for lessees:

(a) On entering a lease contract, the lessee obtains a valuable right (the right to use the leased item). On analysis, this right appears to meet the boards' definitions of an asset. Similarly, the lessee assumes an obligation (the obligation to pay rentals) that meets the boards' definitions of a liability. However, if the lessee classifies the lease as an operating lease these rights and obligations are not recognised. Analysts of financial statements routinely adjust the published figures in an attempt to reinstate these missing assets and liabilities and reflect the effect of lease contracts in profit or loss. However, the information available to analysts in the notes to the financial statements is insufficient for them to make accurate adjustments.

(b) It has proved difficult to define the dividing line between finance leases and operating leases in a principled way. The standards use a mixture of subjective judgements and bright-line tests and as a result are complicated for preparers to apply. They also provide opportunities to structure transactions so that they fall just to the operating lease side of the dividing line – providing a source of off-balance sheet financing.

(c) The existence of two very different accounting models for leases (the finance lease model and the operating lease model) means that similar transactions can be accounted for very differently. It is possible to devise lease arrangements that are classified as operating leases that give rise to rights and obligations that are economically very similar to a lease that is classified as a finance lease.

(d) The lease accounting standards are old; while both leasing standards have been amended several times, FASB Statement No. 13, *Accounting for Leases* was originally issued in 1976 and IAS 17 *Leases* in 1982. Consequently, there are significant and growing differences between the accounting framework for lease accounting and other standards. This has lead to inconsistencies between arrangements that meet the definition of a lease and similar arrangements that do not.

(e) The SEC in its June 2005 Report, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, commented upon the inadequacies of the current leasing standards and recommended that the FASB undertake a project to reconsider the leasing standards, preferably as a joint project with the IASB.

History of the project

1.7 Standard setters and other interested parties have debated how to improve lease accounting for many years.

1.8 In 1996, the G4+1 group of standard setters[2] published a discussion paper (*Accounting for Leases: A New Approach – Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts)*. This paper proposed a new approach to lease accounting that abolished the requirement to classify leases as operating leases or finance leases. Under this new approach a lessee would recognise as assets and liabilities all material rights and obligations arising in a lease contract.

1.9 The G4+1 published another discussion paper in 2000 (*Leases: Implementation of a New Approach*). That paper set out proposals for how the approach described in

[2] The G4+1 group of standard setters comprised the accounting standard boards of Australia, Canada, New Zealand, the United Kingdom and the United States plus the International Accounting Standards Committee (the predecessor organisation to the IASB).

the 1996 paper might be made to work and included proposals on lessor accounting.

1.10 In July 2006, the boards added a joint project on lease accounting to their agendas. This project is part of the 2006 Memorandum of Understanding (updated in 2008) between the boards to work towards convergence. The aim of this project is to produce a significantly improved, converged lease accounting standard.

The decision to defer consideration of lessor accounting

1.11 When the boards added lease accounting to their agendas in July 2006, they agreed that the project would consider both lessee and lessor accounting. However, in July 2008, the boards tentatively decided to defer consideration of lessor accounting and concentrate on developing an improved lessee accounting model. Consequently, this discussion paper considers lessee accounting only.

1.12 The boards' reasons for deferring consideration of lessor accounting were as follows:

(a) Lessor accounting raises issues that relate to other projects the boards are currently considering – in particular, derecognition and revenue recognition. Until conceptual models for derecognition and revenue recognition have been developed, it will be difficult and perhaps premature to build an accounting model for lessors.

(b) Any project dealing with lessor accounting will need to consider how to account for investment property. There are significant economic differences between lessors of real estate and other lessors that will require detailed analysis.

(c) Consideration of lessor accounting at the same time as lessee accounting will delay publication of a new accounting standard for lessees. Lessee accounting affects a wide range of entities across all industries. Current accounting standards significantly understate the extent of those entities' assets and liabilities. Consequently, improvements to lessee accounting would be of benefit to a large number of users. In contrast, lessors are a smaller population of financial businesses.

1.13 There are a number of potential disadvantages to the approach adopted by the boards:

(a) There may be a lack of symmetry between lessee and lessor accounting for some time. One consequence of this lack of symmetry is the need to produce guidance for situations in which an entity acts as both a lessee and a lessor of the same asset.

(b) Continuing to develop lessor accounting might provide additional insights into lessee accounting and a better understanding of the economics of lease contracts.

(c) Further changes to lessee accounting may be required when lessor accounting is eventually addressed.

(d) Different accounting models for lessees and lessors could result in structuring opportunities.

1.14 Although the boards have decided to defer consideration of lessor accounting, they welcome any suggestions from lessors on how to avoid the disadvantages associated with the proposed approach. The boards intend to restart work on lessor accounting once they have developed a new standard for lessees.

Questions for respondents

Question 1

Do you believe a new accounting standard for leases is required? Please explain your reasons.

Question 2

Please describe any additional problems associated with the existing lease accounting standards that the boards should address in developing a new standard.

Question 3

The boards have decided to defer consideration of lessor accounting. Do you agree with this approach? If you disagree with this approach, please explain why.

Question 4

Please describe any further issues arising out of the boards' decision to defer consideration of lessor accounting that will need to be addressed.

Chapter 2 Scope of lease accounting standard

Introduction

2.1 The purpose of this chapter is to describe the boards' preliminary views about the scope of the new lease accounting standard. As discussed in chapter 1, this discussion paper deals with lessee accounting only.

Proposed approach to scope

Possible approaches to scope

2.2 The boards considered two possible approaches to defining the scope of the lease accounting standard.

2.3 The first possible approach considered by the boards was to base the scope of the new standard on that of the current lease accounting standards. That is, the scope of the new lease accounting standard would be similar to the scope of Statement 13 and IAS 17 and would include those arrangements brought into the scope of the current standards by EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," and IFRIC 4, *Determining Whether an Arrangement Contains a Lease*. Appendix B describes the scope of the current lease accounting standards. There are a number of differences between the scope of Statement 13 and that of IAS 17. These will need to be reconciled before publication of a new lease accounting standard. This approach would result in all contracts that are currently accounted for as lease contracts continuing to be accounted for as leases under the new standard.

2.4 The second approach considered was to undertake a fundamental reconsideration of what constitutes a lease. This approach would potentially change the scope of the leases standard and would require the boards to discuss (amongst other things):

(a) the borderline between contracts that convey a right of use to the lessee and contracts that do not (for example, certain service contracts)

(b) whether it is possible to lease a component of a larger asset

(c) whether licenses of particular intangible assets are leases.

2.5 This approach would be likely to result in some contracts that are within the scope of the existing lease accounting standards being excluded from the scope of the new standard; and some contracts that are currently outside the scope of the lease accounting standards being included in the scope of the new standard.

Preliminary view

2.6 The boards' preliminary view is that the scope of the new standard should be based upon the scope of the existing standards.

2.7 The boards adopted this approach for the following reasons:

(a) The approach to scope adopted in the current standards is familiar to constituents. Consequently, basing the scope of the new standard on the scope of the existing standards may be easier to understand and implement for constituents.

(b) Although it may sometimes be difficult to apply the detailed guidance in IFRIC 4 and Issue 01-8, in most common situations it is clear whether a lease contract falls within the scope of the existing standards.

Possible disadvantages associated with the proposed approach

2.8 There are a number of possible disadvantages to the boards' proposed approach to scope. These include:

(a) The fundamental question of what is a lease contract and how it differs from other contracts will remain unanswered. In particular, some constituents have expressed concern that the scope of IFRIC 4 and Issue 01-8 results in some arrangements being classified as leases inappropriately. These concerns will not be addressed.

(b) Similar contracts with similar characteristics may not be accounted for consistently. For example, executory contracts, service contracts, maintenance contracts, and lease contracts share similar characteristics but have different accounting.

(c) Requiring lessees to capitalise all operating leases may lead to arrangements being structured so the contract is considered a contract for services rather than a contract conveying a right of use. This will result in the current guidance on scope being placed under more strain than is currently the case.

(d) Additional guidance on how to split payments for services from payments for the right to use an asset may be required. There is an existing requirement to split payments for services from lease payments. However, if the lease is classified as an operating lease, the lessee recognises both the payment for services and the lease payment in profit or loss, generally on a straight-line basis. Requiring capitalisation of the lease payments may mean that the existing guidance on how to split the payments is inadequate.

Short-term and immaterial leases

2.9 A number of constituents have argued that the costs associated with recognising and measuring the rights and obligations arising under short-term lease contracts (usually defined as leases of less than one year) outweigh the benefits. Consequently, they argue that any new lease accounting standard should exclude from its scope short-term leases. Those constituents believe that leases meeting the definition of a short-term lease should continue to be accounted for as operating leases.

2.10 There are a number of issues with this approach:

(a) Even short-term leases can give rise to material assets and liabilities.

(b) Excluding short-term leases from the scope of the new standard will encourage structuring of leases so that the term is (or appears to be) less than the specified threshold.

(c) The definition of a short-term lease will inevitably be arbitrary.

(d) Any scope exception leads to more complexity in the new standard.

2.11 Similarly, a number of constituents have argued that any new lease accounting standard should not apply to immaterial lease contracts. However, other constituents note that the materiality concept is not unique to leases and they do not believe it should be specifically addressed here.

2.12 The boards have discussed whether the materiality issue could be addressed by a company's capitalization policy. In general, companies do not capitalise items of property, plant and equipment whose value is less than a particular threshold. A similar approach could be applied to assets arising from lease contracts.

2.13 The boards have not reached a preliminary view on whether to provide a scope exemption for short-term or immaterial leases.

Next steps

2.14 In developing an exposure draft, the boards will need to undertake the following:

(a) draft new scope paragraphs that integrate the requirements of Statement 13, IAS 17, IFRIC 4 and Issue 01-8

(b) consider the need for clarification of the requirements of IFRIC 4 and Issue 01-8 and additional guidance on distinguishing between payments for the right to use a leased asset and payments for services

(c) discuss whether to provide a scope exemption for short-term or immaterial lease contracts.

Questions for respondents

Question 1

Do you agree with the preliminary view to base the scope of the new lease accounting standard on the scope of the existing lease accounting standards?

If you disagree, please explain why and describe how you would define the scope of the new standard

Question 2

Is additional guidance or clarification required on how to apply the scope paragraphs of the existing standards? If so, please describe where additional guidance or clarification is required.

Question 3

Is additional guidance needed on how to separate payments for services from payments for the right to use the leased item? If so, please describe what additional guidance is needed.

Question 4

Should the new standard include an exemption for short-term and/or immaterial leases? If you believe an exemption should be included, please explain why and how you would describe those leases to be excluded from the scope of the new standard.

Chapter 3 Approach to lessee accounting

Introduction

3.1 The purpose of this chapter is to describe the overall approach to lessee accounting proposed by the boards.

3.2 The boards propose a new accounting model for all leases, including leases currently classified as operating leases, that requires the lessee to recognise:

(a) an asset representing its right to use the leased item for the lease term

(b) a liability for its obligation to pay rentals.

Approach used in the existing standards

3.3 IAS 17 and Statement 13 require lessees to classify lease contracts as either finance leases or operating leases. IAS 17 defines finance leases as those leases that transfer substantially all the risks and rewards incidental to ownership of the asset. All other leases are classified as operating leases. The requirements of Statement 13 are similar.

3.4 Leases that transfer substantially all the risks and rewards of ownership to the lessee are viewed to be economically similar to a purchase of the leased asset. Consequently, the accounting required by IAS 17 and Statement 13 reflects this similarity. Lessees are required to account for these leases as the acquisition of an asset and the assumption of an obligation to pay for that asset.

3.5 Operating leases are not viewed as economically similar to a purchase. As a result, the lessee recognises no assets or liabilities (other than the normal accrual of rentals due or prepaid).

3.6 However, some argue that this two-model approach to accounting for lease contracts fails to represent faithfully the economics of many lease contracts. For example, on entering into a 15-year non-cancellable lease of real estate, a lessee obtains a valuable right (the right to use the property). In addition, the lessee assumes a significant obligation (the obligation to pay rentals). However, if the lease is classified as an operating lease, the lessee recognises no assets or liabilities.

3.7 Consequently, the boards undertook an analysis of the rights and obligations that arise in a simple lease contract to determine whether they give rise to assets and liabilities that should be recognised in the financial statements. The following section describes this analysis.

Analysis of rights and obligations arising in a simple lease

Rights and obligations arising in a simple lease

3.8 To identify the rights and obligations arising in a simple lease contract the boards analysed the following example:

> *A piece of machinery is leased for a fixed term of 5 years; the expected life of the machinery is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machinery at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the machinery has been delivered; these are fixed amounts that are specified in the original agreement. No maintenance or other arrangements are entered into.*

3.9 In reality, lease contracts are often significantly more complex than the lease described in the example. However, by analysing a simple lease, the boards believe they can identify the rights and obligations that are common to most lease contracts.

3.10 To simplify the analysis further, the boards only considered those rights and obligations that exist after the leased item is delivered to the lessee. Assets and liabilities may arise prior to delivery of the leased item (for example, when the contract is signed). Chapter 8 discusses this issue.

3.11 Generally, in lease contracts the lessee is required to maintain the machinery in a specified condition. In addition, the lessee may be required to incur costs to return the machinery to the lessor (for example, costs to dismantle the machinery and/or transportation costs). However, commitments of this type are ignored for the purposes of this simple example.

3.12 The lease described in this example is non-cancellable. That is, the lessee has no contractual right to terminate the lease agreement, return the machinery and cease making payments to the lessor. Equally, the lessor has no contractual right to terminate the lease agreement and demand the return of the machinery prior to the end of the lease term. Chapter 6 discusses leases that incorporate a contractual right of termination (cancellable leases).

3.13 The following table summarises the lessee rights and obligations identified by the boards:

Lessee rights	**Lessee obligations**
• Right to use machinery for the lease term	• Obligation to pay rentals • Obligation to return the machinery at the end of the lease term

Application of the asset and liability definitions

3.14 Having identified the rights and obligations arising in this simple lease, the boards then considered whether they meet their definitions of assets and liabilities.

3.15 Although the wording of the current IASB and FASB asset definitions are different, the basic concepts underpinning them are very similar. The IASB's *Framework for the Preparation and Presentation of Financial Statements* (Framework) and the FASB Concepts Statement No. 6 *Elements of Financial Statements* (CON 6)[3] have the following characteristics of an asset in common:

(a) There is an economic resource or benefit that the reporting entity controls.

(b) It arises out of a past event.

(c) Future economic benefits are expected to flow to the entity.

3.16 Similarly, the liability definitions contain the same basic characteristics:

(a) There exists a present obligation of the reporting entity.

(b) The obligation arises out of a past event.

(c) The obligation is expected to result in an outflow of economic benefits.

3.17 The boards used these common characteristics to analyse whether the rights and obligations identified above meet the definition of an asset or liability.

[3] The boards are currently working on a joint project that will revise the definitions of assets and liabilities (the Conceptual Framework project). However, until that project is finalised, the boards will continue to use the existing definitions.

Preliminary views

The right to use a leased item

3.18 The boards tentatively concluded that for a non-cancellable lease:

(a) The right to use the leased item (for example, the machinery described in paragraph 3.8) is an economic resource of the lessee because the lessee can use it to generate cash inflows or reduce cash outflows.

(b) The lessee controls the right to use the leased item during the lease term, since the lessor is unable to recover or have access to the resource without consent of the lessee (or breach of contract).

(c) The control results from past events – the signing of the lease contract and the delivery of the item by the lessor to the lessee. Some argue that the lessee's right to use the machinery described above is conditional upon the lessee making payments over the lease term. That is, if the lessee does not make payments as they fall due, it may forfeit its right to use the machinery. However, once the lessee has possession of the machinery, no further action is required by the lessor to enable the lessee to use it for the whole of the lease term. The lessee has no contractual right to return the machinery and cease making payments to the lessor until the end of the lease.

(d) Future economic benefits from the right to use the item during the lease term will flow to the lessee.

3.19 Accordingly, the boards have tentatively concluded that the lessee's right to use a leased item for the lease term meets the Framework and CON 6 definitions of an asset.

The obligation to pay rentals

3.20 Some argue that the lessee's obligation to make payments over the lease term is a conditional obligation. That is, unless the lessor provides the lessee with the item and permits its use each day, the lessee has no obligation to pay rentals for that day.

3.21 However, under a non-cancellable lease the lessor has no contractual right to cancel the lease, nor the contractual right to take back possession of the item until the end of the lease term (assuming there is no breach). Equally, the lessee has no contractual right to terminate the lease prior to the end of the lease and avoid paying rentals. The lessee, therefore, has an unconditional obligation to pay rentals over the lease term.

3.22 In summary, for a non-cancellable lease, the boards tentatively concluded:

(a) The lessee has a present obligation for all of the lease payments due over the lease term.

(b) This obligation arises out of past events— entering into the lease agreement and the delivery of the item from the lessor to the lessee.

(c) The obligation is expected to result in the outflow of resources embodying economic benefits (usually cash).

3.23 Accordingly, the boards have tentatively concluded that the lessee's obligation to pay rentals under a non-cancellable lease meets the Framework and CON 6 definition of a liability.

The obligation to return the leased item at the end of the lease term

3.24 The lessee has physical possession of the leased item at the end of the lease term and, therefore, may have an obligation to return the leased item to the lessor at the end of the lease term. This is a present obligation that is established by a past event (the delivery of the machine in the above example). Therefore, if this obligation to return the leased item results in an outflow of economic benefits, the obligation will meet the definition of a liability.

3.25 It might seem that there is an outflow of economic benefits at the end of the lease term because the lessee must surrender the leased item (which presumably still has some economic potential). However, the boards have tentatively concluded that there is no outflow of economic benefit from the lessee when it returns the leased item. Although the lessee has physical possession of the leased item, it has no rights to use the item once the lease term has expired. The position of the lessee at the end of the lease term can be compared to that of an asset custodian. The lessee is holding an asset on behalf of a third party but has no rights to the economic benefits embodied in that asset.

3.26 Consequently, the boards have tentatively concluded that the obligation to return the leased item does not result in an outflow of economic benefits from the lessee and does not meet the definition of a liability.

3.27 In summary, the boards' preliminary view is that in the simple lease example described above, the following assets and liabilities can be identified:

Description of right	**Control**	**Past event**	**Future economic benefit**	**Asset?**
Right to use machinery during the lease term	Legally enforceable right established by the lease contract	Delivery following signing of the lease contract	Yes	Yes

Description of Obligation	**Present obligation**	**Past event**	**Outflow of economic benefits**	**Liability?**
Obligation to pay rentals	Legally enforceable obligation established by the lease contract	Delivery following signing of the lease contract	Yes (cash payments)	Yes
Obligation to return the machinery at the end of the lease term	Legally enforceable obligation established by the lease contract	Delivery following signing of the lease contract	No, because the lessee has no right to economic benefits from the machinery after the end of the lease term.	No

A new accounting model

Preliminary views

3.28 The boards noted that any new accounting model that fails to recognise the identified assets and liabilities arising in a lease would be unlikely to solve the problems associated with existing standards. Thus, the boards tentatively decided to develop an accounting model for leases that would result in the recognition of an asset for the right to use the leased item and a liability for the obligation to pay rentals.

3.29 The boards noted that this could be achieved by modifying the existing model for finance leases so that it applied to the recognition and measurement of leases that are currently classified as operating leases. Rather than treating the lease as similar to a purchase of the leased item, the new model would treat the lease contract as an acquisition of the right to use the leased item for the lease term. Thus, the lessee would recognise the following:

(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)

(b) a liability for its obligation to pay rentals.

3.30 The current model for the recognition and measurement of finance leases is familiar to preparers and users. Consequently, modifying this model and applying it to all lease contracts is less likely to give rise to implementation issues than developing a completely new accounting model.

3.31 As a result, the boards tentatively decided to develop a model based on the current finance lease model, adapted where necessary, to leases currently classified as operating leases. The following chapters of this paper discuss when and how to adapt the current finance lease model.

3.32 The boards also discussed a number of other possible accounting models. However, the boards rejected these models, because they did not result in the recognition of the identified assets and liabilities. Appendix C describes the rejected accounting models.

Lease classification

3.33 Having tentatively decided to adapt the current model for finance leases and apply it to leases currently classified as operating leases, the boards considered whether to retain the current requirement to classify leases as either finance or operating.

Reasons to remove the classification requirement

3.34 The boards noted a number of reasons for removing the classification requirement:

(a) The boards have tentatively concluded that all leases, whether they are classified as operating leases or finance leases, give rise to a right to use the leased item that meets the definition of an asset. Consequently, it can be argued that a single conceptual model for accounting for all leases is preferable.

(b) The requirement to classify leases is a source of complexity in the current standards for both users and preparers. Removing this requirement would result in a significantly simpler lease accounting standard that would be easier for preparers to apply and users to understand.

(c) It is often difficult to determine lease classification. Consequently, economically similar leases can be classified differently. Removing the requirement to classify leases would result in similar transactions being accounted for similarly, leading to increased comparability for users.

Reason to retain a classification requirement

3.35 The boards noted that the main reason to retain a lease classification requirement would be if they decided that the accounting model for leases that are in-substance purchases should be different from other lease contracts. For example, the boards could conclude one or more of the following:

(a) Initial measurement of the asset recognised should be different.

(b) Subsequent measurement of the asset recognised should be different for in-substance purchases (for example, the boards may wish to permit revaluation of assets held under finance leases or require different amortisation methods for leases classified as operating leases).

(c) Initial and subsequent measurement of the liability should be different for in-substance purchases (for example, the boards may wish to require a different discount rate to be used for operating leases).

(d) Presentation in the statement of financial position of assets held under leases that are in-substance purchase should be different from the presentation of other right-of-use assets.

(e) Presentation in the income statement of the costs associated with the lease contract should be different for in-substance purchases.

3.36 The boards also noted that removing the requirement to classify leases would have the following implications:

(a) Any decisions to move away from the accounting requirements of IAS 17 may result in a change to the required accounting for leases currently classified as finance leases.

(b) The boards will need to develop new guidance for a number of areas that currently rely on the lease classification requirements (for example, scope exclusions and accounting for sale and leaseback transactions).

Preliminary views

3.37 The preliminary view of most Board members is that the boards should develop a single conceptual model for the recognition, measurement and presentation of all lease contracts. Consequently, they support the proposal to remove the classification requirement.

3.38 However, some Board members disagree with this approach.

3.39 Some Board members believe that lease contracts that are in-substance purchases should be accounted for the same as any other instalment purchase. Consequently, they support retaining some form of classification requirement to exclude contracts of this type from the scope of the lease accounting standard.

3.40 The boards' preliminary view is that lease contracts give rise to assets and liabilities that the lessee should recognise in its statement of financial position. However, some Board members believe that for lease contracts currently classified as operating leases it is inappropriate to record a finance cost and depreciation or amortisation in profit or loss. These Board members believe that recording the annual rental cost in profit or loss better reflects the economics of operating lease contracts. They also note that this approach would be simpler for preparers to apply. These Board members would continue to record a finance cost and amortisation or depreciation for leases currently classified as finance leases.

Consequently, they support retaining the requirement to classify leases. Chapter 6 discusses this issue further.

3.41 Finally, some Board members believe assets acquired under leases that are in-substance purchases should be presented in the statement of financial position together with owned assets (and separately from other leased assets). Consequently, they would retain a simplified classification requirement for presentation purposes.

Questions for respondents

Question 1

Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Question 2

Are there types of lease contracts that do not give rise to a right of use and an obligation to pay rentals? Please provide examples.

Question 3

Do you support removing the requirement to classify leases as finance leases or operating leases?

If you support retaining a classification requirement, please explain why.

Question 4

If you support retaining a classification requirement, please explain how you would differentiate between the two types of lease. Would you support retaining the classification requirements in IAS 17, or Statement 13 or would you support a different approach?

Chapter 4 Initial measurement

Introduction

4.1 The purpose of this chapter is to describe the boards' preliminary views on initial measurement of the lessee's right-of-use asset and its obligation to pay rentals.

Identifying the cash flows

4.2 To determine the initial measurement of the right-of-use asset and the obligation to pay rentals, the lessee must first identify which cash flows to measure. Lease contracts can convey a range of different rights and obligations to the lessee. For example, a lease contract may include:

(a) options to extend the lease on payment of additional rentals

(b) options to terminate the lease early

(c) obligations to pay variable or contingent rentals

(d) obligations to compensate the lessor if the value of the leased asset falls below a specified value (residual value guarantees)

(e) options to purchase the leased asset on payment of an additional amount.

4.3 Existing lease accounting standards require the lessee to identify the minimum lease payments. The minimum lease payments include:

(a) lease rentals payable during the initial period of the lease

(b) rentals payable during optional periods if it is reasonably certain (reasonably assured under US GAAP) that the option to use the asset in the optional period will be exercised

(c) the maximum value of any residual value guarantee

(d) the exercise price of any option to purchase the leased asset if exercise of the option is reasonably certain (reasonably assured).

Minimum lease payments exclude obligations to pay contingent rentals.

4.4 If the lease is classified as a finance lease, the lessee recognises an asset and liability that is equal to the present value of the minimum lease payments (or the fair value of the leased item if that is lower).

4.5 In measuring the asset and liability recognised under existing standards, the lessee groups together cash flows arising from several different rights and obligations.

4.6 An alternative approach would be for the lessee to recognise and measure each of the components of the lease separately. For example, a new standard could require the lessee to separately identify and measure options to extend a lease or obligations to make payments under residual value guarantees.

4.7 The boards' preliminary view is that the measurement of the lessee's right-of-use asset and its obligation to pay rentals should include a best estimate of the cash flows arising in optional periods and contingent rentals payable. That is, the boards have decided not to recognise and measure these components of the lease separately. Chapters 6 and 7 discuss this approach. The boards have not yet reached a preliminary view on the treatment of other common components of a lease contract (for example, purchase options or residual value guarantees).

4.8 This chapter does not discuss further which cash flows should be included in the initial measurement of the right-of-use asset or the obligation to make payments. Instead, this chapter describes the boards' preliminary views regarding how to measure the identified cash flows.

Approaches to measuring the obligation to pay rentals

4.9 The boards discussed two possible approaches to initial measurement of the lessee's obligation to pay rentals:

(a) fair value

(b) present value of lease payments as a proxy for fair value.

Fair value

4.10 It can be argued that fair value represents the most relevant measure for a liability on initial recognition as it reflects current market conditions. Requiring the use of fair value produces information for users that is more comparable as it ignores entity specific factors.

4.11 In addition, the lessee's obligation to pay rentals meets the definition of a financial liability in IAS 32 *Financial Instruments: Presentation.* IAS 39 *Financial Instruments: Recognition and Measurement* requires financial instruments to be initially measured at fair value.

4.12 Under US GAAP, the same general approaches to measuring financial liabilities apply. Some financial liabilities, particularly derivatives not in a hedging relationship (FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*) and financial liabilities to which the fair value option has been elected (FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) are initially measured at fair value. Many other financial liabilities, such as notes exchanged for property, goods, or services, are initially measured at an amount that reasonably approximates the market value of the note.

4.13 Consequently, some board members argue that the lessee's obligation to pay rentals should be measured on a basis that is consistent with other financial liabilities.

Present value of lease payments as a proxy for fair value

4.14 The boards noted that in most lease contracts it is not possible to observe the fair value of the obligation to pay rentals directly. Consequently, discounted cash flow techniques can be used to determine the fair value of the obligation to pay rentals. In most leases, the present value of the lease payments (discounted at an appropriate rate) will be a reasonable approximation to fair value.

4.15 Requiring lessees to initially measure the obligation to pay rentals at the present value of the lease payments rather than at fair value would be simpler for lessees to apply and easier for users to understand.

Preliminary view

4.16 The boards' preliminary view is that that the initial measurement of the lessee's obligation to make rental payments should be recorded at the present value of the lease payments. The boards adopted this approach for the following reasons:

(a) The fair value of the lessee's obligation to pay rentals may be difficult to determine directly.

(b) It is simpler for lessees to apply than requiring them to consider the fair value of the obligation to pay rentals.

(c) It is consistent with the approach to initial measurement used in the current standards. Consequently, adopting this approach may be easier for users to understand and lessees to implement.

Discount rate

4.17 The boards also discussed the discount rate the lessee should use to determine the present value of the lease payments.

Current approach

4.18 IAS 17 states that the discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease if this is practicable to determine; if not, the lessee's incremental borrowing rate is used.

4.19 Statement 13 requires a lessee to use its incremental borrowing rate unless it is practicable to determine the implicit rate computed by the lessor and that implicit rate is lower than the incremental borrowing rate. If so, the implicit rate is used.

4.20 It is more common for entities applying IAS 17 to use the rate implicit in the lease than for entities applying Statement 13 who, in general, use the incremental borrowing rate to discount the lease payments.

4.21 The current definition of the interest rate implicit in the lease in IAS 17 is "the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor."

4.22 The IAS 17 definition of the lessee's incremental borrowing rate is "the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset."

Possible approaches

4.23 The boards considered three possible approaches to determining the discount rate:

(a) retaining the approach required by IAS 17

(b) requiring the use of the interest rate implicit in the lease

(c) requiring the use of the lessee's incremental borrowing rate.

4.24 Some may consider the interest rate implicit in the lease the appropriate rate to use because it is the rate that the lessor is charging in the transaction and is specific to the liability being measured; however, in many instances the lessee will not know or be able to determine the implicit rate as computed by the lessor. The lessor's estimate of the residual value of the leased property affects the interest rate implicit in the lease. The lessee may have little knowledge of or interest in the residual value of the leased asset at the end of the lease.

4.25 In addition, determining the interest rate implicit in the lease is more difficult for leases currently classified as operating leases than for finance leases. This is because the residual value is much larger when the lease is an operating lease. The interest rate implicit in the lease will be more subjective as it will be hard for the lessee to determine the residual value estimated by the lessor.

Preliminary view

4.26 The boards' preliminary view is to discount the minimum lease payments using the lessee's incremental borrowing rate. The boards adopted this approach for the following reasons:

(a) Determining the implicit rate is often difficult for lessees because it requires the lessee to estimate the fair value of the leased item and its residual value.

(b) Removing the requirement to consider the interest rate implicit in the lease would result in a standard that is simpler for lessees to apply.

(c) The concept of an incremental borrowing rate is easier for users of financial statements to understand than the concept of the interest rate implicit in the lease.

Approaches to measuring the right-of-use asset

4.27 The boards considered the following approaches to measuring the right-of-use asset:

(a) fair value

(b) present value of lease payments.

Fair value

4.28 The boards discussed measuring the right-of-use asset initially at fair value; that is, the fair value of the lessee's right to use the leased item. This is different from the fair value of the leased item itself. For example, in a 15-year lease of a building, the fair value of the leased item is the fair value of the building; the fair value of the right-of-use asset is the fair value of the right to use the building for 15 years.

4.29 Supporters of this approach argue that fair value represents the most relevant measure for an asset on initial recognition as it reflects current market conditions. In addition, requiring the use of fair value produces information for users that is more comparable because it ignores entity specific factors.

4.30 However, there are a number of disadvantages to this approach:

(a) The fair value of the right to use the leased item may be difficult to measure and/or costly to determine. Most leases are independently negotiated between the lessee and the lessor. Consequently, there is no current observable market for right-of-use assets.

(b) If the lessee records its obligation to pay rentals at an amount other than fair value, measuring the right-of-use asset at fair value could result in the lessee recognising gains or losses on initial recognition. Recording a gain or loss because of a mismatch between the measurement bases for the asset and the liability would be potentially misleading to the users of the financial statements.

(c) Requiring fair value measurement would be inconsistent with the treatment of other similar assets. For example, IAS 16 *Property, Plant and Equipment*, and IAS 38 *Intangible Assets* require initial measurement at cost rather than fair value. Similarly, US GAAP requires the initial (and subsequent) measurement of assets at cost under ARB No. 43, *Restatement and Revision of Accounting Research Bulletins.*

Present value of lease payments

4.31 The boards also discussed initial measurement of the right-of-use asset at an amount equal to the present value of the lease payments. This is broadly consistent with the current approach to initial measurement. Under existing standards, the lessee measures its asset at an amount equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments.

4.32 The boards noted a number of advantages to this approach:

(a) The present value of the lease payments is a measure of the cost of the right-of-use asset. Consequently, this approach is consistent with the initial measurement of similar assets recorded at cost (for example, property, plant and equipment and intangible assets).

(b) Unlike the fair value of the right-of-use asset, the present value of the lease payments can always be measured reliably.

(c) If the lessee initially measures its obligation to pay rentals at the present value of the lease payments, no gain or loss on initial recognition will arise.

(d) This approach to initial measurement is familiar to users and preparers as it is consistent with the approach used in the existing standards.

Preliminary view

4.33 The boards' preliminary view is that the lessee should measure its right-of-use asset at the present value of the lease payments.

4.34 As noted above, current accounting standards require the lessee to recognise its asset at an amount equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments. The boards have tentatively decided to remove the requirement for lessees to consider the fair value of the leased property at initial recognition.

4.35 The boards noted that if the fair value of the right-of-use asset is lower than the present value of the lease payments, the lessee must be receiving something in addition to the use of the leased item (for example, additional goods or services).

Questions for respondents

Question 1

Do you agree with the board's tentative decision to measure the lessee's obligation to make payments at the present value of the lease payments?

If you disagree, please explain why and describe how you would initially measure the lessee's obligation to make payments.

Question 2

Do you agree with the board's tentative decision to discount the lease payments at the lessee's incremental borrowing rate?

If you disagree, please explain why and describe how you would discount the lease payments.

Question 3

Do you agree with the board's tentative decision to initially measure the lessee's right-of-use asset at the present value of the lease payments?

If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset?

Question 4

The boards have tentatively decided to remove the requirement for lessees to consider the fair value of the leased property at initial recognition. Do you agree with this preliminary view? Please explain why.

Chapter 5 Subsequent measurement

Introduction

5.1 The boards considered several approaches to the subsequent measurement of the lessee's right-of-use asset and obligation to make rental payments. This Chapter discusses the various approaches, describes the boards' preliminary views, and seeks input from constituents.

Subsequent measurement of the obligation to pay rentals

5.2 The boards considered two approaches for the subsequent measurement of the lessee's obligation to pay rentals:

(a) fair value

(b) apportion the lease payments between finance charge and the outstanding obligation.

5.3 The boards also discussed an approach that would link the subsequent measurement of the right-of-use asset and the obligation to pay rentals. The subsequent measurement of the right-of-use asset section of this chapter describes this approach.

Fair value

5.4 The boards discussed subsequent measurement of a lessee's obligation to pay rentals at fair value. Fair value measurement reflects current market conditions. Therefore, it can be argued that it provides information that is more relevant to users of financial statements. In addition, requiring fair value measurement of the obligation to pay rentals would be consistent with the boards' stated long-term objective to require measurement of all financial liabilities at fair value.

5.5 However, the boards noted the following disadvantages to requiring fair value measurement of the lessee's obligation to pay rentals:

(a) Requiring subsequent measurement at fair value would be inconsistent with the board's tentative decision not to require fair value measurement on initial recognition.

(b) Requiring continuous remeasurement of the obligation to pay rentals to fair value would be costly and complex for preparers. Fair value measurement would be costly because it requires the use of both current expected cash flows and current market interest rates. Determining current market interest rates for lease obligations is complex because the interest rate used must reflect the fact that the obligation to pay rentals is secured on the leased item. The degree of security could be different from lease to lease and from period to period depending on the fair value of the leased item.

(c) Subsequently measuring the lessee's liability at fair value would result in the lessee potentially reporting significant gains and losses, caused by changes in the lessee's credit quality in profit or loss. Decreases in an entity's credit quality would lead to reported gains, whilst increases in an entity's credit quality would lead to reported losses.

(d) Requiring fair value could result in lease liabilities being measured differently to similar non-lease financial liabilities, which reduces comparability for users. Under both IFRS and US GAAP, many similar financial liabilities are subsequently measured using a cost-based method.

(e) Requiring fair value measurement may not provide more relevant information to users in situations where the liability is unlikely to be transferred.

Apportion lease payments between finance charge and outstanding obligation

5.6 The boards discussed subsequent measurement of the obligation to pay rentals by apportioning the rentals paid between a finance charge and the reduction of the outstanding liability.

5.7 This approach is consistent with the subsequent measurement requirements of the existing standards. Subsequent accounting for finance leases under the existing standards apportions the lease payment between a finance charge and the reduction of the outstanding liability. The finance charge is allocated to each period during the lease term so as to provide a constant periodic rate of interest on the remaining balance of the liability.

5.8 This approach accounts for the lessee's obligation to pay rentals as the acquisition of debt. It is also consistent with the effective interest method required by current accounting standards for financial liabilities not measured at fair value. Subsequent accounting for financial liabilities not measured at fair value follows an effective interest method of calculating the amortised cost and allocates the interest expense over the relevant period (the lease term, in this case). Over the term of the liability, both apportioning the lease payments method and the fair value method would result in the same aggregate expense. The difference between the two methods is that the fair value method results in a more volatile pattern of net income due to changes in the fair value of the obligation.

Preliminary views

5.9 Both boards believe that the disadvantages (described above) of requiring subsequent measurement of the obligation to pay rentals at fair value out-weigh the potential benefits to users. Consequently, they tentatively decided not to require fair value measurement of the obligation to pay rentals.

5.10 The IASB tentatively decided to require the lease payments to be apportioned between a finance charge and a reduction of the outstanding liability, consistent with the current treatment of finance leases. The finance charge would be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

5.11 Although a number of FASB board members supported this approach, the FASB was unable to reach a preliminary view. Some FASB members expressed support for a third approach to subsequent measurement that links the subsequent measurement of the right-of-use asset and the obligation to pay rentals. This is described further below.

Subsequent measurement of the right-of-use asset

5.12 The boards considered three approaches to the subsequent measurement of the lessee's right-of-use asset:

(a) fair value

(b) amortised cost

(c) linking the subsequent measurement of the right-of-use asset and the obligation to pay rentals.

5.13 Each of these approaches is discussed in more detail below.

Fair value

5.14 The boards discussed subsequent measurement of a lessee's right to use a leased item at fair value. As described above, fair value measurement reflects current market conditions. Therefore, it can be argued that it provides information that is more relevant to users of financial statements.

5.15 However, the boards noted the following disadvantages to requiring fair value measurement of the right of-use-asset:

(a) Requiring subsequent measurement at fair value would be inconsistent with the board's tentative decision not to require fair value measurement of the right-of-use asset on initial recognition.

(b) As discussed in chapter 4, it may not be possible to determine the fair value of the right-of-use asset reliably. This is a more significant issue for subsequent measurement than for initial measurement as there is no transaction price to help determine fair value.

(c) Requiring continuous remeasurement of the right-of use asset to fair value would be costly for preparers.

(d) Requiring fair value measurement could reduce comparability for users of financial statements, as it would be inconsistent with the treatment of other similar assets. For example, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* permit but do not require subsequent measurement at fair value. Under US GAAP, acquired property, plant and equipment and intangible assets are measured on an amortised cost basis (ARB No. 43, Chapter 9, *Depreciation* and FASB Statement No. 142, *Goodwill and Other Intangible Assets*).

Amortised cost

5.16 The boards discussed subsequent measurement of the right-of-use asset on an amortised cost basis.

5.17 Existing lease accounting standards require subsequent measurement of the leased asset on an amortised cost basis. Under IAS 17, the lessee is required to allocate the depreciable amount of the leased item to each accounting period during the period of expected use on a systematic basis consistent with IAS 16 and IAS 38. IAS 16 and IAS 38 generally require straight-line depreciation/amortisation over the asset's useful life. When it is reasonably certain that the lessee will obtain ownership of the leased item at the end of the lease, the period of expected use is the useful life of the asset; otherwise, the asset is depreciated over the shorter of the lease term and its useful life.

5.18 The new lease accounting standard for lessees could:

(a) Follow subsequent measurement based on the nature of the underlying asset
- Refer to IFRS (IAS 16 and IAS 38)
- Refer to current local GAAP (IAS 16 and IAS 38 for IFRS and ARB 43 for US GAAP)

(b) Follow subsequent measurement based on the right-of-use asset as an intangible asset
- Refer to IFRS (IAS 38)

- Refer to current local GAAP (IAS 38 for IFRS and Statement 142 for US GAAP)

(c) Specify its own subsequent amortisation/depreciation model for leases.

5.19 Requiring a lessee to refer to the applicable IFRS standards (IAS 16 or IAS 38) for the subsequent measurement of the right-of-use asset would result in a converged lease accounting standard. However, for lessees applying US GAAP, this approach could result in inconsistent accounting between leased assets and other similar assets that do not fall into the scope of the new lease accounting standard.

5.20 Requiring a lessee to refer to current local GAAP for the subsequent measurement of the right-of-use asset could result in a non-converged lease accounting standard. The main difference between US GAAP and IFRS in this area is that both IAS 16 and IAS 38 permit revaluation of the recognised asset. Revaluation of right-of-use assets is discussed further below.

5.21 Specifying the subsequent measurement of the right-of-use asset in the new lease accounting standard would result in a converged lease accounting standard. However, this approach could result in inconsistent accounting between leased assets and other similar assets that do not fall into the scope of the new lease accounting standard.

Linking the subsequent measurement of the right-of-use asset and the obligation to pay rentals

5.22 The boards also discussed an approach that would link the subsequent measurement of the right-of-use asset to the measurement of the obligation to pay rentals.

5.23 Under this approach, the right-of-use asset would be amortised using mortgage-based amortisation using the lessee’s incremental borrowing rate. Subsequent measurement of the liability would be consistent with current finance lease accounting (reducing the obligation at each accounting period under a mortgage amortisation model). However, the lease payment would not be split into a principal and interest component. Instead, the reduction to the right-of-use asset each accounting period would equal the reduction of the liability.

5.24 This would result in the asset and liability balance remaining equal over the lease term. Rental payments made in each accounting period would be included as an expense in the income statement on a straight-line basis over the lease term. This approach would leave the income statement impact for operating leases the same as under current operating lease guidance.

5.25 Some believe this linked methodology reflects the underlying economics in a decision-useful manner. Lease pricing for operating leases involves pricing that results in level rents over the lease term. This approach results in the lessee recognising these level rentals in the income statement. Accounting for these leases as similar to finance leases would result in a higher expense in the early periods than in the later periods of a lease.

5.26 This approach is simpler for lessees to apply than a non-linked approach and, in some jurisdictions, would align the profit and loss effect and the tax treatment of these leases.

Preliminary views

5.27 Both boards believe that the disadvantages (described above) of requiring subsequent measurement of the right-of-use asset at fair value out-weigh the potential benefits to users of financial statements. Consequently, they tentatively decided not to require fair value measurement of the right-of-use asset.

5.28 The IASB tentatively decided that a lessee should amortise the right-of-use asset over the shorter of the lease term and the economic life of the leased asset based upon the pattern of consumption of economic benefits embodied in the right-of-use asset. For leases of items where it is reasonably certain that the lessee will obtain title at the end of the lease term, the amortisation period would be the economic life of the leased item.

5.29 Although some FASB members agreed with this approach, the FASB failed to reach a preliminary view.

5.30 A number of FASB members expressed support for linking the subsequent measurement of the right-of-use asset to the obligation to pay rentals for lease contracts that are not in-substance purchases of the underlying asset. Right-of-use assets arising from leases that are in-substance purchases of the underlying asset would continue to be amortised as the right-of-use asset is consumed (normally on a straight-line basis). Thus, some FASB members would support retaining some form of lease classification requirement to differentiate between leases that would be accounted for using the linked approach and those in-substance purchases that would not.

5.31 The boards did not reach a preliminary view as to the nature of the right-of-use asset (that is, whether the accounting should mirror the nature of the underlying asset or whether a right-of-use asset should be accounted for as an intangible asset).

Impairment

5.32 As with all other assets, the right-of-use asset should be considered for impairment. The boards were not asked to reach a preliminary view on how to determine impairment of a right-of-use asset. The following are the approaches to consider:

(a) follow IFRS (IAS 36 *Impairment of Assets*)

(b) follow current local GAAP (IAS 36 for IFRS or FASB Statement No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* for US GAAP)

(c) develop an impairment model for leases.

5.33 Requiring all entities to apply the IAS 36 impairment model for leases would result in a converged leases standard; however, the result under US GAAP would be different impairment accounting models for right-of-use assets and other assets. This approach may not work for impairments of a group of assets. For example, an entity could have one leased component of a production line whilst the rest is owned. To test for impairment, the production line as a whole may need to be considered. It would not be possible to test one component of the production line for impairment under IAS 36 and the rest of the production line under Statement 144.

5.34 Following current local GAAP would resolve the differences in the impairment models for owned assets versus leased assets. However, the result would be a lease accounting standard that is not converged.

5.35 Developing an impairment model for leases would result in a converged lease accounting model. However, there could be different impairment models for leases than for other assets. This would make it difficult to test for impairment when a leased item is part of a larger group of cash-generating assets.

Revaluation

5.36 The boards discussed, but were not asked to reach a preliminary view on, whether revaluation of the right-of-use asset should be permitted. IAS 16 and IAS 38 permit the revaluation of assets (although revaluation under IAS 38 is restricted to those assets for which there is an active market). It is unclear whether IAS 17 permits revaluation of assets held under finance leases. However, practice has developed under IAS 17 such that some assets held under finance leases are revalued, for example, long-term leases of buildings. There is no revaluation currently permitted under Statement 13.

Questions for respondents

Question 1

Which approach do you prefer for the subsequent measurement of the lessee's obligation to make payments and why?

Question 2

Which approach do you prefer for the subsequent measurement of the lessee's right-of-use asset and why?

Question 3

Which approach do you prefer for addressing the impairment of a leased asset and why?

Question 4

Should revaluation of a right-of-use asset be permitted? Please explain your reasons.

Chapter 6 Options to extend or terminate a lease

Introduction

6.1 Lease contracts will often grant the lessee the right (but not the obligation) to extend the lease beyond the initial lease period. Similarly, a lease contract may also grant the lessee the right to terminate a lease before the end of the lease period. This chapter discusses:

(a) how to account for leases that contain options to extend or terminate the lease

(b) the factors to be considered when determining whether a lessee will exercise an option to extend or terminate the lease.

Recognition and measurement of options to extend or terminate a lease

6.2 Lease contracts sometimes incorporate optional periods—that is, the lessee may have the right to use the leased item during the optional period but is not contractually required to do so. For example, a lessee may sign a five-year lease that incorporates an option to extend the lease for an additional three years. Under this lease, the lessee is contractually required to lease the item for five years but has the option to lease the item for an additional three years. An economically identical lease could also be structured as an eight-year lease with an option to terminate after five years.

Components approach to leases

6.3 If the rights and obligations arising in a lease are separated into components and analysed individually, then it is possible to conclude that options to extend or terminate the lease meet the definition of an asset.

6.4 Consider the following example:

A piece of machinery with an expected life of 10 years is leased for a period of 5 years (the primary period) for a fixed annual rental. At the end *of the primary period, the lessee has a right to extend the lease for an additional 3 years (the secondary period) for the same fixed annual rental. The lease is non-cancellable during the primary or secondary period.*

6.5 The following components (individual rights and obligations) can be identified in this lease contract:

Lessee rights	**Lessee obligations**
• Right to use machinery in the primary period • Right to use the machinery in the secondary period (conditional upon exercise of the option to extend the lease) • Option to extend the lease	• Obligation to pay rentals in the primary period • Obligation to pay rentals in the secondary period (conditional upon exercise of the option to extend the lease) • Obligation to return the machinery (at the end of the primary or secondary period)

6.6 As with the simple lease described in chapter 3, the lessee's right to use the machinery during the primary period meets the boards' definitions of an asset. Similarly, the component representing the obligation to make payments during the primary period meets the boards' definition of a liability. However, the obligation to return the machinery does not meet the definition of a liability.

6.7 The lessee's right to use the asset in the secondary period does not meet the definition of an asset nor does the obligation to make payments in the secondary period meet the definition of a liability. This is because both the right to use the asset and the obligation to make payments in the secondary period are conditional upon the lessee exercising its option to extend the lease. Until the lessee exercises its option, the lessee has no present right to use the machinery nor does it have a present obligation to pay rentals in the secondary period.

6.8 However, the lessee has an unconditional right to call for the use of the machinery in the secondary period (the option). The lessee controls this right. It arises from a past event (the signing of the lease contract) and it gives rise to future economic benefit (the right to use the machinery in the secondary period). Consequently, the lessee’s option to extend the lease term meets the boards’ definitions of an asset.

6.9 The boards believe that if the individual rights and obligations arising in the lease are analysed separately, options to extend or terminate a lease meet the definition of an asset. However, they have identified a number of problems associated with separate recognition:

(a) The fair value of options of this type is difficult to measure reliably. This is because options of this type are not normally priced separately from the lease contract and there is no market for most lease contracts. Measurement is complicated by the fact that, unlike many financial options, the assets underlying options to extend or terminate a lease are often unique and may not be exercisable until a long way in the future (e.g., 20 years in some real estate leases).

(b) This approach may not provide relevant information to users because options that are seemingly out of the money (for example, leases in which the contractual rentals in the secondary period are higher than market rentals for the same asset) may nevertheless be exercised for entity specific reasons.

(c) Recognising and measuring options separately could provide structuring opportunities. For example, the assets and liabilities recognised by a lessee could be minimised if the lease contract is restructured as a short-term lease with an option to extend (the lessor’s return could be protected by incorporating a residual value guarantee or a penalty for failing to exercise the option to extend).

(d) This approach can produce seemingly anomalous results. If the lessee can cancel the lease at any point upon payment of a termination penalty, the lessee would not recognise an asset for its right to use the leased item. Rather, the lessee would recognise as an asset its option to extend the lease, which on initial recognition would be on favourable terms.

6.10 Because of these problems, the boards decided to consider an alternative to the separate recognition of options.

Single asset and liability approach

6.11 Under this approach, the lessee treats its right to use the leased item and the option to extend or terminate the lease as a single asset. The obligation to pay rentals is also treated as a single liability. This is similar to the existing lease accounting standards, which do not require the separate recognition of options to extend or terminate a lease. Instead, lessees are required to consider the existence of options and the likelihood of their exercise when assessing the lease term.

6.12 Under this approach, the lessee has a right to use the leased item for the assessed lease term and an obligation to pay rentals during that term. Whether a lease is characterised as a long lease with an option to terminate or a short lease with an option to extend does not matter. In both scenarios, the lessee must assess the lease term and recognise an asset for its right to use and a liability for its obligation to pay rent during the assessed lease term.

Preliminary views

6.13 The boards tentatively decided to adopt a single asset and liability approach to the treatment of options as they consider it unlikely that they will be able to develop a components-based approach that would address all the issues outlined in paragraph 6.9.

6.14 Consequently, the boards have tentatively decided not to recognise options to extend or terminate a lease separately from the right-of-use asset. Instead, the boards propose that the assets and liabilities recognised by the lessee be based upon an assessment of the lease term.

6.15 The following section considers how an assessment of the lease term should be made.

Assessing the lease term

Probability threshold approach

6.16 The first approach considered by the boards was to require lessees to apply a probability threshold to determine whether an optional period should be included in the lease term. Under this approach, optional periods are included in the lease term if the probability that the lessee will exercise its right to use the leased item in the optional period exceeds a defined probability threshold. This is similar to the approach used in the current leasing standards where a reasonably certain (reasonably assured) probability threshold is applied. Under existing standards, optional periods are included in the lease term if it is reasonably certain (reasonably assured) that the right to use the leased item in the optional period will be exercised.

6.17 The types of probability thresholds that could be considered in assessing the lease term are summarised in the following table (there may be more):

Threshold	**Description**
Virtually certain	Optional periods are included in the lease term only if it is virtually certain that the lessee’s right to use the leased item in the optional period will be exercised.
Reasonably certain	Optional periods are included in the lease term only if it is reasonably certain that the lessee’s right to use the leased item in the optional period will be exercised.
Probable	Optional periods are included in the lease term if it is probable that the lessee’s right to use the leased item in the optional period will be exercised.

More likely than not	Optional periods are included in the lease term if it is more likely than not that the lessee's right to use the leased item in the optional period will be exercised.

'Best estimate' approach

6.18 The second approach considered by the boards is to require lessees to make a best estimate of the lease term. The boards discussed two different interpretations of 'best estimate'.

6.19 The first interpretation would require the lessee to calculate a probability-weighted best estimate of the expected lease term. The second interpretation would require the lessee to make a non-probability weighted best estimate of the expected lease term. The factors the lessee would consider in making a best estimate are discussed later in this chapter.

6.20 Example 1 illustrates these two interpretations:

Example 1

A lessee enters into a 1-year lease. At the end of each year, the lessee has an option to extend the lease for another year up to a maximum of 5 years. The probability of each of the possible lease terms is as follows:

Lease term	1 year	2 years	3 years	4 years	5 years
Probability	35%	5%	5%	25%	30%

Using a probability-weighted best estimate of the lease term, the assessed term would be 3.1 years (1 x 35% + 2 x 5% + 3 x 5% + 4 x 25% + 5 x 30%).

In this example, the lease term is likely to be either 4 or 5 years. Using a non-probability-weighted best estimate approach the lessee would be required to make best estimate of whether the term will be 4 or 5 years. The factors to be considered in making this best estimate are discussed below. It should be noted that the non-probability-weighted best estimate of the lease term is not necessarily the lease term with the highest probability (in this example that would be a 1-year term).

Preliminary views

6.21 The boards tentatively decided not to require lessees to apply a probability threshold to determine whether an option should be included in the lease term. Their reasons were as follows:

(a) There is no conceptually correct probability threshold. Each of the different approaches described above could be a reasonable way to draw the line between including an optional period in a lease term and excluding it. Consequently, picking any one probability threshold would be arbitrary.

(b) Some Board members expressed the view that setting a probability threshold would represent a rule rather than a principles based approach.

6.22 Consequently, both boards tentatively decided that the assessed lease term should be based upon the lessee's best estimate.

6.23 The IASB did not reach a preliminary view on whether to use a probability-weighted best estimate or a non-probability-weighted best estimate of the lease term. However, a number of IASB members expressed a preference for using a probability-weighted best estimate of the lease term.

6.24 Those Board members who support a probability-weighted best estimate of the lease term argue that, as the measurement of the resulting assets and liabilities approximates to fair value, the financial statements will be more relevant. However, other Board members note that this approach can result in an impossible assessed lease term – an assessed lease term that does not equal any of the possible actual outcomes. To illustrate, in the example above the lease term could be 1, 2, 3, 4 or 5 years. It could never be 3.1 years. It would be possible to mitigate this problem if reassessment of the lease term is required. This is because, as the lease term is reassessed, the assessed term will in general tend towards the non-probability-weighted best estimate of the term.

6.25 The FASB supports requiring the lessee to use a non-probability-weighted best estimate of the lease term because it believes it is simpler to apply and easier to understand (as it will not result in an impossible assessed lease term).

Reassessment of the lease term

6.26 The boards have not reached a preliminary view on whether to require reassessment of the lease term after initial recognition nor have they discussed the effect that reassessment would have on the recognised assets and liabilities.

6.27 Current lease accounting standards do not require reassessment of the lease term unless particular conditions are met (for example, the terms of the lease are changed). Consequently, the initially recognised assets and liabilities are not usually adjusted for changes in the assessed lease term.

6.28 Example 2 illustrates the statement of financial position and profit or loss effect of a lease that is not reassessed until an option to extend is exercised using a non-probability-weighted best estimate approach. Upon exercising the option to extend, the lessee recognises a new right-of-use asset and a corresponding liability.

Example 2 – No reassessment of the lease term

Assumptions

- Primary non-cancellable lease period – 5 years
- Secondary optional period – 3 years
- Annual rentals – CU 100, paid in arrears

- Lessee's incremental borrowing rate over the entire lease period– 10 per cent
- For initial measurement, (1) the lease obligation is measured at the present value of the lease payments over the expected lease term using the lessee's incremental borrowing rate and (2) the right-of-use asset is equal to the obligation.
- For subsequent measurement, (1) the obligation is amortised using the effective interest method over the expected lease term and (2) the right-of-use asset is depreciated straight line over the expected lease term.
- At the inception of the lease, the lessee's best estimate of the lease term is five years.
- The lessee is neither required nor permitted to exercise the renewal option until the end of the 5-year period.
- At the end of 5 years, the lessee exercises its option to renew the lease.
- Upon exercise of the option, the lessee will recognise the present value of the remaining lease payments as the revised lease obligation (CU 249) and adjust the right-of-use asset.

The following table illustrates the relevant portions of the statement of financial position and the profit or loss:

	End of year 0	1	2	3	4	5	6	7	8		Totals
Statement of financial position											
Right-of-use asset	379	303	227	152	76	249	166	83	0		
Lease obligation	(379)	(317)	(249)	(174)	(91)	(249)	(174)	(91)	(0)		
Cumulative cash paid	0	(100)	(200)	(300)	(400)	(500)	(600)	(700)	(800)	(800)	Cash Paid
Profit or loss											
Depreciation expense		(76)	(76)	(76)	(76)	(76)	(83)	(83)	(83)	(628)	Depreciation Exp
Interest expense		(38)	(32)	(25)	(17)	(9)	(25)	(17)	(9)	(172)	Interest Exp
		(114)	(108)	(101)	(93)	(85)	(108)	(100)	(92)	(800)	Total Net Expenses

6.29 Example 3 illustrates the effect of early termination on a lease whose term is not reassessed (again using a non-probability-weighted best estimate approach). In general, early termination of a lease whose term is not reassessed will result in the lessee recognising a gain.

Example 3 – No reassessment of the lease term with an early termination

Assumptions

- All assumptions are the same as example 1 except:
  - The best estimate of the lease term at inception is 8 years.
  - At the end of year 5, the option to extend the lease is not exercised.

The following table illustrates the relevant portions of the statement of financial position and the profit or loss:

	End of year 0	1	2	3	4	5		
Statement of financial position								
Right-of-use asset	533	467	400	333	267	200		
Lease obligation	(533)	(487)	(436)	(379)	(317)	(249)		Totals
Cumulative cash paid	0	(100)	(200)	(300)	(400)	(500)	(500)	Cash Paid
Profit or loss								
Depreciation expense		(67)	(67)	(67)	(67)	(67)	(333)	Depreciation exp
Interest expense		(53)	(49)	(44)	(38)	(32)	(215)	Interest exp
Gain/(loss) on over/(under) accrual		0	0	0	0	49	49	Gain on over accrual
		(120)	(115)	(110)	(105)	(50)	(500)	Total Net Expenses

6.30 Whether they are carried at amortised cost or fair value, liabilities are generally remeasured for changes in expected cash outflows. For example, non-financial liabilities accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are remeasured for changes in expected cash flows. A change in the assessed term of a lease will result in a change in expected cash outflows. Consequently, to be consistent with the treatment of other liabilities, the obligation to pay rentals arguably should be remeasured to reflect changes in the assessed lease term. In addition, remeasuring the liability to reflect current best estimates of the lease term is likely to provide users of the financial statements with more relevant information. However, requiring reassessment of the lease term is more complex and is likely to be more costly for preparers.

6.31 If the boards decide to require remeasurement of the obligation to pay rentals for changes in the assessed lease term, the boards will also need to determine how to recognise the resulting differences. There are two possible approaches:

(a) recognise any change in the liability in profit or loss

(b) recognise any change in the liability as an adjustment to the carrying value of the right-of-use asset.

6.32 Example 4 illustrates the effect of reassessment if changes in the obligation are recognised as an adjustment to the carrying value of the right-of-use asset (using a non-probability-weighted best estimate).

Example 4 – Reassessment of the lease term

Assumptions

- All assumptions are the same as example 1 except:
  - The lease term is reassessed and the best estimate of the expected lease term changes to eight years at the start of year 4.
  - At the end of year 4, the lessee calculates the present value of the remaining lease payments and adjusts the amount of the lease obligation and right-of-use asset.
  - No adjustment is necessary for the lease obligation and the right-of-use asset when the option is actually exercised.

The following table illustrates the revised relevant portions of the statement of financial position and the income statement assuming no further changes in the best estimate of the lease term:

	End of year										
	0	1	2	3	4	5	6	7	8		
Statement of financial position											
Right-of-use asset	379	303	227	152	286	214	143	71	0		
Lease obligation	(379)	(317)	(249)	(174)	(317)	(249)	(174)	(91)	(0)		Totals
Cumulative cash paid	0	(100)	(200)	(300)	(400)	(500)	(600)	(700)	(800)	(800)	Cash Paid
Profit or loss											
Depreciation expense		(76)	(76)	(76)	(71)	(71)	(71)	(71)	(71)	(585)	Depreciation Exp
Interest expense		(38)	(32)	(25)	(38)	(32)	(25)	(17)	(9)	(215)	Interest Exp
		(114)	(108)	(101)	(109)	(103)	(96)	(89)	(81)	(800)	Total Net Expenses

6.33 Recognising the change in the liability in profit or loss is consistent with the treatment of most other liabilities. In general, a change in a recognised liability would not result in a change in the carrying value of an asset.

6.34 However, in lease contracts there is a clear link between the right-of-use asset and the obligation to pay rentals. If the assessed lease term increases from 3 years to 4 years, the obligation to pay rentals will increase. However, there is a corresponding increase in the value of the right-of-use asset (assuming there is no impairment) as the lessee now expects to use the asset for 4 years rather than 3. A change in the liability can be viewed as a change to the originally estimated cost of the right-of-use asset. This is similar to the approach adopted for decommissioning liabilities under IFRIC 1 *Changes to Existing Decommissioning, Restoration and Similar liabilities* and FASB Statement No. 143 *Accounting for Asset Retirement Obligations* where the carrying value of the recognised asset is adjusted for changes in a decommissioning liability.

6.35 In addition, if the boards decide to require remeasurement of the liability, they will need to specify the interest rate that should be used to discount the revised lease payments.

Factors to be considered in determining the lease term

6.36 Options to extend or terminate a lease are very different from some financial options (for example, an option to buy or sell foreign currency or an option to buy or sell an equity instrument). Unlike such financial options, whether a lessee exercises an option to extend or terminate a lease may depend upon factors other than whether the exercise price of the option is less than the fair value of the rights acquired. Consequently, the Boards discussed whether to provide guidance on the factors to be considered when determining the lease term.

6.37 Factors that could affect the term of a lease can broadly be characterised as follows:

Category	**Description**	**Examples**
Contractual factors	Explicit contractual terms that could affect whether or not the lessee extends or terminates the lease.	• Level of rentals in any secondary period (bargain, discounted, market ,or fixed rate) • The existence and amount of any residual value guarantees • The existence and amount of any termination penalties • Costs associated with returning the leased item in a contractually specified condition or to a contractually specified location
Non-contractual financial factors	Financial consequences of a decision to extend or terminate the lease that are not explicitly stated in the contractual terms	• The existence of significant leasehold improvements that would be lost if the lease were terminated or not extended • Non-contractual relocation costs • Costs of lost production • Tax consequences • Costs associated with sourcing an alternative item

Business factors	Non-financial business factors that could affect the lease term	• Nature of the asset (core vs. non-core, specialised vs. non-specialised, willingness to allow a competitor to use the leased property) • Industry practice
Lessee specific factors	Lessee-specific considerations	• Lessee intent • Past practice

6.38 Under the existing lease accounting standards, all of the factors listed in the table above are considered in determining the lease term with the exception of lessee intent and past practice, which generally are not considered.

6.39 The boards discussed a number of different approaches to providing guidance on determining the lease term. These included:

(a) Restricting the factors that should be considered to contractual factors. This would be the simplest approach to apply but would result in a shortening of recognised lease terms. For example, a lessee who undertakes significant leasehold improvements on a leased asset is unlikely to terminate the lease early and lose the benefit of those improvements. However, under this approach the lessee ignores the leasehold improvements in determining the lease term.

(b) Requiring lessees to consider contractual factors and non-contractual financial factors. However, this approach would ignore the effect that the nature of the leased asset could have on the lease term. For example, a lessee that leases a core asset (for example, a production line) is much less likely to terminate the lease early than a lessee who leases a non-core asset (for example, the chief financial officer's car).

(c) Requiring lessees to consider contractual, non-contractual and business factors. This approach is consistent with current practice.

(d) Requiring lessees to consider all relevant factors in determining the lease term (including lessee intent and past practice). Clearly, basing the lease term solely on the lessee's stated intention would be open to abuse. However, it might be reasonable to consider the lessee's intentions if they are supported by evidence (for example, budgets, plans, forecasts, prior actions and industry practice).

Preliminary views

6.40 The boards tentatively decided to provide guidance on the factors to consider when determining the lease term. Their preliminary view is that the guidance should specify that contractual, non-contractual and businesses factors are considered in determining the lease term. Lessee intent and past practice would not be explicitly considered.

6.41 This approach is consistent with current practice. Consequently, it should be easy for lessees to apply and users of financial statements to understand.

Next steps

6.42 In developing the exposure draft, the boards will need to undertake the following:

(a) form a view on which of the possible approaches to assessing the lease term should be required

(b) decide whether to require reassessment of the lease term and, if reassessment is required, decide how to recognise adjustments to the carrying value of the liability.

Questions for respondents

Question 1

The boards' preliminary view is that options to extend or terminate a lease should not be recognised separately from the right-of-use asset. Do you agree? Please explain your reasons.

If you disagree, how would you resolve the measurement and structuring issues described in this chapter?

Question 2

The boards' preliminary view is that the assets and liabilities recognised by the lessee should be based upon an assessment of the lease term. Do you agree? Please explain your reasons.

If you disagree, what alternative approach would you recommend?

Question 3

Do you agree with the boards' tentative decision to base the assessment of the lease term on a best estimate of the lease term? Please explain why.

If you disagree, which alternative approach would you support?

Question 4

Which of the two different interpretations of best estimate do you support – probability-weighted or non-probability-weighted? Please explain why.

Question 5

Should a new lease accounting standard require reassessment of the lease term? Please explain why.

Question 6

If the new lease accounting standard requires reassessment if the lease term, how should changes in the obligation to pay rentals be recognised?

Question 7

Do you agree with the boards' tentative decision to provide guidance on the factors to be considered in determining the lease term or do you believe such guidance to be unnecessary in a principles based standard? Please explain why.

Question 8

Do you agree with the boards' preliminary view that contractual, non-contractual and business factors should all be considered in determining the lease term? Please explain why.

If you disagree, please describe the factors that should be considered in determining the lease term.

Chapter 7 Contingent Rentals

Introduction

7.1 Lease contracts often contain payments that increase or decrease because of changes in factors occurring after the inception of the lease, other than the passage of time (contingent rentals). This chapter discusses how to account for leases that contain contingent rentals, specifically:

(a) whether the lessee's liability for the obligation to pay rentals should reflect the obligation to make contingent rental payments

(b) how contingent rentals should be measured as part of the lessee's obligation to pay rentals.

7.2 Contingent rentals fall into three main categories:

(a) Contingent rentals based on price changes or an index. In this type of lease, rentals are adjusted for changes in market lease rates or other indices such as market interest rates or the consumer price index.

(b) Contingent rentals based on the lessee's performance derived from the leased item. An example is a lease of retail property where the lessee pays rentals based upon an agreed percentage of sales made from that property.

(c) Contingent rentals based on usage. For example, a car lease may require the lessee to pay additional rentals if the lessee exceeds a specified mileage.

Recognition of contingent rentals

7.3 The boards considered two approaches to the recognition of contingent rentals:

(a) the approach required under existing lease accounting standards (generally expense as incurred)

(b) reflect the obligation to pay contingent rentals in the liability recognised by the lessee.

7.4 Each of these approaches is discussed below.

Approach required by existing standards

7.5 Under existing standards, contingent rentals that are based on usage or the lessee’s performance are excluded from the calculation of minimum lease payments and are expensed in the period incurred.

7.6 Contingent rentals that are based on an existing index are included in minimum lease payments based upon the current level of the index. Any increases or decreases in lease payments that result from subsequent changes in the index are charged as expenses in the periods in which they are incurred.

7.7 Supporters of this approach believe that the lessee’s obligation to pay contingent rentals does not exist until the future event requiring the payment occurs (that is, the leased asset is used, a sale is made or the level of the index changes). Consequently, they believe that recognising an obligation to pay contingent rentals before the contingency crystallises would overstate the liabilities of the lessee.

7.8 However, there are a number of disadvantages to this approach:

(a) It may understate the assets of the lessee. For example, in a lease where rentals are completely contingent on sales from the leased property, the lessee would record no asset for the right to use the property even though that asset could be valuable.

(b) It is inconsistent with the boards’ preliminary views on the recognition of options to extend or terminate a lease. The obligation to pay rentals in an optional period is contingent upon the lessee exercising its option to extend the lease. However, the boards have tentatively decided that the lessee’s obligation to pay rentals should include a best estimate of the rentals payable in the optional period.

(c) It would be possible to minimise both the right-of-use asset and the obligation to pay rentals by including a significant element of contingent rentals in the lease contract.

Reflect the obligation to pay contingent rentals in the liability

7.9 Under this approach, the liability recognised by the lessee reflects the obligation to pay contingent rentals. The lessee's obligation to pay rentals is viewed a single liability that includes both a fixed and variable component. The fact that all (or a portion) of the rentals are contingent would be reflected in the measurement of the asset and liability.

7.10 This approach has a number of advantages:

(a) It is consistent with the board's preliminary views on the recognition of options to extend or terminate the lease. The boards have tentatively concluded that the lessee's obligation to pay rentals should include a best estimate of the rentals payable in the optional period.

(b) It reflects the fact that, although the lessee's rental payments are contingent, the lessee has still obtained an asset representing the right to use the leased item. Excluding contingent rentals from the obligation to pay rentals would lead to an understatement of that right-of-use asset.

(c) It is consistent with the treatment of other asset acquisitions. For example, if an entity agrees to buy a freehold property in return for a payment that is contingent upon future sales, the acquiring entity would record the property as an asset and a liability for its obligation to pay for the property. This would be the case, even though that liability is contingent on future sales.

Preliminary views

7.11 The boards' preliminary view is that the assets and liabilities recognised by the lessee should reflect the obligation to make contingent rental payments. Although the amount of contingent rental payments that the lessee would make is conditional on future events, the obligation to make them if the specified future events occur is unconditional.

Measurement of contingent rentals

7.12 The boards discussed two different approaches to measuring the lessee's obligation to pay contingent rentals:

(a) basing the obligation to pay rentals on a non-probability-weighted best estimate of the amount payable

(b) basing the obligation to pay rentals on a probability-weighted best estimate of the amount payable.

7.13 Chapter 6 illustrates these two approaches with an example.

Preliminary views

7.14 Both boards tentatively decided that contingent rentals should be included in the initial measurement of the right-of-use asset and the lessee's obligation to pay rentals based upon the lessee's best estimate of the amount payable.

7.15 The FASB tentatively decided to require the lessee to use a non-probability-weighted best estimate of contingent rentals.

7.16 The IASB tentatively decided to require the lessee to use a probability-weighted best estimate of contingent rentals.

7.17 Board members who support using a non-probability-weighted best estimate of contingent rentals noted that:

(a) It is simpler to apply and easier to understand.

(b) Requiring a lessee with a large number of leases to calculate probability-weighted-best estimates of contingent rentals for each lease would be costly and time consuming.

(c) An entity might have little, if any, data to develop a probability distribution reflecting the likelihood that an entity would meet a particular contingency. This concern was acknowledged in the boards' standards on share-based payments (FASB Statement No. 123(revised 2004) *Accounting for Stock-*

Based Compensation and IFRS 2 *Share Based Payment*, respectively), neither of which requires performance conditions to be included in the measurement of an award of a share-based payment.

7.18 Those board members who support using a probability-weighted best estimate of contingent rentals note that:

(a) As the measurement of the resulting assets and liabilities approximates to fair value, the financial statements will be more relevant to users.

(b) This approach is consistent with the board's standards on business combinations. FASB Statement No. 141(revised 2007) *Business Combinations* and IFRS 3(R) *Business Combinations* require obligations and rights associated with contingent consideration arrangements to be measured and recognised at their acquisition-date fair values.

(c) Negotiations between the lessee and lessor inherent in a contingent rental arrangement would provide the data to develop a probability-weighted best estimate.

(d) Many contingent rental arrangements contain a large number of possible outcomes. Consequently, it would be difficult to select one single amount as the best estimate without assigning a probability weighting to the multiple outcomes.

Reassessment of contingent rentals

7.19 The boards have not discussed whether to require reassessment of contingent rentals after initial recognition nor have they discussed the effect that reassessment would have on the recognised assets and liabilities. The following section discusses the treatment of contingent rentals under current standards and the advantages and disadvantages of requiring a reassessment of contingent rentals.

7.20 IAS 17 does not require reassessment of contingent rentals. Contingent rentals are generally expensed in the period incurred and excluded from the minimum lease payments that are used in the measurement of the initial finance lease asset and lease obligation. Statement 13 generally treats contingent rentals in a way that is consistent with IAS 17; however, an exception to expensing contingent lease payments as incurred is found in EITF Issue No. 98-9 Accounting for Contingent Rent. Issue 98-9 requires an entity to accrue contingent rental expense prior to the future achievement of a specified target if it is considered probable that the entity will reach the target.

7.21 Example 1 illustrates the statement of financial position and profit or loss effect of a lease when contingent rentals are not reassessed (using a non-probability weighted best estimate).

Example 1 - No reassessment

Assumptions

- Lease term– 5 years
- Annual fixed rentals – CU 100, paid in arrears
- Contingent rentals, paid in arrears
- Lessee's incremental borrowing rate over the lease term– 10 per cent
- The lessee's initial best estimate of the expected contingent lease payments is CU 50 per year.
- The actual contingent rentals that are incurred are as follows:
    - Year 1: CU 50; Year 2: CU 50; Year 3: CU 75; Year 4: CU 50; Year 5: CU 20
- For initial measurement, (1) the lease obligation is measured at the present value of the lease payments over the expected lease term using the lessee's secured incremental borrowing rate and (2) the right-of-use asset is equal to the obligation.
- For subsequent measurement, (1) the obligation is amortised over the expected lease term with a charge to interest expense and (2) the right-of-use asset is depreciated straight line over the lease term.

The following table illustrates the relevant portions of the statement of financial position and profit or loss:

	End of year							
	0	1	2	3	4	5		
Statement of financial position								
Right-of-use asset	569	455	341	227	114	0		
Lease obligation	(569)	(475)	(373)	(260)	(136)	(0)		Totals
Cumulative cash paid	0	(150)	(300)	(475)	(625)	(745)	(745)	Total Cash Paid
Profit or loss								
Depreciation expense		(114)	(114)	(114)	(114)	(114)	(569)	Depreciation Exp
Interest expense		(57)	(48)	(37)	(26)	(14)	(181)	Interest Exp
Gain/(loss) on over/(under) accrual		0	0	(25)	0	30	5	Net gain on over accrual
		(171)	(161)	(176)	(140)	(97)	(745)	Total Net Expenses

7.22 Liabilities, whether they are carried at amortised cost or fair value, are generally remeasured for changes in expected cash outflows. A change in the contingent rentals of a lease will result in a change in expected cash outflows. Consequently, to be consistent with the treatment of other liabilities, the lessee should remeasure its obligation to pay rentals to reflect changes in the contingent rentals. In addition, remeasuring the liability to reflect current best estimates of contingent rentals is likely to provide users of the financial statements with more relevant information.

7.23 However, requiring a reassessment of the best estimate of contingent rentals could represent a significant cost for preparers.

7.24 If the boards decide to require remeasurement of the obligation to pay rentals for changes in expected contingent rentals, the boards will also need to determine how to recognise the resulting debit or credit. There are three possible approaches:

(a) always recognise any change in the liability in profit or loss

(b) always recognise any change in the liability as an adjustment to the carrying value of the right-of-use asset

(c) base the treatment of reassessments on the type of contingent rental.

Recognise any change in the liability in profit or loss

7.25 In general, a change in a recognised liability would not result in a change in the carrying value of an asset. Recognising any change in the obligation to pay rentals in profit or loss would be consistent with the treatment of other contingent liabilities. For example, changes in an obligation to pay contingent consideration arising from a business combination are recognised in profit or loss.

7.26 In addition, a change in the obligation to pay lease rentals (subsequent to the initial measurement) may not indicate an increase in the value of the right-of-use asset. For example, an increase in an obligation to pay rentals arising from an increase in market interest rates may not indicate an increase in the value of a right to use a retail property.

Recognise any change in the liability as an adjustment to the carrying value of the right-of-use asset

7.27 In lease contracts, there is a clear link between the right-of-use asset and the obligation to pay rentals. If the expected contingent rentals increase, the obligation to pay rentals will also increase. However, it can be argued that there is also a corresponding increase in the value of the right-of-use asset (assuming there is no impairment). In addition, if the original estimate of contingent rentals were correct the future changes in the liability would have been included in the original asset. A change in the liability can be viewed as a change to the originally estimated cost of the right-of-use asset. This is similar to the approach adopted for decommissioning liabilities under IFRIC 1 *Changes to Existing Decommissioning, Restoration and Similar liabilities* and FASB Statement No. 143 *Accounting for Asset Retirement Obligations* where the carrying value of the recognised asset is adjusted for changes in a decommissioning liability.

7.28 Example 2 illustrates this approach (using a non-probability-weighted best estimate).

Example 2

Assumptions

- The same as example 1 except:
  - The best estimate of the expected contingent lease payments changes to CU 75 per year at the start of year three, and it changes back to CU 50 per year at the start of year four.
  - Using those revised estimates, the lease obligation and the right-of-use asset are adjusted at the start of years three and four.
  - At the end of year five, the lessee learns that it will have to pay CU 20 in contingent rental payments for the year, rather than the CU 50 that had been accrued.

The following table illustrates the relevant portions of the statement of financial position and the profit or loss:

	End of year 0	1	2	3	4	5	Totals	
Statement of financial position								
Right-of-use asset	569	455	341	269	113	0		
Lease obligation	(569)	(475)	(373)	(304)	(136)	(0)		
Cumulative cash paid	0	(150)	(300)	(475)	(625)	(745)	(745)	Cash Paid
Profit or loss								
Depreciation expense		(114)	(114)	(134)	(113)	(113)	(587)	Depreciation Exp
Interest expense		(57)	(48)	(44)	(26)	(14)	(188)	Interest Exp
Gain/(loss) on over/(under) accrual		0	0	0	0	30	30	Gain on over accrual
		(171)	(161)	(178)	(139)	(96)	(745)	Total Net Expenses

Base the treatment of reassessments on the type of contingent rental

7.29 Under this approach, the effects of reassessment of contingent rentals would depend on the type of contingent rental arrangement.

7.30 For example, contingent rentals that are usage based are economically similar to renewal options. Both types of arrangement give the lessee the option to purchase additional usage of the leased item. In a renewal, the lessee purchases more time, whereas in a usage-based rental the lessee may purchase more miles or more copies. Consequently, it can be argued that changes in the obligation to pay rentals that arise from changes to future expected usage should be recognised as an adjustment to the carrying value of the right-of-use asset. Changes that relate to past usage should be recognised in profit or loss.

7.31 It can be argued that changes in the obligation to pay rentals that arise from changes in an index or changes in the lessee's performance, simply result in the lessee paying more (or less) for the asset. That is, the lessee has not purchased additional usage of the leased asset and the asset is not necessarily more or less valuable than it was before the reassessment. Rather, the change in rentals arises from changes in the lessee's business results (for leases linked to performance) or changes in an external index. Consequently, the change should be recognised in profit or loss.

7.32 However, in some situations changes in an index or changes in the lessee's performance could indicate a change in the value of the right-of-use asset. For example, if the contingent rental is linked to market rental rates, then changes in the estimate of future market rental rates could result in a change in the value of the right-of-use asset. Similarly if a lessee's revised estimate of future sales is higher than the original estimate, this may result in an increase in the value of right-of-use asset.

Disclosure of contingent rentals

7.33 Both Statement 13 and IAS 17 require specific disclosures for contingent lease payments, including a general description of the basis on which contingent lease payments are made and the separate identification of contingent lease payments incurred in the reporting period. If the boards decide to change the recognition and measurement of contingent rentals, they will also need to consider if changes to the disclosure requirements are required.

Next steps

7.34 In developing the exposure draft, the boards will need to undertake the following:

(a) form a view on which of the possible approaches to including contingent rentals in the measurement of the obligation to pay rentals

(b) decide whether to require reassessment of contingent rentals and, if reassessment is required, decide how to recognise adjustments to the carrying value of the liability

(c) consider if changes to the disclosure requirements for contingent rentals are required.

Questions for respondents

Question 1

The boards propose that assets and liabilities recognised by the lessee should reflect the obligation to make contingent rental payments. Do you agree? Please explain why.

If you disagree, what alternative approach would you recommend?

Question 2

Do you agree with the boards' proposal to base the measurement of the obligation to pay rentals on a best estimate of contingent rentals? Please explain why.

If you disagree, which alternative approach would you support?

Question 3

Which of the two different interpretations of best estimate do you support – probability adjusted or non-probability adjusted? Please explain your reasons.

Question 4

Should a new lease accounting standard require reassessment of contingent rentals? Please explain why.

Question 5

If the new lease accounting standard requires reassessment of contingent rentals, how should changes in the obligation to pay rentals be recognised? Please explain your reasons

Question 6

If the new lease accounting standard changes the recognition and measurement requirements for contingent rentals, what changes to the disclosure requirements would you recommend?

Chapter 8 Other issues

Introduction

8.1 The purpose of this chapter is to ask for views on how to address each of the following issues:

(a) residual value guarantees

(b) purchase options

(c) timing of initial recognition

(d) sale and leaseback transactions

(e) initial direct costs

(f) sub-leases

(g) lessor specific issues

(h) presentation

(i) disclosure.

8.2 The Boards have not yet discussed these issues. Consequently, the purpose of this chapter is to provide a brief overview of what the boards will need to resolve before publication of an exposure draft.

8.3 This chapter also asks respondents to provide details of any other issues that the boards will need address before publication of an exposure draft.

Residual value guarantees

8.4 Lease contracts will sometimes include residual value guarantees. Under these guarantees, the lessee will compensate the lessor if the value of the leased item at the end of the lease falls below a specified value. A residual value guarantee may require the lessee to purchase the property for a certain or determinable amount or make up a deficiency below a stated amount at termination of the lease. Residual value guarantees are used to protect the lessor's expected return.

8.5 Under existing accounting standards, the maximum amount payable under a residual value guarantee is included in the minimum lease payments. Consequently, if a lease is classified as a finance lease, the liability recognised by the lessee includes the present value of the maximum amount payable under the guarantee.

8.6 The boards could continue to require the current approach to residual value guarantees in the new lease accounting standard. However, requiring recognition of the maximum amount payable is arguably inconsistent with the boards' tentative decisions to include a best estimate of contingent rentals and optional periods in the liability.

8.7 Alternatively, the boards could consider the following approaches:

(a) Require separate recognition of the residual value guarantee. However, this would be inconsistent with the boards' tentative decisions to adopt a single unit of account approach for optional periods and contingent rentals.

(b) Only recognise an obligation to make payments under the residual value guarantee if payment is probable.

(c) Require fair value measurement of the residual value guarantee.

(d) Measure the obligation to make payments under the guarantee using a non-probability-weighted best estimate.

(e) Measure the obligation to make payments under the guarantee using a probability-weighted best estimate.

Question for respondents

Question 1

How should residual value guarantees be recognised and measured under the new lessee accounting model? Please explain your answer.

Purchase options

8.8 Purchase options allow the lessee the option to purchase the leased property on or after a specified date. The exercise price of the option may be at a bargain price, at fair value or the price may be a specified fixed amount.

8.9 A bargain purchase option allows the lessee to purchase the property for a price that is significantly lower than the expected fair value of the property at the date the option becomes exercisable. A fair value purchase option allows the lessee to purchase the property at fair value at the date the option becomes exercisable. A fixed price purchase option allows the lessee to purchase the property at a fixed price at the date the option becomes exercisable.

8.10 Existing standards require the exercise price of a purchase option to be included in the minimum lease payments if it is reasonably certain[4] at inception of the lease that the lessee will exercise the purchase option. Consequently if the lease is classified as a finance lease, the exercise price of the option is included in the recognised asset and liability.

8.11 The boards could continue to require the current approach to purchase options in the new lease accounting standard. However, including the exercise price of the option in the recognised assets and liabilities only when it is reasonably certain it will be exercised is arguably inconsistent with the boards' tentative decisions to include a best estimate of contingent rentals and rentals payable in optional periods in the liability.

8.12 The boards could decide to require separate recognition of purchase options. However, this approach would be inconsistent with the boards' tentative decisions to adopt a single unit of account approach to the recognition of options to extend or terminate a lease.

[4] Statement 13 uses the term *reasonably assured*.

8.13 There are a number of other approaches to recognition and measurement that the boards could consider, including:

(a) fair value measurement of the option (separately or as part of the right-of-use asset)

(b) incorporating the exercise price of the option in the recognised right-of-use-asset and the obligation to pay rentals using a non-probability-weighted best estimate of whether the option will be exercised

(c) incorporating a probability-weighted best estimate of the option price in the recognised right-of-use asset and the obligation to pay rentals

(d) incorporating the exercise price of the option in the recognised right-of-use-asset and the obligation to pay rentals if exercise of the option is considered probable (or some other probability threshold)

(e) only recognise the rights and obligations arising from the option upon exercise.

Question for respondents

Question 2

How should purchase options be recognised and measured under the new lessee accounting model? Please explain your answer.

Timing of initial recognition

8.14 Before publishing an exposure draft, the boards must decide when to recognise the assets and liabilities arising in a lease contract. There is often a time gap between when the lease contract is signed (the inception date) and when the leased assets are delivered to or accepted by the lessee (the commencement date). The value of the leased asset and liability may change between lease inception and commencement. For example, the value of an office building may increase significantly between the date the lessee signs the lease and the date the lessee obtains access to the building.

8.15 Under existing accounting standards, the lessee recognises its assets and liabilities on the lease commencement date. However, the lessee may obtain rights and obligations that meet the definitions of assets and liabilities before the lease commencement date (for example, when the lease is signed).

8.16 If this is the case, the boards must decide:

(a) whether to recognise those assets and liabilities. It can be argued that prior to delivery of the leased item, the contract is an executory contract. Rights and obligations arising under non-financial executory contracts are typically not recognised in the financial statements.

(b) whether those rights and liabilities should be recorded gross or net. The lessee's rights and obligations between lease signing and delivery of the leased item are similar to those arising in a forward contract. Rights and obligations arising under a forward contract are normally recognised net.

(c) how to measure any recognised assets and liabilities.

8.17 The boards must also decide how to account for contracts that require construction of the leased asset before delivery.

Questions for respondents

Question 3

When should the lessee recognise the rights and obligations arising in the lease contract on contract signing, on commencement of the lease term or at some other point? Please explain why.

Question 4

If you believe the lessee should recognise its rights and obligations on contract signing, would you record them net or gross in the financial statements? Please explain why.

Question 5

How would you measure any recognised asset or liability? Please explain your reasons.

Sale and leaseback transactions

8.18 In a sale and leaseback transaction the seller / lessee sells an asset it owns to a buyer / lessor and then leases back that same asset. Such transactions may be performed to improve an entity's statement of financial position, generate cash flow or reduce the risks associated with owning the asset

8.19 Current accounting for sale and leaseback transactions depends upon the classification of the leaseback. If the lessee classifies the leaseback as an operating lease and the transaction is established at fair value, then any gain or loss on sale is recognised immediately. If the leaseback is a finance lease, the lessee defers and amortises any gain on sale over the lease term.

8.20 US GAAP has additional rules for sale and leaseback transactions involving real estate. FASB Statement No. 98, *Accounting of Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases* describes specific forms of continuing involvement that do not allow a seller / lessee to qualify for sale and leaseback accounting. If a sale and leaseback transaction includes these provisions, sale and leaseback accounting is not allowed and the transaction must be accounted for under the deposit method or as a financing. If the sale is not recorded, the asset remains on the books of the seller / lessee, the asset's operation and depreciation continue to be recorded, and any sales proceeds are recorded as a liability.

8.21 Sale and leaseback transactions are seen as having two components: the sale of the asset from the seller to the buyer and the leaseback of the asset from the buyer / lessor to the seller / lessee. Each component is accounted for rather than the seller / lessee accounting for the net effect of the combined transactions.

8.22 Accounting for a sale and leaseback transaction is difficult because the buyer / lessor may be willing to pay more than the fair value of the asset in return for higher than market value rentals. Similarly, the seller / lessee may be willing to accept less than fair value for the asset if the future rentals are below market rates.

8.23 The boards could consider a number of different approaches to sale and leaseback transactions, including:

(a) Treating all sale and leaseback transactions as financings. The seller / lessee would not derecognise the sold asset, and any sales proceeds would be recognised as a liability to be amortised over the term of the leaseback. This approach may work well for transactions that are in-substance financings. However, it may not faithfully represent the economics of all sale and leaseback transactions.

(b) Treating all sale and leaseback transactions as sales. The seller/lessee would derecognise the sold asset and recognise a right-of-use asset and an obligation to pay rentals. This approach may work well if the sales price and the subsequent leaseback are each established at fair value. If, however, they are not at fair value, this approach my not faithfully represent the economics of the transaction.

(c) Adopting a hybrid approach. The seller lessee would treat the sale and leaseback as a sale or a financing depending upon specified criteria.

8.24 In addition, the boards will need to determine whether gains or losses arising on the sale of the asset should be recognised immediately in income or deferred over the lease term.

Question for respondents

Question 6
How should sale and leaseback transactions be accounted for? Please explain your answer.

Initial direct costs

8.25 Lessees will often incur costs negotiating and arranging leases. These costs are referred to as initial direct costs. IAS 17 defines initial direct costs as those incremental costs that are directly attributable to negotiating and arranging a lease. Direct costs include commissions, legal fees and internal costs that are directly attributable to arranging a lease.

8.26 Currently, initial direct costs of the lessee are added to the amount recognised as an asset and amortised with that asset.

8.27 The boards could decide to retain this approach in the new lease accounting standard. Including initial direct costs in the carrying value of the right-of-use asset is consistent with the treatment of the costs associated with acquiring property, plant and equipment or intangible assets.

8.28 Alternatively, the boards could decide to expense such costs as incurred. This treatment is consistent with the accounting for transaction costs arising in business combinations and the treatment of transaction costs arising on the acquisition of some financial instruments.

Question for respondents

Question 7

Should initial direct costs be included in the carrying value of the right-of-use asset or should they be expensed as incurred? Please explain your answer.

Sub leases

8.29 A reporting entity will sometimes act as both a lessee and a lessor of the same asset. For example, a reporting entity may lease a piece of equipment from one party (the head-lease) and then sublet the same piece of equipment to another party (the sub-lease).

8.30 If the approach suggested in this discussion paper is adopted, the reporting entity would be required to account for the asset obtained under the head lease as a right-of-use asset. The sub-lease would be accounted for under the existing lessor accounting standards (IAS 17 or Statement 13 as appropriate).

8.31 The boards will consider the need to provide additional guidance on situations of this type.

Question for respondents

Question 8

Is additional guidance required for situations where a reporting entity acts as both a lessee and lessor of the same asset?

Lessor issues

8.32 In the current joint leases project, the boards have decided to defer consideration of lessor accounting. However, to achieve convergence, the FASB is considering whether to require lessors currently applying Statement 13 to adopt IAS 17. Significant issues would need to be addressed if the FASB were to adopt this approach. Appendix D discusses the implications of adopting IAS 17 for lessors that currently apply Statement 13.

Question for respondents

Question 9

Should the FASB require lessors to adopt IAS 17 to achieve convergence? If not, why not?

Question 10

Are there any other major differences between Statement 13 and IAS 17 that have not been identified above?

Question 11

Are there any other lessor issues that the boards should address at this stage of the project?

Presentation

8.33 The lessee presents assets held under a finance lease in the statement of financial position as property, plant and equipment (unless the lease is for an intangible asset in which case they are presented as intangibles). This is consistent with the view that finance leases are similar to an instalment purchase of the underlying asset. However, with the new lease standard being based on a right-to-use asset, such presentation may change.

8.34 The boards could consider the following different approaches to presentation of the right-of-use asset:

(a) Present the right-of-use asset based on the underlying leased item. For example, a lease of a motor vehicle would be presented in the statement of financial position with other motor vehicles. Owned motor vehicles could be presented separately from motor vehicles that are leased.

(b) Present the right-of-use asset as an intangible asset. It can be argued that all right-of-use assets are in-substance intangible assets. Consequently, they should be presented in the statement of financial position with other intangible assets.

(c) Use a different presentation for different types of lease. For example, right-of-use assets arising from leases that are in-substance instalment purchases could be presented based on the underlying asset. All other right-of-use assets would be presented as intangible assets.

Questions for respondents

Question 12

How should the right-of-use asset be presented in the statement of financial position? Please explain your answer.

Question 13

What other presentation issues should the boards consider?

Disclosure

8.35 Disclosure requirements for leased assets and liabilities are currently based on the classification of the leased item.

8.36 The boards will review these requirements before publication of an exposure draft and decide which of the disclosures to retain and whether additional disclosures are required. In particular, additional disclosures might be considered for leases that contain options or contingent rentals, where the accounting treatment discussed in chapters 6 and 7 is unable to convey the full extent of the rights and obligations of the lessee.

Questions for respondents

Question 14

Which of the disclosures currently required by the existing standards should be retained? Please explain why.

Question 15

What additional disclosures should be required? Please explain your reasons.

Additional question for respondents:

Question 16

What other issues should be addressed in this project and why?

Appendix A Summary of questions for respondents

[Outstanding]

Appendix B Scope of existing lease accounting standards

B1 The boards' preliminary view is to base the scope of the new lease accounting standard on the scope of the existing standards. This appendix describes the similarities and differences between the scope of the existing standards. The boards will reconcile any differences in scope before publication of a new lease accounting standard.

Similarities between IAS 17 and Statement 13

B2 The term *lease* is used to cover a wide range of arrangements between contracting parties. Both IAS 17 and Statement 13 define a lease as an agreement whereby the lessor conveys to the lessee the right to use an asset for a period of time[5]. Contracts for services that do not transfer the right to use an asset from one contracting party to another are not leases.

B3 Other than the exceptions mentioned in the following paragraphs, all arrangements that convey a right to use an asset for a period are within the scope of the standards, even though substantial services by the lessor may be called for in connection with the operation or maintenance of the leased assets.

B4 Both standards exclude from their scope:

(a) leases to explore for or use natural resources, such as minerals, oil, and natural gas

(b) licensing agreements for such items as motion pictures, plays, manuscripts, patents, and copyrights.

B5 Additionally, biological assets (living plants or animals) held by lessees under finance leases and biological assets provided by lessors under operating leases are accounted for in accordance with IAS 41, *Agriculture*, and AICPA Statement of

[5] IAS 17 also includes the phrase "in return for a payment or a series of payments" in its definition of a lease. The staff is not aware of any diversity in practice under IAS 17 and Statement 13 resulting from this difference (such as a lease entered into in return for the transfer of an asset).

Position (SOP) 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives*.

Differences between IAS 17 and Statement 13

B6 There are some significant scope differences between IAS 17 and Statement 13.

B7 Statement 13 only applies to an arrangement that conveys a right to use property, plant, and equipment (land and/or depreciable assets). IAS 17 defines a lease as a right to use "an asset". Consequently, the scope of IAS 17 is wider than the scope of Statement 13 and includes leases of intangible assets.

B8 Property held by lessees that is accounted for as investment property and investment property provided by lessors under operating leases is accounted for in accordance with IAS 40, *Investment Property*, rather than IAS 17. However, Statement 13 applies to all leases of investment property.

Determining whether an arrangement contains a lease

B9 Many arrangements that comprise a transaction or series of related transactions do not take the legal form of a lease, but nonetheless convey a right to use an asset. Both IFRIC 4 and Issue 01-8 require consideration of the substance of the arrangement and provide guidance on whether such arrangements are, or contain, a lease and should be accounted for within the scope of IAS 17 and Statement 13, respectively.

B10 In determining whether an arrangement is, or contains, a lease, both IFRIC 4 and Issue 01-8 require an assessment of whether:

(a) Fulfilment of the arrangement is dependent on the use of a specific asset or assets (including assets implicitly specified).

(b) The arrangement conveys a right to use the asset.

B11 IFRIC 4 defines a right to use the asset as an arrangement that conveys to the lessee "the right to control the use of the underlying asset". The right to control the use of the underlying asset is conveyed if any of the following conditions is met:

(a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

B12 Issue 01-8 similarly defines the right to control the use of an underlying asset.

B13 Examples of such arrangements often include, but are not limited to:

(a) outsourcing arrangements

(b) take-or-pay and similar energy contracts

(c) transportation contracts.

Evaluating the substance of transactions

B14 The forms of lease arrangements can vary significantly and, accordingly, can be difficult to assess. SIC Interpretation 27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*, provides additional guidance on determining (a) whether a series of transactions is linked and should be accounted for separately and (b) whether an arrangement meets the definition of a lease. Issue 01-8 provides guidance on accounting for a series of transactions, but there is no equivalent to SIC 27 in US GAAP.

B15 SIC 27 states that 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. Issue 01-8 similarly states that separate contracts with the same or related parties that are entered into at or near the same time are presumed to be negotiated as a package and should be evaluated as a single arrangement, unless there is sufficient evidence to the contrary.

B16 SIC 27 also provides indicators that individually demonstrate that an arrangement may not, in substance, involve a lease, such as:

(a) An entity retains all the risks and rewards of ownership and substantially the same rights to its use of the underlying asset as before the arrangement

(b) The primary reason for the arrangement is to achieve a particular tax result and not convey the right to use an asset

(c) An option is included on terms that make its exercise almost certain (such as a put option that is deep in the money)

B17 An entity is required to apply, evaluate and weight all aspects of an arrangement to determine the substance of the transaction.

Appendix C Other accounting models rejected by the boards

C1 In developing the approach described in this discussion paper, the boards discussed a number of other possible accounting models. The boards rejected these models, because they do not result in the recognition of the identified assets and liabilities. This appendix describes the rejected accounting models.

The whole asset model

Description of the model

C2 The whole asset model is based on the premise that during the lease term, the leased item is under the control of the lessee. Accordingly, this model recognises the leased item in full as an asset of the lessee—both the right to the economic benefits during the lease term and the possession of the asset at the end of the lease term—in effect, recognising the full economic value of the asset.

C3 To correspond to these assets, the lessee recognises two liabilities—a liability for the payments to be made over the lease term and a liability representing the lessee's obligation to return the asset at the end of the lease term. If the lease is for substantially all of the leased item's expected useful life, the obligation to return the item at the end of the term is comparatively insignificant. However, for a short-term lease, the obligation to return would be more substantial.

Reasons for rejection

C4 The boards rejected the whole asset approach for the following reasons:

(a) It overstates the assets of the lessee. The asset recognised by the lessee (the full value of the physical item) includes the economic benefits deliverable from the use of the item after the end of the lease term—a right not obtained by the lessee.

(b) It overstates the liabilities of the lessee as a liability is recognised for the lessee's obligation to return the physical item. As the lessee has no right over the leased asset after the end of the lease term, there is no outflow of economic benefit from the lessee when the leased item is returned.

The executory contract model

Description of the model

C5 This model treats all leases as executory contracts. It is based upon the premise that the lessee's right to use the machinery is conditional upon making payments under the lease. Similarly, the lessee's obligation to make payments is assumed to be conditional upon the lessor granting the lessee quiet enjoyment of the machinery throughout the lease term.

C6 Consequently, the lessee recognises no assets or liabilities in respect of the lease contact. However, the lessee's rights and obligations under this model are disclosed in the financial statements. The executory contract model is therefore very similar to the operating lease model used in current accounting standards.

Reasons for rejection

C7 The boards rejected the executory contract model because it fails to recognise the identified assets and liabilities of the lessee. That is, it fails to recognise the lessee's right to use the leased item and its obligation to pay for that right.

The model adopted in the existing standards

Description of the model

C8 Current leasing standards adopt a hybrid model. Leases are classified as either finance leases or operating leases, depending on whether substantially all the risks and rewards of ownership of the physical item are transferred to the lessee. The lessee treats a finance lease as substantially equivalent to the purchase of the physical item. Accordingly, the lessee recognises an asset together with a liability to make the payments over the lease term. Leases classified as operating leases are accounted for as executory contracts.

Reasons for rejection

C9 The Boards rejected this approach for the following reasons:

(a) When a lease is classified as an operating lease, this approach fails to recognise the identified assets and liabilities of the lessee. Even short-term leases convey to the lessee a right to use the leased item and a corresponding obligation to pay for that right.

(b) The two-model approach means that economically similar transactions can be accounted for very differently.

(c) The dividing line between finance and operating leases is hard to define in a principled way.

Appendix D Implications of adopting IAS 17 for lessors that currently apply Statement 13

Introduction

D.1 The purpose of this appendix is to describe the major differences in lessor accounting under Statement 13 and IAS 17 and discuss the advantages and disadvantages of requiring US GAAP lessors to adopt IAS 17.

Background

D.2 In the current joint leases project, the FASB and the IASB have decided to defer consideration of lessor accounting; that project will only address the accounting for lessees. Therefore, this appendix is designed to describe significant issues that would need to be considered if the FASB were to require lessors applying Statement 13 to adopt IAS 17. A result of the decision to converge to IAS 17 for lessor accounting is that the completion of this project will result in a completely converged accounting standard for leases.

Significant differences between Statement 13 and IAS 17

Classification criteria

D.3 Classification of a lease under Statement 13 is based on the following four criteria (a) the lease transfers ownership of the property to the lessee by the end of the lease term; (b) the lease contains a bargain purchase option; (c) the lease term is equal to 75% or more of the estimated economic life of the leased property; and (d) the present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property. Upon meeting one criterion, a lease is deemed to be a capital lease that must be accounted for as a direct financing lease, sales-type lease, or leveraged lease. If none of the criteria are met, the lease is classified as an operating lease. In addition, to be classified as a sales-type lease, direct financing lease, or leveraged lease, the collectability of the minimum lease payments must be reasonably predictable and no important uncertainties can surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

D.4 IAS 17 has a principle that finance lease classification is achieved upon transferring substantially all the risks and rewards of ownership of the leased property. Operating lease classification results if the lease does not transfer substantially all the risks and rewards incidental to ownership.

D.5 IAS 17 provides indicators rather than criteria to determine when risks and rewards of ownership have transferred. These indicators of situations that individually or in combination would normally lead to a lease being classified as a finance lease are (a) the lease transfers ownership of the asset to the lessee by the end of the lease term; (b) the lessee has the option to purchase the asset lower than fair value; (c) the lease term is for a major part of the economic life of the asset even if title is not transferred; (d) the present value of the minimum lease payments amounts to at least substantially all of the fair value of the lease asset; and (e) the leased assets are of such a specialised nature that only the lessee can use them without major modification.

D.6 Differences in practice may arise when applying the principal of substantially all risk and rewards of ownership have transferred under IAS 17 compared to the criteria application under Statement 13. For example, a lease may result in 89.9 percent of the present value of fair value of the leased asset not meeting the capital lease criteria under Statement 13, but based on the judgement allowed under IAS 17, substantially all risk and rewards may have transferred resulting in a finance lease under IAS 17. In practice, some companies have developed internal accounting policies that use the tests in US GAAP to help interpret the indicators in IFRS. For these companies, the effect of applying the four indicators under IAS 17 rather than the criteria of Statement 13 may not be significant.

D.7 Under IAS 17, a lease may qualify to be accounted for as a manufacturer or dealer lease (that is, similar to a sales-type lease under Statement 13). However, a leveraged lease is not an option under IAS 17 (this will be discussed in more detail later in this Appendix).

Measurement of net investment

D.8 The net investment historically measured and recognised under Statement 13 is similar to the measurement and recognition under IAS 17. Both are based on the sum of the minimum lease payments plus any unguaranteed residual value accruing to the lessor. Lessors are specifically forbidden to make an upward adjustment to their unguaranteed residual value estimate under US GAAP. IFRS is silent regarding increases in residual value estimates. This could allow for a lessor that previously recognized an impairment loss related to an unguaranteed residual value to reverse that loss if the estimated residual value increased.

Definition of lease term

D.9 Periods to be considered in the lease term must be considered at inception of the lease (that is, the definition of a lease term). Statement 13 provides guidance of which periods should be considered when determining the minimum lease term used to calculate the minimum lease payments. Under Statement 13 the lease term includes the fixed non-cancellable term of the lease plus (a) all periods covered by bargain renewal options; (b) all periods for which failure to renew the lease imposes a penalty on the lessee in such amount that renewal appears, at inception of the lease, to be reasonably assured; (c) all periods covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be outstanding; (d) all periods covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable; and (e) all periods representing renewals or extensions of the lease at the lessor's option. IAS 17 does not provide such guidance. Under IAS 17, non-cancellable periods include options to renew if at inception of the lease it is reasonably certain that the lessee will exercise that option.

D.10 Because Statement 13 has extensive guidance and considerations in determining the lease term, differences from IAS 17 may arise in practice.

Rate of return

D.11 Recognition of income for finance leases under Statement 13 and IAS 17 should reflect a constant periodic rate of return on the lessor's net investment. Statement 13 allows for other methods if the results are not materially different from a constant periodic rate of return, which IAS 17 does not allow for. In practice, application of IAS 17 should not result in major differences as other methods used under Statement 13 are not materially different from a constant periodic rate of return.

Sales-type leases

D.12 Accounting consequences for sales-type leases under Statement 13 are similar to those of manufacturer or dealer leases under IAS 17. Both allow for a normal selling profit and finance income. Preparers may be required to adjust the rate used to determine the profit or loss as Statement 13 is based on the rate implicit in the lease, and profit or loss under IAS 17 may be based on a market rate in certain situations. However, in many instances, the market rate used under IAS 17 is likely to be the rate implicit in the lease, resulting in no difference. Initial direct costs are expensed when the selling profit or loss is recognised under both Statement 13 and IAS 17.

Leases involving land and building

D.13 Leases that involve real estate may potentially be accounted for differently under IAS 17. Statement 13 has established specific guidance for leases of (a) land only; (b) land and building; (c) equipment as well as real estate; and (d) only part of a building. Under Statement 13, leases involving land and buildings are generally considered as one unit unless the fair value of the land is greater than 25% of the total leased property fair value. Leases involving land and building are considered separately under IAS 17 unless the land element of the lease is immaterial in which case the land and building are treated as a single unit for lease classification purposes. Accordingly, differences may arise in practice. US lessors would have to consider the two elements separately (land and building) and then determine the fair value of the land and the fair value of the building for classification purposes. This could be a time-consuming change to practice for US GAAP lessors.

D.14 Operating leases of land and buildings are often scoped out of IAS 17 because they meet the definition of investment property. Accordingly, such leases are accounted for under IAS 40. US GAAP does not have a concept similar to "investment property".

Measurement of investment property

D.15 Investment property is scoped out of IAS 17 and is accounted for under IAS 40. Under IAS 40, investment property may be accounted for at historical cost or by using fair value accounting with changes recognised in net profit or loss. Statement 13 requires historical cost; there is no concept of investment property.

D.16 If the lessors adopt IAS 17, consideration must be given to adopt IAS 40 or accept that accounting for investment property will not be converged. Adopting IAS 40 would represent a significant change in practice by companies under Statement 13.

Leveraged leases

D.17 Special accounting requirements for leveraged leases exist under Statement 13, but the key features are that the net investment in the lease is presented net of the non-recourse financing obligation and income is recognised at a constant periodic rate of return based on after-tax cash flows in the periods during which there is a positive net investment in the lease. There will be differences in practice because there are no leveraged leases under IAS 17.

Operating leases

D.18 Operating lease lessor accounting is conceptually similar under both Statement 13 and IAS 17. Future contractual rental payments are recognised as receivables over the lease term as the payments become receivable. Rents are recognised on a straight-line basis over the life of the lease and contingent rent is recognised as income in the period earned.

D.19 For public companies, the lessor only recognises contingent rent under Statement 13 when the specified condition that triggers the lessor's right to receive contingent rent has been met. IAS 17 has no specific guidance on when contingent rent is to be recognised by a lessor (for example, when it becomes probable or when it has been met). Differences in practice may arise due to Statement 13 having specific guidance on when to recognise contingent rent for lessors.

D.20 Assets held in use are recognised on the balance sheet of the lessor; classified as plant, property and equipment; depreciated based on their economic useful lives; and tested for impairment following their respective applicable GAAP.

Participation by third parties

D.21 US GAAP has specific guidance regarding the sale of property subject to an operating lease by a lessor. For example, Statement 13 specifies that the sale of property subject to an operating lease shall not be treated as a sale if the seller or any party related to the seller retains substantial risks of ownership in the leased property. IFRS is silent on these issues.

Advantages for the US to require lessors to adopt IAS 17

D.22 The main advantage of requiring lessors to adopt IAS 17 is that it will result in a converged lease accounting standard. There is no guarantee that additional delays will not be encountered when the boards address lessor accounting.

D.23 If lessors adopt IAS 17, all of Statement 13, its related authoritative literature, and its complexities would be eliminated and lessors would follow one standard that may have easier application.

Disadvantages for the US to require lessors to adopt IAS 17

D.24 Although requiring lessors to adopt IAS 17 may help convergence, it may not be the best accounting standard for lessors. Adopting IAS 17 would potentially require lessors to adopt two standards (that is, the first being IAS 17 as written today, and the second being the new lessor standard to be released in the future) in a short period of time. This would have a significant impact on lessor accounting and increase costs to lessors.

D.25 Revenue recognition also impacts lessor lease accounting. US lessors adopting IAS 17 would essentially follow two revenue recognition models, one for leases and one for transactions not within the scope of IAS 17. A significant gap in accounting guidance would be created, because there is significant revenue recognition guidance a lessor must apply in addition to Statement 13 (For example, EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables").

D.26 Adopting IAS 17 would require lessors to adopt an additional revenue recognition standard and its impacts on lessor accounting upon completion of the joint revenue recognition project.

D.27 Upon adoption of IAS 17, guidance on specific lease issues would no longer be authoritative as such issues are not addressed in lease accounting under IAS 17.

IAS 17 is a principles based standard that allows preparers to derive appropriate accounting treatment based upon the underlying principles. However, in certain situations, the Board may need to provide additional guidance to achieve consistent application of the guidance.