

Request for Comment on IASB Discussion Paper DP/2009/1 *Leases – Preliminary Views*

Comments to AASB by 12 June 2009



Australian Government

**Australian Accounting
Standards Board**

Commenting on this AASB Invitation to Comment

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comments by 12 June 2009. Comments should be addressed to:

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Australian Accounting Standards Board
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Respondents to the IASB are asked to send their comments electronically through the 'Open to Comment' page on the IASB website (www.iasb.org)

All non-confidential submissions to the AASB will be made available to the public on the AASB website: www.aasb.gov.au.

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AASB REQUEST FOR COMMENTS

In light of the Australian Accounting Standards Board's (AASB's) policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

- (a) any of the proposals in the attached International Accounting Standards Board (IASB) Discussion Paper, including the specific questions listed in the Invitation to Comment section of the attached IASB Discussion Paper; and
- (b) the 'AASB Specific Matters for Comment' listed below.

The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 12 June 2009. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

Background to the IASB-FASB Leases Project

This project is part of the 2006 Memorandum of Understanding (updated in 2008) between the FASB and the IASB to work towards convergence.

The aim of the project is to develop a new common approach to lease accounting that would ensure that all assets and liabilities arising under lease contracts are recognised in the statement of financial position.

AASB Specific Matters for Comment

The AASB would particularly value comments on whether:

- (a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
 - (i) not-for-profit entities; and
 - (ii) public sector entities.
- (b) overall, the proposals would result in financial statements that would be useful to users; and
- (c) the proposals are in the best interests of the Australian economy.

March 2009

Discussion Paper DP/2009/1

Leases

Preliminary Views

Comments to be received by 17 July 2009



International
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Discussion Paper
Leases
Preliminary Views

Comments to be received by 17 July 2009

DP/2009/1

This discussion paper *Leases—Preliminary Views* is published by the International Accounting Standards Board (IASB) for comment only.

The discussion paper has been prepared as part of a joint project by the IASB and the US Financial Accounting Standards Board and it sets out the boards' preliminary views. Those views may be modified in the light of comments received before being published as an exposure draft of a proposed standard.

Comments on the contents of the discussion paper should be submitted in writing so as to be received by **17 July 2009**. Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Invitation to comment and summary

Introduction

- IN1 This discussion paper presents the preliminary views of the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on significant components of an accounting model for lessees. It also includes a discussion of some of the issues that will need to be addressed in any new standard on lessor accounting.
- IN2 It is designed to gather information to assist the boards in developing a new standard on lease accounting.

Summary of the discussion paper

- IN3 The following paragraphs summarise the content of this discussion paper and the preliminary views reached by the boards.
- IN4 Chapter 1 explains why the boards decided to add a project on lease accounting to their agendas and describes the history of the lease accounting project.
- IN5 The boards' proposed approach to scope is discussed in chapter 2. The boards tentatively decided that the scope of the proposed new standard should be based on the scope of their existing standards on lease accounting.
- IN6 Chapter 3 describes the overall approach to lessee accounting proposed by the boards. The boards tentatively decided that in a simple lease the lessee obtains a right to use the leased item that meets the definition of an asset and that the related obligation to pay rentals meets the definition of a liability. Consequently, the boards tentatively decided to adopt a new accounting model for leases that results in the lessee recognising:
- (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.

- IN7 The boards also tentatively decided not to recognise the components of a lease contract separately (such as options to renew, purchase options, contingent rental arrangements or residual value guarantees). Instead, the boards tentatively decided that the lessee should recognise:
- (a) a single right-of-use asset that includes rights acquired under options; and
 - (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
- IN8 Chapters 4 and 5 describe the boards' preliminary views on measurement of the lessee's right-of-use asset and its obligation to pay rentals arising in a simple lease.
- IN9 The boards tentatively decided that the lessee's obligation to pay rentals should be measured initially at the present value of the lease payments discounted using the lessee's incremental borrowing rate. Subsequent measurement would be on an amortised cost basis.
- IN10 The boards also tentatively decided that the lessee's right-of-use asset should be measured initially at cost. Cost equals the present value of the lease payments discounted using the lessee's incremental borrowing rate. The boards 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 item.
- IN11 Chapter 6 discusses how to account for leases that include options that grant the lessee the right to extend the lease, terminate the lease or purchase the leased item.
- IN12 The boards tentatively decided that the assets and liabilities recognised by the lessee should be based on the most likely lease term. For example, in a 10-year lease that includes an option to extend for an additional five years, the lessee must decide whether the lease term is 10 years or 15 years. Measurement of the obligation to pay rentals and the right-of-use asset would be consistent with the most likely lease term.
- IN13 The boards tentatively decided to require the lease term to be reassessed at each reporting date. Changes in the obligation to pay rentals arising from a reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

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- IN14 The boards tentatively decided that the accounting requirements for purchase options should be the same as for options to extend or terminate the lease. Thus:
- (a) in recognising the obligation to pay rentals, the lessee must decide whether it is likely that an option to purchase will be exercised. If the lessee decides that the option to purchase is likely to be exercised, the obligation to pay rentals will include the exercise price of the option. This assessment will be based on the lessee's determination of the most likely outcome.
 - (b) whether a purchase option will be exercised will be reassessed at each reporting date. Changes in the obligation to pay rentals arising from a reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.
- IN15 Chapter 7 describes the boards' preliminary views on the recognition and measurement of leases that include contingent rental arrangements and residual value guarantees. The boards tentatively decided that the lessee's obligation to pay rentals should reflect the lessee's obligation to make payments under contingent rental arrangements.
- IN16 The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The obligation to pay rentals should be remeasured at each reporting date to reflect changes in estimated contingent rental payments. Changes in the obligation to pay rentals arising from reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.
- IN17 The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payments. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. The FASB also tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee would initially measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Changes in amounts payable arising from changes in the indices would be recognised in profit or loss. For other forms of contingent rentals the obligation to pay rentals should also be remeasured at each reporting date to reflect changes in estimated contingent rental payments. Changes in the obligation to pay rentals arising from these reassessments should also be recognised in profit or loss.

- IN18 The boards tentatively decided not to recognise residual value guarantees separately from the obligation to pay rentals. The boards also tentatively decided that leases that include residual value guarantees should be measured on the same basis as leases that include contingent rental arrangements.
- IN19 Chapter 8 describes the boards' preliminary views on how the assets, liabilities, expenses and cash flows arising from lease contracts should be presented in the financial statements. Those preliminary views are based on existing presentation requirements. The effect that proposed changes to financial statement presentation could have on the boards' preliminary views is discussed at the end of chapter 8.
- IN20 Chapter 9 provides a brief overview of a number of lessee accounting issues the boards have not yet discussed in sufficient detail to reach a preliminary view. The boards will need to resolve those issues before publishing an exposure draft.
- IN21 Chapter 10 describes some of the issues that will need to be addressed in any new lessor accounting standard.

The leases working group

- IN22 In 2006 the boards set up a joint lease accounting working group that includes users, preparers and auditors of both lessees' and lessors' financial statements. The group met in February 2007 and provided valuable comments on the early proposals for lease accounting. Since then, members of the working group have continued to contribute to the project informally and at a meeting in October 2008 commented on an early draft of this discussion paper.

Next steps

- IN23 In April 2008 the boards announced their intention to produce a revised standard for lessees by mid-2011. Consequently, after publishing this discussion paper, the boards intend to work on an exposure draft of a proposed new standard for lessees. The boards will decide on the timing of any new standard for lessors after publishing this discussion paper. In developing an exposure draft, the boards will review the responses to this paper and decide whether to modify or confirm 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.

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- IN24 As discussed in subsequent chapters, the boards reached different preliminary views in some areas. The boards will resolve those differences in the light of comments received on this discussion paper.
- IN25 The boards expect the work on lease accounting to proceed in parallel with other projects that may provide useful inputs to this project (including those on the conceptual framework, derecognition, revenue recognition, financial statement presentation and financial instruments) 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.

Invitation to comment

- IN26 The boards invite comments on all matters in this paper. Chapters 2-10 include questions for respondents. Appendix A lists all the questions. Comments are most helpful if they:
- (a) respond to 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.
- IN27 Respondents need not comment on all the questions and are encouraged to comment on any additional issues.
- IN28 The boards will consider all comments that are received in writing by 17 July 2009.

Chapter 1: Background

Purpose of this discussion paper

- 1.1 This discussion paper:
- (a) summarises the proposed approach to a new lease accounting standard
 - (b) sets out preliminary views on how various lease accounting issues will be addressed in a proposed new standard
 - (c) discusses other issues that will need to be addressed before a new lease accounting standard is issued
 - (d) seeks views on all of these matters.

Problems with the existing lease accounting standards

- 1.2 Leasing is an important source of finance to business. Therefore, it is important that lease accounting provides users of financial statements with a complete and understandable picture of an entity's leasing activities. The boards decided to add lease accounting to their agendas in the light of criticisms of the existing accounting model for leases. The following sections describe that model and explain those criticisms.

Description of the existing accounting model

- 1.3 Existing lease accounting standards require lessees to classify their lease contracts as either finance (capital)* leases or operating leases. Finance leases are defined as those leases that transfer to the lessee substantially all the risks and rewards incidental to ownership of the leased asset. All other leases are operating leases.
- 1.4 Leases classified as finance leases are treated as similar to a purchase of the underlying asset. Consequently, the lessee recognises in its statement of financial position the leased item and an obligation to pay rentals. The lessee depreciates the leased item and apportions lease payments between a finance charge and a reduction of the outstanding liability.

* US generally accepted accounting principles (GAAP) uses the term 'capital' lease rather than 'finance' lease. To avoid repetition, this document uses the term 'finance' lease.

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No similar assets or liabilities are recognised by the lessee when the lease is classified as an operating lease. The lessee recognises lease payments under an operating lease as an expense, normally on a straight-line basis over the lease term.

- 1.5 Under IAS 17 *Leases* lessors are required to classify leases as finance leases or operating leases. Finance leases are defined as leases that transfer substantially all the risks and rewards incidental to ownership. All other leases are operating leases.
- 1.6 If the lease is classified as a finance lease, the lessor derecognises the leased asset and recognises a receivable for an amount equal to the net investment in the lease. The net investment in the lease is equal to the present value of the minimum lease payments and the present value of any unguaranteed residual value. Finance income is recognised on the basis of a pattern reflecting a constant periodic rate of return on the net investment in the finance lease. Manufacturer or dealer lessors recognise selling profit or loss on finance leases in the same way as for outright sales. If the lease is classified as an operating lease, the lessor continues to recognise the leased asset and presents it in the statement of financial position according to the nature of the asset. The leased asset is depreciated on a basis that is consistent with the lessor's normal depreciation policy for owned assets. Lease income is normally recognised on a straight-line basis over the lease term.
- 1.7 Under FASB Statement No. 13 *Accounting for Leases* (SFAS 13), lessors are required to classify leases as:
- (a) sales-type leases
 - (b) direct financing leases
 - (c) leveraged leases
 - (d) operating leases.
- 1.8 Sales-type leases, direct financing leases and leveraged leases are leases that transfer substantially all the benefits and risks incidental to ownership of the property. Whether a lease transfers substantially all the benefits and risks incidental to ownership of the property is determined by reference to a number of criteria.
- 1.9 If the lease is classified as a sales-type lease or a direct financing lease, the lessor recognises an asset representing its gross investment in the lease and unearned income. The gross investment in the lease is equal to the undiscounted minimum lease payments plus any unguaranteed residual value. The unearned income is amortised over the lease term to produce

a constant periodic rate of return on the net investment in the lease (the net investment in the lease equals the gross investment less unearned income). Sales-type leases give rise to manufacturer's or dealer's profit or loss. Direct financing leases are leases other than leveraged leases that do not give rise to manufacturer's or dealer's profit or loss.

- 1.10 Leveraged leases are a special type of structured lease involving non-recourse financing. The lessor recognises its investment in a leveraged lease (determined in accordance with SFAS 13) net of the non-recourse debt.
- 1.11 If a lease is classified as an operating lease, the leased item is included in the statement of financial position with or near property, plant and equipment and is depreciated in accordance with the lessor's normal depreciation policy. Lease income is normally recognised on a straight-line basis over the lease term.

Criticisms of the existing accounting model

- 1.12 The existing accounting model for leases has been criticised for failing to meet the needs of users of financial statements. In particular:
 - (a) many users think that operating leases give rise to assets and liabilities that should be recognised in the financial statements of lessees. Consequently, users routinely adjust the recognised amounts in an attempt to recognise those assets and liabilities and reflect the effect of lease contracts in profit or loss. However, the information available to users in the notes to the financial statements is insufficient for them to make reliable adjustments to the recognised amounts.
 - (b) 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. This reduces comparability for users.
 - (c) the existing standards provide opportunities to structure transactions so as to achieve a particular lease classification. If the lease is classified as an operating lease, the lessee obtains a source of unrecognised financing that can be difficult for users to understand.

LEASES—PRELIMINARY VIEWS

- 1.13 Preparers and auditors have criticised the existing model for its complexity. In particular, it has proved difficult to define the dividing line between finance leases and operating leases in a principled way. Consequently, the standards use a mixture of subjective judgements and ‘bright-line’ tests that can be difficult to apply.
- 1.14 Some have argued that the existing accounting model is conceptually flawed. In particular:
- (a) on entering a lease contract, the lessee obtains a valuable right (the right to use the leased item). This right meets 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, that right and obligation are not recognised.
 - (b) there are significant and growing differences between the accounting model for leases and other contractual arrangements. This has led to inconsistent accounting for arrangements that meet the definition of a lease and similar arrangements that do not.
- 1.15 The US Securities and Exchange Commission (SEC) recognised the inadequacies of the existing lease accounting standards in its June 2005 Report, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* 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

- 1.16 Standard-setters and other interested parties have debated how to improve lease accounting for many years.
- 1.17 In 1996 the G4+1 group of standard-setters* published a discussion paper *Accounting for Leases: A New Approach—Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts*. The paper proposed an approach to lease accounting that would abolish the requirement to classify leases as operating leases or finance leases. Under that approach, a lessee would recognise as assets and liabilities all material rights and obligations arising in a lease contract.

* The G4+1 comprised members of the national standard-setters of Australia, Canada, New Zealand, the United Kingdom and the United States and of the International Accounting Standards Committee (the IASB’s predecessor organisation).

- 1.18 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 the 1996 paper might be made to work and included proposals on lessor accounting.
- 1.19 In July 2006 the boards added to their agendas a joint project on lease accounting. 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 common standard on lease accounting. This discussion paper is the first step towards that goal.
- 1.20 When the boards added lease accounting to their agendas, they agreed that the project would consider both lessee accounting 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, most of this discussion paper focuses on lessee accounting.
- 1.21 The boards' reasons for deferring consideration of lessor accounting were as follows:
- (a) Most of the problems associated with the existing accounting model relate to the treatment of operating leases in the financial statements of lessees. Users of financial statements have raised fewer concerns about the existing accounting for lessors.
 - (b) Consideration of lessor accounting at the same time as lessee accounting could delay publication of a new accounting standard for lessees. Lessee accounting affects a wide range of entities across all industries. Existing accounting standards significantly understate the extent of those entities' assets and liabilities. Consequently, improvements to lessee accounting would benefit a large number of users.
 - (c) Lessor accounting raises issues that relate to other projects that the boards are currently considering, particularly derecognition and revenue recognition. Until conceptual models for derecognition and revenue recognition have been developed, it will be difficult and perhaps premature to build a new accounting model for lessors.
 - (d) Any lessor accounting project will need to address how to account for investment property. The existing accounting models for investment property under US generally accepted accounting

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principles (GAAP) and International Financial Reporting Standards (IFRSs) are very different. Therefore, reconciling those differences may be difficult and time-consuming.

- 1.22 There are a number of potential disadvantages to deferring consideration of lessor accounting:
- (a) Developing lessor accounting might provide additional insights into lessee accounting and a better understanding of the economics of lease contracts.
 - (b) Further changes to lessee accounting may be required when lessor accounting is addressed.
 - (c) If an accounting standard for lessees is issued before a new standard for lessors, lessees will apply a conceptual model to lease contracts that is different from the model applied by lessors. 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 (subleases). In addition, the existence of different accounting models for lessees and lessors could result in new structuring opportunities and could reduce the understandability of financial statements.
- 1.23 The final chapter of this discussion paper sets out some of the issues that will need to be resolved in developing a new standard on lessor accounting. The boards will decide the timing of any new standard for lessors after publishing this discussion paper.

Chapter 2: Scope of lease accounting standard

Proposed approach to scope

Possible approaches to scope

- 2.1 The boards considered two possible approaches to defining the scope of a proposed new lease accounting standard.
- 2.2 The first approach considered was to base the scope of the proposed new standard on that of the existing lease accounting standards, ie the scope of the new lease accounting standard would be similar to that of SFAS 13 and IAS 17. The existing standards cover most contracts that convey a right to use an asset for a period. However, there are differences between the scope of SFAS 13 and that of IAS 17. For example, SFAS 13 applies only to arrangements that convey 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 SFAS 13 and includes leases of some intangible assets.
- 2.3 Those differences will need to be reconciled before a new standard is issued. Appendix B describes the scope of the existing standards.
- 2.4 The proposed new standard would incorporate the requirements of EITF Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease*, IFRIC 4 *Determining whether an Arrangement contains a Lease* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.
- 2.5 This approach would result in all contracts that are accounted for at present as lease contracts being accounted for as leases under the proposed new standard.
- 2.6 There are disadvantages to this approach. They include:
 - (a) some constituents have expressed concern that the scope of IFRIC 4 and EITF 01-8 result in some arrangements being classified inappropriately as leases. Those concerns will not be addressed.
 - (b) similar contracts with similar characteristics may not be accounted for consistently. For example, some executory contracts, service contracts, maintenance contracts and lease contracts share similar characteristics but have different accounting.
 - (c) requiring lessees to recognise assets and liabilities arising in all lease contracts may lead to arrangements being structured so that

the contract is considered a contract for services rather than a contract conveying a right of use. This will result in greater pressure being placed on the existing guidance on scope.

- (d) additional guidance on how to distinguish payments for services from payments for the right to use an asset may be required. There is an existing requirement to distinguish payments for services from lease payments. However, if the lease is classified as an operating lease in accordance with existing standards, the lessee recognises in profit or loss both the payment for services and the lease payment, normally on a straight-line basis. Requiring capitalisation of the lease payments may reveal that the existing guidance on how to distinguish the payments is inadequate.
- 2.7 The second approach considered was to undertake a fundamental reconsideration of what constitutes a lease. This approach would potentially change the scope of any proposed new leases standard and would require the boards to determine (among other things):
- (a) the distinction between contracts that convey a right of use to the lessee and contracts that do not (eg some service contracts)
 - (b) when a lease conveys a right to use a component of a larger asset
 - (c) whether licences of some intangible assets are leases.
- 2.8 This approach would be likely to result in both an extension of the scope to include some additional contracts and a removal of some contracts from the scope of the lease accounting standards.

Preliminary views

- 2.9 The boards' preliminary view is that the scope of the proposed new standard should be based on the scope of the existing standards.
- 2.10 The boards adopted this approach for the following reasons:
- (a) The approach to scope adopted in the existing standards is familiar to constituents. Consequently, basing the scope of the proposed new standard on the scope of the existing standards may be easier for constituents to understand and implement.
 - (b) Although it may sometimes be difficult to apply the detailed guidance in IFRIC 4 and EITF 01-8, in most situations it is clear whether a lease contract is within the scope of the existing standards.

- (c) The boards think that it will be more efficient to focus on the main aspects of a new accounting approach for leases before determining whether any changes in scope are needed.
- 2.11 The boards noted that leases that are in substance purchases (eg leases that automatically transfer the title of the leased item to the lessee at the end of the lease) are within the scope of the existing standards. The boards discussed whether leases of this type should be excluded from the scope of any new leases standard.
- 2.12 The boards tentatively decided not to exclude leases that are in substance purchases from the scope of any new leases standard because:
- (a) the accounting proposed in this discussion paper for lessees should result in accounting that is similar to that required for assets that are purchased.
 - (b) attempting to define what is meant by an in-substance purchase may be difficult. Some would restrict the term to those leases that automatically transfer title to the lessee. Others would expand the definition to include, for example, leases of the asset for its entire useful life.
 - (c) if the definition of an in-substance purchase is expanded to include leases other than those that transfer title, differentiating between leases that are in substance purchases and those that are not may require the creation of rules that are similar to those in the existing standards.

Scope exclusions

- 2.13 The existing standards include scope exclusions. For example, leases to explore for or use natural resources are excluded from the scope of both standards. The boards will decide how (and whether) to incorporate those existing exclusions into the scope of the proposed new standard before publishing an exposure draft.
- 2.14 Like other accounting standards, the proposed new lease accounting standard will not apply to immaterial items.
- 2.15 Some constituents have suggested that the proposed new standard should provide scope exclusions for non-core asset leases and short-term leases. The following sections discuss those possible scope exclusions. The boards have not reached preliminary views on either of those issues.

However, any scope exclusion will lead to more complexity in the proposed new standard, making it more difficult for users to understand and preparers to apply. The boards note that some short-term leases and some leases of non-core assets may be immaterial to the lessee.

Non-core asset leases

- 2.16 Some constituents have said that leases of assets that are not essential to the operations of an entity (non-core assets) are of little interest to users of the entity's financial statements. For example, recognising and measuring the assets and liabilities arising from an aircraft lease provides important information to the users of the financial statements of an airline. However, the assets and liabilities arising from the lease of an aircraft by a consumer products company may be of little interest to users of financial statements. Those constituents consider that the costs associated with recognising and measuring the assets and liabilities arising from non-core asset leases outweigh the benefits. Consequently, they think that non-core asset leases should be accounted for as operating leases.
- 2.17 There are problems with this approach:
- (a) Defining non-core assets may be difficult.
 - (b) Different entities may interpret the meaning of non-core assets differently, thereby reducing comparability for users.
 - (c) Non-core asset leases may give rise to material assets and liabilities. Users are likely to be interested in material assets and liabilities whether they arise from leases of non-core assets or from leases of core assets.
 - (d) It can be argued that all assets are essential to the operation of a business. If an asset is not required for the business to operate effectively, why was it acquired?

Short-term leases

- 2.18 Some constituents have also stated 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 think that any new lease accounting standard should exclude short-term leases from its scope. In their view, leases meeting the definition of a short-term lease should continue to be accounted for as operating leases.

- 2.19 However, excluding short-term leases from the scope of a new standard may fail to meet the needs of users because:
- (a) many short-term leases could give rise to material assets and liabilities.
 - (b) excluding short-term leases may 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, so similar contracts may be accounted for differently. This would reduce comparability for users.

Next steps

- 2.20 Assuming the boards decide to confirm their preliminary views on scope, the boards will need to do the following:
- (a) draft new scope paragraphs that integrate the requirements of SFAS 13, IAS 17, IFRIC 4, EITF 01-8 and SIC-27
 - (b) consider the need to clarify the requirements of IFRIC 4 and EITF 01-8, and to provide additional guidance on distinguishing between payments for the right to use a leased item and payments for services
 - (c) discuss whether to provide a scope exclusion for non-core or short-term lease contracts.

Questions for respondents

Question 1

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach? If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Chapter 3: Approach to lessee accounting

Introduction

- 3.1 This chapter describes the overall approach to lessee accounting proposed by the boards.
- 3.2 The first section summarises the boards' analysis of the rights and obligations that arise under a simple lease contract and compares those rights and obligations to the boards' definitions of assets and liabilities. The next section sets out the boards' preliminary views on a new approach to accounting for all leases, including leases at present classified as operating leases. Under that approach, the lessee would recognise:
- (a) an asset representing its right to use the leased item for the lease term
 - (b) a liability for its obligation to pay for the right to use the leased item.
- 3.3 The final section of this chapter describes the boards' proposed approach to more complex leases.

Analysis of rights and obligations arising in a simple lease

- 3.4 As discussed in chapter 1, the existing accounting model for lessees fails to meet the needs of users. In particular, it 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 (other than the accrual of rentals due or prepaid).
- 3.5 The boards decided to analyse 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 sections describe that analysis.

Rights and obligations arising in a simple lease

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

Example 1

A machine is leased for a fixed term of five years; the expected life of the machine is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machine 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 machine has been delivered; these are fixed amounts that are specified in the original agreement. No maintenance or other arrangements are entered into.

- 3.7 Lease contracts are often much more complex than the lease described in example 1. However, by analysing a simple lease, the boards have identified the rights and obligations that are common to most lease contracts.
- 3.8 To simplify the analysis further, the boards considered only those rights and obligations that exist after the leased item is delivered to the lessee. Assets and liabilities may arise before delivery of the leased item (eg when the contract is signed). Chapter 9 discusses that issue.
- 3.9 A lease contract may require the lessee to maintain the leased item in a specified condition. In addition, the lessee may be required to incur costs to return the leased item to the lessor (eg costs to dismantle the machine or transport costs). Obligations of this type may give rise to liabilities that should be recognised in the financial statements. For example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and SFAS 5 *Accounting for Contingencies* may require the lessee to recognise a liability for the costs associated with returning the machine. However, commitments of this type do not change the basic rights and obligations arising in a lease contract and are not considered further in this paper.
- 3.10 The lease described in this example is non-cancellable, ie the lessee has no contractual right to terminate the lease agreement, return the machine 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 machine before the end of the lease term. Chapter 6 discusses leases that incorporate a contractual right of termination (cancellable leases).

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

| Lessee rights | Lessee obligations |
|---|--|
| <ul style="list-style-type: none"> • Right to use the machine for the lease term | <ul style="list-style-type: none"> • Obligation to pay rentals • Obligation to return the machine at the end of the lease term |

Application of the asset and liability definitions

- 3.12 Having identified the rights and obligations arising in this simple lease, the boards then considered whether those rights and obligations meet the definitions of assets and liabilities.
- 3.13 Although the wording of the existing IASB and FASB asset definitions are different, the concepts underpinning them are the same. The IASB's *Framework for the Preparation and Presentation of Financial Statements* and the FASB's *Concepts Statement No. 6 Elements of Financial Statements (CON 6)** have the following characteristics of an asset in common:
- The entity **controls** an economic resource or benefit.
 - It arises out of a **past event**.
 - Future economic benefits** are expected to flow to the entity.
- 3.14 Similarly, the boards' liability definitions contain the same basic characteristics:
- There exists a **present obligation** of the entity.
 - The obligation arises out of a **past event**.
 - The obligation is expected to result in an **outflow of economic benefits**.
- 3.15 The boards used those common characteristics to analyse whether the rights and obligations identified above meet the definition of an asset or liability.

* 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 use the existing definitions.

Preliminary views

The right to use a leased item is an asset

- 3.16 The boards identified the right to use the leased item (eg the machine described in example 1) as an economic resource of the lessee because the lessee can use it to generate cash inflows or reduce cash outflows. The boards tentatively concluded that:
- (a) the lessee **controls** the right to use the leased item during the lease term because the lessor is unable to recover or have access to the resource without the consent of the lessee (or breach of contract).
 - (b) 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 think that the lessee's right to use the machine described in example 1 is conditional on the lessee making payments during the lease term. In other words, if the lessee does not make payments, it may forfeit its right to use the machine (this is similar to the situation that would arise if an entity failed to make payments on an instalment purchase). However, unless the lessee breaches the contract, the lessee has an unconditional right to use the leased item.
 - (c) **future economic benefits** will flow to the lessee from the use of the leased item during the lease term.
- 3.17 Accordingly, the boards tentatively concluded that the lessee's right to use a leased item for the lease term meets the definitions of an asset in the *Framework* and CON 6.

The obligation to pay rentals is a liability

- 3.18 Some think that the lessee's obligation to pay rentals during the lease term is a conditional obligation. That is because, 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.
- 3.19 However, unless the lessee breaches the contract, the lessor has no contractual right to take possession of the item until the end of the lease term. Equally, the lessee has no contractual right to terminate the lease and avoid paying rentals. Therefore the lessee has an unconditional obligation to pay rentals.

- 3.20 In summary, the boards tentatively concluded that:
- (a) the lessee has a **present obligation** to pay rentals.
 - (b) this obligation arises out of **past events**—the signing of the lease contract and the delivery of the item by the lessor to the lessee.
 - (c) the obligation is expected to result in an **outflow of economic benefits** (usually cash).
- 3.21 Accordingly, the boards tentatively concluded that the lessee’s obligation to pay rentals meets the definitions of a liability in the *Framework* and CON 6.

The obligation to return the leased item at the end of the lease term is not a liability

- 3.22 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. This is a present obligation that is established by a past event (the signing of the lease contract and the delivery of the machine in example 1). Therefore, if the obligation to return the leased item results in an outflow of economic benefits, the obligation meets the definition of a liability.
- 3.23 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 tentatively concluded that there is no outflow of economic benefits from the lessee when it returns the leased item (other than the incidental costs discussed in paragraph 3.9). Although the lessee has physical possession of the leased item, it has no right to use the item once the lease term expires. The position of the lessee at the end of the lease term is like that of an asset custodian. The lessee is holding an asset on behalf of a third party but has no right to the economic benefits embodied in that asset.
- 3.24 Consequently, the boards 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.

- 3.25 In summary, the boards' preliminary view is that in the simple lease described in example 1, the following assets and liabilities can be identified:

| Description of right | Control | Past event | Future economic benefits? | Asset? |
|--|---|--|----------------------------------|---------------|
| Right to use machine 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 machine 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 machine and will not have to make any payments after the end of the lease term | No |

A new approach

Preliminary views

- 3.26 On the basis of the preceding analysis, the boards tentatively concluded that the existing lease accounting model is inconsistent with the asset and liability definitions in the *Framework* and CON 6. The boards tentatively decided to develop a new approach to accounting for leases that would result in the recognition of the assets and liabilities identified as arising in a lease contract. Rather than treating some lease contracts like a purchase of the leased item (finance leases) and others as executory contracts (operating leases), the new approach would treat all lease contracts as the acquisition of a 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.
- 3.27 In reaching that conclusion, the boards discussed some other possible approaches to lessee accounting. Appendix C describes these approaches and explains why the boards tentatively decided not to develop them further.
- 3.28 The boards noted that this new approach to lease accounting would address many of the criticisms of the existing standards. In particular:
- (a) Assets and liabilities arising in leases at present classified as operating leases will be recognised in the statement of financial position. Consequently, users will no longer need to adjust the recognised amounts to attempt to reinstate those missing assets and liabilities.
 - (b) The new approach applies the same accounting to all lease contracts. Consequently, similar transactions will no longer be accounted for differently and comparability for users will be increased.
 - (c) The opportunity to structure transactions so that they provide a source of unrecognised financing will be reduced. This will make the financial statements more comparable and easier for users to understand.
 - (d) The new approach is consistent with the boards' conceptual frameworks and recently issued standards.

Accounting for more complex leases

- 3.29 Lease contracts are frequently more complex than the simple lease described in example 1. Lease contracts can convey a range of 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) options to purchase the leased asset on payment of an additional amount
 - (d) obligations to pay variable rentals or contingent rentals
 - (e) obligations to compensate the lessor if the value of the leased asset declines below a specified value (residual value guarantees).
- 3.30 The boards discussed whether to require the lessee to recognise and measure each of the rights and obligations in a complex lease separately (a components approach). For example, a new standard could require the lessee to identify and measure separately options to extend a lease or obligations to make payments under residual value guarantees.
- 3.31 The boards initially discussed whether to require lessees to recognise and measure separately options to extend or terminate a lease. If the rights and obligations arising in a complex lease are separated into components and analysed individually, it is possible to conclude that options to extend or terminate the lease meet the definition of an asset. Similarly, it is possible to conclude that purchase options meet the definition of an asset and that residual value guarantees meet the definition of a liability.
- 3.32 However, the boards identified the following problems associated with requiring the lessee to recognise the components of a lease separately:
- (a) Preparers may find it difficult to apply an accounting standard that requires separate identification, recognition and measurement of the components of a lease contract.
 - (b) The components of a lease contract are often interrelated. For example, a lease may include an option to extend, an option to purchase and a residual value guarantee; payments under the residual value guarantee are made only if the lessee does not exercise one of its options. Recognising a liability in respect of a

residual value guarantee may not provide useful information to users if the lessee is likely to exercise its purchase option or extend the lease.

- (c) Unless all components of the lease are measured on the same basis (eg fair value), it may be possible to structure leases to reduce the amount recognised for the lessee's obligation to pay rentals. This means that economically similar leases could be accounted for differently, thereby reducing comparability for users.
- (d) The fair value of options to extend or terminate a lease is difficult to measure. This is because there is no market for options of this type and they are not normally priced separately from the lease contract. Measurement is complicated by the fact that, unlike many financial options, the assets underlying options to extend or terminate a lease are often specialised and may not be exercisable until a long way in the future (eg 20 years in some real estate leases).
- (e) A components approach may not provide users with complete information about the economic position of the lessee. That is because options to extend a lease that are seemingly out of the money may nevertheless be exercised for entity-specific reasons. For example, an entity that leases a production line may choose to exercise an option to extend the lease, thereby avoiding disruption to its activities, even though the exercise price of the option is greater than the market rate.

Preliminary views

- 3.33 Because of the problems identified in paragraph 3.32, the boards tentatively decided not to adopt a components approach to accounting for complex lease contracts. Instead, the boards tentatively decided that the lessee should recognise:
- (a) a single right-of-use asset that includes rights acquired under options
 - (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

Questions for respondents

Question 3

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 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:

- (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.

Appendix C describes some possible accounting approaches that were rejected by the boards.

Do you support the proposed approach?

If you support an alternative approach, please describe the approach and explain why you support it.

Question 5

The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:

- (a) a single right-of-use asset that includes rights acquired under options
- (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

Do you support this proposed approach? If not, why?

Chapter 4: Initial measurement

Introduction

- 4.1 This chapter describes the boards' preliminary views on initial measurement of the lessee's right-of-use asset and its obligation to pay rentals.
- 4.2 This chapter illustrates initial measurement using the simple lease described in example 1 of chapter 3. Under that simple lease, the lessee has no right to extend the lease term or purchase the leased item nor does the lessee guarantee the value of the leased item at any point. Rentals payable are fixed.
- 4.3 Subsequent chapters describe how to account for more complex leases.

Measuring the obligation to pay rentals

- 4.4 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 measured initially at fair value (but excludes lease liabilities from its scope).
- 4.5 Under US GAAP, some financial liabilities, particularly derivatives not in a hedging relationship (SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*) and financial liabilities for which the fair value option has been elected (SFAS 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 the fair value of the property or at an amount that reasonably approximates the fair value of the note, whichever is more clearly determinable.
- 4.6 The boards discussed whether to require the lessee to measure the obligation to pay rentals initially at fair value. The boards noted the following advantages to initially measuring the obligation to pay rentals at fair value:
 - (a) Fair value reflects current market conditions. Thus, supporters of this approach think that it provides users of financial statements with more relevant information than other measures.
 - (b) Requiring the use of fair value produces information for users that is more comparable because it ignores entity-specific factors.

- (c) As discussed above, initial measurement at fair value is consistent with the treatment of some other financial liabilities. Consequently, requiring initial measurement at fair value would make the financial statements more comparable.
- 4.7 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 will be used to determine the initial measurement of the obligation to pay rentals.
- 4.8 The boards discussed the discount rate that should be used to measure the obligation to pay rentals using a discounted cash flow technique. The boards considered two possible rates:
 - (a) the interest rate implicit in the lease
 - (b) the lessee's incremental borrowing rate.
- 4.9 In IAS 17 the definition of the interest rate implicit in the lease 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.'
- 4.10 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.' Consequently, the incremental borrowing rate takes account of:
 - (a) the credit standing of the lessee
 - (b) the length of the lease
 - (c) the nature and quality of the security provided (ie the leased item).
- 4.11 SFAS 13 contains similar definitions of both the interest rate implicit in the lease and the incremental borrowing rate.
- 4.12 Some view the interest rate implicit in the lease as the appropriate rate to use because it is the rate that the lessor charged 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. The lessor's estimate of the residual value of the leased property may affect the interest rate implicit in the lease. The lessee may have little knowledge of the residual value of the leased asset at the end of the lease.

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- 4.13 In addition, determining the interest rate implicit in the lease is more difficult for leases at present classified as operating leases than for those classified as finance leases. This is because the residual value is often much larger when the lease is an operating lease and therefore has a greater proportionate effect on the interest rate.
- 4.14 Because of the problems associated with determining the interest rate implicit in the lease, the boards also discussed whether to retain the approach used in the existing standards which require lessees to discount the lease payments using the interest rate implicit in the lease if it is practicable to determine that rate. If it is not practicable to determine that rate, the lessee's incremental borrowing rate is used.

Preliminary views

- 4.15 The boards tentatively decided to initially measure the lessee's obligation to pay rentals at the present value of the lease payments, discounted using the lessee's incremental borrowing rate.
- 4.16 The boards noted that in most leases the present value of the lease payments discounted using the lessee's incremental borrowing rate would be a reasonable approximation to fair value. Consequently, requiring lessees to measure the obligation to pay rentals using this approach would provide users of financial statements with information similar to measuring the obligation at fair value. In addition, this approach would normally be simpler for lessees to apply than a requirement to measure the obligation to pay rentals at fair value.
- 4.17 The boards tentatively decided to require the use of the lessee's incremental borrowing rate to discount the lease payments because determining the implicit rate is often difficult for lessees. The boards tentatively decided not to retain the approach to discount rates used in the existing standards because it would be more complex for preparers to apply and might reduce comparability for users.

Measuring the right-of-use asset

- 4.18 The lessee's right-of-use asset is a non-financial asset. Most non-financial assets are initially measured at cost. For example, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* require initial measurement at cost rather than at fair value. Similarly, US GAAP requires the initial (and subsequent) measurement of assets at cost under ARB No. 43 Chapter 9 *Depreciation* (ARB 43) and SFAS 142 *Goodwill and Other Intangible Assets*.

- 4.19 The boards discussed measuring the right-of-use asset initially at cost. In a lease contract, the cost of the right-of-use asset will generally equal the fair value of the obligation to pay rentals. As discussed above, in most situations the present value of the lease payments discounted using the lessee's incremental borrowing rate will be a reasonable approximation to the fair value of the obligation to pay rentals. The boards tentatively decided to require the obligation to pay rentals to be measured initially at the present value of the lease payments rather than at fair value. Consequently, in discussing a cost-based measurement for the right-of-use asset, the boards concluded that cost would equal the present value of the lease payments discounted using the lessee's incremental borrowing rate.
- 4.20 The boards noted the following advantages to requiring initial measurement at cost:
- (a) It is consistent with the initial measurement of other non-financial assets. Consequently, requiring initial measurement at cost will increase comparability for users.
 - (b) A cost-based approach is easier and less costly for preparers to apply than requiring fair value measurement.
 - (c) The cost of the right-of-use asset will be a reasonable approximation to its fair value at the inception of the lease. Consequently, requiring lessees to initially measure the right-of-use asset at cost will provide users of financial statements with similar information to measuring the asset at fair value at the inception of the lease.
- 4.21 The boards also discussed measuring the right-of-use asset initially at fair value, ie the fair value of the lessee's right to use the underlying item. This is different from the fair value of the underlying item itself. For example, in a 15-year lease of a building, the fair value of the underlying 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.
- 4.22 Supporters of this approach think that because fair value reflects current market conditions, it provides users with more relevant information about the asset on initial recognition. In addition, using fair value produces information for users that is more comparable because it ignores entity-specific factors.

Preliminary view

- 4.23 The boards tentatively decided that the lessee should initially measure its right-of-use asset at cost. Cost equals the present value of the lease payments discounted using the lessee's incremental borrowing rate.

Questions for respondents

Question 6

Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?

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

Question 7

Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?

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

Chapter 5: Subsequent measurement

Introduction

- 5.1 This chapter sets out the boards' preliminary views on subsequent measurement of the lessee's right-of-use asset and its obligation to pay rentals.
- 5.2 This chapter mainly deals with subsequent measurement of the simple lease described in example 1 in chapter 3. Under this simple lease, the lessee has no right to extend the lease term or purchase the leased item nor does the lessee guarantee the value of the leased item at any point. Rentals payable are fixed.
- 5.3 Subsequent chapters describe how to account for more complex leases.
- 5.4 The boards discussed whether subsequent measurement of the right-of-use asset and the obligation to pay rentals should be linked. The first part of this chapter describes this approach.

A linked approach to subsequent measurement

- 5.5 In a lease there is a link between the obligation to pay rentals and the right-of-use asset. They arise from the same contract and do not normally exist independently of each other. The boards' decisions on initial measurement reflect this linkage.
- 5.6 Some think that subsequent measurement of the obligation to pay rentals and the right-of-use asset should also be linked for some leases. Consequently, they suggest a linked approach to subsequent measurement. This approach is based on the idea that there is a fundamental difference between a lease that is classified as an operating lease and a lease that is classified as a finance lease in accordance with existing standards.
- 5.7 Under this approach, leases that are currently classified as finance leases would be accounted for as purchases. Thus, the lessee would recognise interest expense on the obligation to pay rentals, amortise the asset and treat rental payments made as a reduction of the obligation to pay rentals.
- 5.8 A different method would apply to leases currently classified as operating leases. The lessee would:
 - (a) amortise the obligation to pay rentals using mortgage-based amortisation. No interest would be accrued on the obligation.

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Mortgage-based amortisation results in the obligation decreasing more in the later years of the lease than in the early years.

- (b) amortise the right-of-use asset using mortgage-based amortisation. This would result in a periodic amortisation charge that increases over the lease term.
- (c) base the amortisation of both the asset and the liability on the lessee's incremental borrowing rate. The amortisation of the asset and liability would net to zero in the income statement.
- (d) include rental payments as an expense in the income statement on a straight-line basis over the lease term.

Example 2 illustrates this approach to subsequent measurement.

Example 2 – A linked approach to subsequent measurement

A machine is leased for a fixed term of five years. The expected life of the machine is 10 years. The lease is non-cancellable, and there are no rights to purchase the machine at the end of the term and no guarantees of its value at that point. Lease payments of CU35,000* are due each year. No maintenance or other arrangements are entered into.

At the start of the lease the present value of the lease payments, discounted at the lessee's incremental borrowing rate of 8 per cent, is CU139,745.

Lease amortisation schedule

| Year | Obligation at the end of the year | Rent payment | Interest |
|---------------|--|-----------------------|----------------------|
| | CU | CU | CU |
| 0 | 139,745 | | |
| 1 | 115,925 | 35,000 | 11,180 |
| 2 | 90,199 | 35,000 | 9,274 |
| 3 | 62,415 | 35,000 | 7,216 |
| 4 | 32,408 | 35,000 | 4,993 |
| 5 | – | 35,000 | 2,592 |
| Total: | | <u>175,000</u> | <u>35,255</u> |

* In this paper monetary amounts are denominated in 'currency units (CU)'.

The following table illustrates the effect of the linked approach to subsequent measurement on the statement of financial position and the profit or loss:

| Statement of financial position | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---------------|---------------|---------------|---------------|---------------|
| | CU | CU | CU | CU | CU |
| Right-of-use asset | 115,925 | 90,199 | 62,415 | 32,408 | - |
| Obligation to pay rentals | (115,925) | (90,199) | (62,415) | (32,408) | - |
| Total: | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Profit or loss | | | | | |
| Amortisation of the right-of-use asset | 23,820 | 25,726 | 27,784 | 30,007 | 32,408 |
| Amortisation of the obligation to pay rentals | (23,820) | (25,726) | (27,784) | (30,007) | (32,408) |
| Rental expense | 35,000 | 35,000 | 35,000 | 35,000 | 35,000 |
| Total: | <u>35,000</u> | <u>35,000</u> | <u>35,000</u> | <u>35,000</u> | <u>35,000</u> |

- 5.9 This method of accounting for leases currently classified as operating leases results in:
- the right-of-use asset and the obligation to pay rentals remaining equal over the lease term (assuming even rental payments and no asset impairment)
 - the same income statement effect for leases currently classified as operating leases under existing lease accounting standards.
- 5.10 Supporters of this approach think that it has the following advantages:
- It reflects the pattern in which the economic benefits from the lease are consumed by the lessee. In a straightforward lease, the lessee pays for its right to use the leased item at the same time it receives the right and consumes its benefits.

- (b) It reflects the way in which some lease contracts are priced. Operating leases are priced to achieve an even rent expense over the lease term. This approach results in the lessee recognising these even rentals in the income statement over the lease term. Alternative approaches that require the lessee to recognise interest expense on the obligation to pay rentals and amortise the right-of-use asset, possibly on a straight-line basis, result in higher expenses in the early years of the lease.
- (c) This approach may be simpler for lessees to apply than an approach that does not link the lessee's right-of-use asset and obligation to pay rentals and, in some jurisdictions, would align the income statement and the tax treatment of leases.

Preliminary views

- 5.11 Some board members support the linked approach to subsequent measurement for some leases because they think that the costs associated with requiring recognition of interest and amortisation on some leases outweigh the benefits. However, these board members did not define to which leases this approach should apply.
- 5.12 However, the boards tentatively decided to reject this approach for the following reasons:
 - (a) The treatment of the obligation to pay rentals is inconsistent with the treatment of other financial liabilities, which could reduce comparability for users. Non-derivative financial liabilities (other than those measured at fair value) give rise to interest expense. The obligation to pay rentals in a lease contract clearly contains an interest component. If the lessee chose to prepay the lease, the amount prepaid would equal the present value of the future rentals discounted at a market rate of interest. Not recognising this interest component would fail to reflect the economics of the transaction. No interest expense is recognised under this approach.
 - (b) This approach requires the lessee to differentiate between finance leases and operating leases. This would add complexity to the proposed new standard and could result in similar lease contracts being accounted for differently.
 - (c) Although the right-of-use asset and the obligation to pay rentals are clearly linked at the inception of the lease, this is not necessarily the case after inception. For example, the right-of-use asset could

be impaired but the lessee would still be required to make the same rental payments. Conversely, increases in the value of the right-of-use asset do not necessarily result in a change to the rental payments.

- 5.13 As noted in chapter 3, the boards tentatively decided that in a lease contract the lessee has bought a right-of-use asset and is funding that acquisition with an obligation to pay rentals. Consistently with that decision, the rest of this chapter discusses non-linked subsequent measurement of the right-of-use asset and the obligation to pay rentals.

Subsequent measurement of the obligation to pay rentals

- 5.14 The boards considered two approaches for the subsequent measurement of the lessee's obligation to pay rentals:
- (a) fair value
 - (b) an amortised cost-based approach in which interest is accrued on the outstanding obligation to pay rentals.

Fair value approach

- 5.15 The boards discussed subsequent measurement at fair value of a lessee's obligation to pay rentals. Fair value measurement reflects current market conditions. Therefore, it can be argued that fair value measurement provides users of financial statements with information that is more relevant.
- 5.16 However, the boards noted the following disadvantages to requiring fair value measurement of the lessee's obligation to pay rentals:
- (a) Requiring fair value could result in lease liabilities being measured differently from similar non-lease financial liabilities. In accordance with both IFRSs and US GAAP, many similar financial liabilities are subsequently measured using an amortised cost-based approach.
 - (b) Requiring subsequent measurement at fair value would be inconsistent with the boards' tentative decision to require measurement at cost on initial recognition.
 - (c) Requiring continuous remeasurement of the obligation to pay rentals to fair value would be more costly and complex for preparers. Fair value measurement would be more costly because it requires the use of both current expected cash flows and current market interest rates.

Amortised cost-based approach

- 5.17 The boards discussed an amortised cost-based approach to subsequent measurement of the obligation to pay rentals. Under this approach the lessee would accrue interest on the outstanding obligation to pay rentals.
- 5.18 The boards noted the following advantages to an amortised cost-based approach:
- (a) It is consistent with the way many other non-derivative financial liabilities are measured. For example, debt used to purchase property, plant and equipment is usually measured on an amortised cost basis.
 - (b) It is consistent with the boards' tentative decision not to require fair value measurement on initial recognition.
 - (c) It is simpler and less costly for preparers.

Preliminary views

- 5.19 The boards think that, in the case of a lease contract, the disadvantages (described above) of requiring subsequent measurement of the obligation to pay rentals at fair value outweigh the potential benefits to users. Consequently, they tentatively decided to adopt an amortised cost-based approach to subsequent measurement of the obligation to pay rentals.
- 5.20 Both IFRSs and US GAAP permit an entity to elect to measure some financial liabilities at fair value. The boards will decide later in the project whether to permit fair value measurement of the obligation to pay rentals.

Reassessment of the incremental borrowing rate

- 5.21 As explained in chapter 4, the boards tentatively decided that on initial measurement the lessee should discount the lease payments using its incremental borrowing rate. The boards discussed whether to require the lessee to revise its obligation to pay rentals to reflect changes in the incremental borrowing rate.
- 5.22 It can be argued that revising the incremental borrowing rate to reflect current market conditions provides more relevant information to users of financial statements. It is also consistent with the approach required by IAS 37.

- 5.23 However, there are disadvantages to this approach:
- (a) It is inconsistent with the way many non-derivative financial liabilities are subsequently measured. Under the amortised cost-based approach, the carrying amount of financial liabilities is not revised for changes in market interest rates.
 - (b) Revising the incremental borrowing rate to reflect current market conditions will be more costly and complex for preparers. 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 by 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) It is arguably inconsistent with an amortised cost-based approach to subsequent measurement.

Preliminary views

- 5.24 The FASB tentatively decided not to require reassessment of the lessee's incremental borrowing rate.
- 5.25 The IASB tentatively decided that the lessee's obligation to pay rentals should be remeasured to reflect changes in the lessee's incremental borrowing rate. However, the IASB did not decide whether reassessment should take place at each reporting date or only when there is a change in estimated cash flows.

Accounting for changes in estimated cash flows

- 5.26 In some lease contracts, the rental payments under the lease are not fixed. Features of a lease contract that could result in a change to rentals payable include:
- (a) options to extend or terminate the lease
 - (b) purchase options
 - (c) contingent rental arrangements
 - (d) residual value guarantees.
- 5.27 Leases that include such features are discussed in later chapters. This section discusses how to reflect changes in the estimated lease payments arising from the features listed above in the lessee's obligation to pay rentals.

- 5.28 The boards discussed three possible ways in which changes in estimated lease payments could be included in the lessee's obligation to pay rentals:
- (a) the prospective approach, in which a new effective interest rate is computed on the basis of the carrying amount and remaining cash flows.
 - (b) the catch-up approach, in which the carrying amount of the liability is adjusted to the present value of the revised estimated cash flows, discounted at the original effective interest rate.
 - (c) the retrospective approach, in which a new effective interest rate is computed on the basis of the original carrying amount, actual cash flows to date and remaining estimated cash flows. The new effective interest rate is then used to adjust the carrying amount to the present value of the revised estimated cash flows, discounted at the new effective interest rate.

Example 3 illustrates these three approaches.

Example 3

A machine is leased for a fixed term of five years with an option to extend for two additional years; the expected life of the machine is 10 years. The lease is non-cancellable, and there are no rights to purchase the machine at the end of the term and no guarantees of its value at any point. Lease payments of CU35,000 are due each year. No maintenance or other arrangements are entered into.

At the start of the lease the present value of the lease payments over the five-year period discounted at the lessee's incremental borrowing rate of 8 per cent is CU139,700. At the start of the lease, the lessee does not intend to exercise the option.

At the end of the third year, the lessee decides it will exercise the option. At this point, the present value of the originally assessed lease payments is CU62,400.

The prospective approach would not adjust the carrying amount of CU62,400 at the end of year 3. A new effective interest rate would be calculated on the basis of the carrying amount of CU62,400 and the remaining cash flows ($CU35,000 \times 4$ years). The new effective interest rate would be 42 per cent.

continued...

...continued

Example 3

The catch-up approach would revise the carrying amount of the liability at the end of year 3. The revised carrying amount would equal the present value of the revised estimated cash flows discounted at the original effective interest rate of 8 per cent (CU115,900).

The retrospective approach would adjust the carrying amount of the liability at the end of year 3 to the present value of the revised estimated cash flows discounted at a new effective interest rate of 16 per cent (CU97,900). The new effective interest rate would be calculated on the basis of the carrying amount of the liability at the start of the lease (CU139,700), actual rental payments to date (CU35,000 × 3 years) and the revised estimated cash flows (CU35,000 × 4 years).

The table below summarises the differences in the carrying amount of the obligation to pay rentals and the effective interest rates for the three approaches discussed in paragraph 5.28:

| Approach | Original carrying amount at the end of year 3 | Original effective interest rate | Revised carrying amount at the end of year 3 | Revised effective interest rate |
|---------------|---|----------------------------------|--|---------------------------------|
| Prospective | 62,400 | 8% | 62,400 | 42% |
| Catch-up | 62,400 | 8% | 115,900 | 8% |
| Retrospective | 62,400 | 8% | 97,900 | 16% |

Preliminary views

- 5.29 The boards noted that the catch-up approach is consistent with how some financial liabilities are measured in accordance with both IFRSs and US GAAP. Consequently, they tentatively decided to adopt the catch-up approach. Thus, the carrying amount of the obligation to pay rentals would be adjusted to reflect the revised estimated cash flows.
- 5.30 However, as noted in paragraph 5.25 the IASB tentatively decided that the lessee's incremental borrowing rate should be updated to reflect current conditions. Thus, a revised incremental borrowing rate, rather than the original incremental borrowing rate, would be used to calculate the catch-up adjustment. The FASB tentatively decided to continue using the original incremental borrowing rate.

Cross-referring to existing guidance

- 5.31 The lessee's obligation to pay rentals meets the definition of a financial liability in accordance with both IFRSs and US GAAP.
- 5.32 In developing their preliminary views, the boards decided to specify the required accounting for the obligation to pay rentals in the proposed leases standard. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
- 5.33 Under IAS 39, financial liabilities that are not classified as at fair value through profit or loss are initially measured at fair value plus transaction costs and are subsequently measured on an amortised cost basis. In addition, if qualifying conditions are met, an entity can elect to measure a financial liability at fair value.
- 5.34 The boards' tentative decisions on initial and subsequent measurement of the obligation to pay rentals are not the same as the requirements of IAS 39. For example, the boards tentatively decided not to require initial measurement at fair value and the IASB tentatively decided that the lessee's incremental borrowing rate should be revised to reflect current conditions.
- 5.35 Similarly, APB Opinion No. 21 *Interest on Receivable and Payables* sets out the accounting requirements for interest-bearing liabilities under US GAAP (the interest method of amortisation), which is consistent with the boards' tentative decisions on subsequent measurement. The FASB could require lessees to account for their obligation to pay rentals in accordance with this guidance rather than specifying the required accounting in the proposed leases standard.
- 5.36 The boards acknowledge that specifying the required accounting rather than cross-referring to existing guidance could reduce comparability for users. This is because financial liabilities arising in a lease contract will be accounted for differently from other financial liabilities. However, specifying the required accounting would result in the obligation to pay rentals being accounted for in the same way under US GAAP and IFRSs even before the two boards' financial instruments standards converge.

Subsequent measurement of the right-of-use asset

- 5.37 The boards considered fair value and amortised cost approaches to the subsequent measurement of the lessee's right-of-use asset.

- 5.38 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 than amortised cost.
- 5.39 However, the boards noted the following disadvantages to requiring fair value measurement of the right-of-use asset:
- (a) Requiring fair value measurement could reduce comparability for users of financial statements because it would be inconsistent with the treatment of other non-financial assets. For example, IAS 16 and IAS 38 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 43 and SFAS 142).
 - (b) Requiring subsequent measurement at fair value would be inconsistent with the boards' tentative decision not to require fair value measurement of the right-of-use asset on initial recognition.
 - (c) Requiring continuous remeasurement of the right-of-use asset to fair value would be difficult and costly for preparers. This disadvantage is more significant for subsequent measurement than for initial measurement because there is no transaction to help determine fair value.
- 5.40 Amortised cost-based measurement requires the lessee to amortise the right-of-use asset over the shorter of the lease term and the economic life of the leased asset. For leases of items in which it is expected 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. Amortisation would be based on the pattern of consumption of economic benefits embodied in the right-of-use asset.
- 5.41 The boards noted that requiring the right-of-use asset to be measured on an amortised cost basis would be:
- (a) consistent with the treatment of other non-financial assets
 - (b) consistent with the boards' tentative decision to measure the right-of-use asset on a cost basis at initial recognition
 - (c) easier and less costly for preparers to apply.

Preliminary views

- 5.42 The boards think that the disadvantages of requiring subsequent measurement of the right-of-use asset at fair value outweigh the potential benefits to users of financial statements. Consequently, the boards tentatively decided that a lessee should subsequently measure the right-of-use asset on an amortised cost basis.
- 5.43 Some members of the FASB think that describing the decrease in value of the right-of-use asset as amortisation or depreciation is potentially misleading for some leases. They think that the decrease in value of the right-of-use asset represents the lessor's charge for the use of the leased item. Consequently, they think the decrease in value of the right-of-use asset should be described in the income statement as rental expense. The interest component of the rental payment would continue to be described as interest expense. However, these board members did not define to which leases this approach should apply.

Impairment

- 5.44 The right-of-use asset will be reviewed for impairment. The boards have not yet reached a preliminary view on how to determine impairment of a right-of-use asset. The boards will resolve this issue before publishing an exposure draft of a proposed new standard.

Questions for respondents

Question 8

The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach?

If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

Question 9

Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

Question 10

Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.

If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

Question 11

In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.

Do you agree with the proposed approach taken by the boards?

If you disagree, please explain why.

Question 12

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.

Would you support this approach? If so, for which leases?

Please explain your reasons.

Chapter 6: Leases with options

Introduction

- 6.1 Lease contracts 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 (term options)
 - (b) the factors to be considered when determining whether a lessee will exercise an option to extend or terminate the lease
 - (c) reassessment of the lease term.
- 6.2 This chapter also discusses how to account for leases that incorporate options that grant the lessee the right to purchase the leased item (purchase options).
- 6.3 The final section of this chapter illustrates how a lease that contains both an option to extend the lease term and a purchase option would be accounted for under the approach proposed in this discussion paper.

Implicit options

- 6.4 It is often the case that at the end of a lease a lessee and lessor negotiate a new contract that permits the lessee to continue using the leased item. Some constituents think that this ability to renegotiate the lease constitutes an implicit option that should be considered when determining the lease term. They note that a lessee that is likely to renegotiate a lease at the end of the lease term is in an economic position similar to a lessee that has a contractual option to renew the lease at market rentals. If only contractual options are considered, the lessee with an implicit option could not recognise a lease term that is longer than the contractually stated term. However, the lessee that has a contractual option could include the optional period in the recognised lease term.
- 6.5 Others note that the contractual position of a lessee with an option to extend is different from that of a lessee without such an option. Consequently, they do not agree that a lessee with an option to renew at market rentals is in the same economic position as a lessee that has no such option.

- 6.6 Options that are included in the terms of a lease contract (contractual options) can significantly affect the rights and obligations arising in a lease contract. Consequently, the rest of this chapter discusses contractual options.

Recognition of leases with term options

- 6.7 If a lease includes an option for the lessee to extend the lease term, the lessee will 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 be structured as an eight-year lease with an option to terminate after five years.
- 6.8 As discussed in chapter 3, the boards tentatively decided not to adopt a components approach to lease contracts and instead decided to adopt a single asset and liability approach. Consequently, although options to extend or terminate a lease both meet the definition of an asset, the boards tentatively decided not to recognise them separately from the right-of-use asset. Similarly, under a components approach to lease contracts it can be argued that the lessee's obligation to pay rentals in an optional period does not meet the definition of a liability. However, under the single asset and liability approach tentatively adopted by the boards, the lease contract is viewed as giving rise to a single liability (the obligation to pay rentals) that may include rentals payable in optional periods.
- 6.9 The boards considered two approaches to accounting for leases that incorporate options to extend or terminate the lease:
- (a) The lessee recognises an obligation to pay rentals and uncertainty about the lease term is addressed through measurement.
 - (b) The lessee recognises an obligation to pay rentals and uncertainty about the lease term is addressed through recognition—ie one of the possible lease terms is selected and the accounting is based on that lease term.

- 6.10 Each of those approaches is discussed below.

Approach (a) — uncertainty about the lease term is addressed through measurement

- 6.11 Under this approach, uncertainty about the lease term would be dealt with in the measurement of the obligation to pay rentals. Consider the following example:

Example 4

A machine is leased for a period of 10 years (the primary period). The lease contract includes an option for the lessee to lease the machine for an additional five years (the secondary period). Annual rentals in both the primary and the secondary period are CU100. The lessee determines there is an 80 per cent probability that the option to use the machine in the secondary period will be exercised.

- 6.12 Ignoring the effect of discounting and using an expected outcome approach to measurement, the lessee would recognise an obligation to pay rentals of CU1,400 ($20\% \times \text{CU}100 \times 10 \text{ years} + 80\% \times \text{CU}100 \times 15 \text{ years}$).
- 6.13 The lessor's delivery of the machine to the lessee is considered the triggering event that will lead to an outflow of economic resources.* For recognition purposes, there is no need to specify whether the lease will be for 10 years or 15 years. The obligation to pay rentals has been incurred and uncertainty about the lease term is addressed through measurement.
- 6.14 This approach does not result in separate recognition of the renewal option. However, the renewal option and the probability that it will be exercised are incorporated into the measurement of the obligation to pay rentals. Consequently, it can be argued that this approach better reflects the existence of the option than approach (b).
- 6.15 Critics of this approach note that reliably measuring the probability of exercise of a renewal option may be difficult. In addition, they note that this approach could result in the lessee recognising an obligation to pay rentals that does not reflect a possible outcome. In example 4, the lessee recognises an obligation to pay rentals of CU1,400. This corresponds to a lease term of 14 years. However, the term of the lease in example 4 can be only 10 years or 15 years; it cannot be 14 years.

* Alternatively, the boards may specify that the signing of the lease contract is the triggering event. This issue is discussed in chapter 9.

Approach (b) — uncertainty about the lease term is addressed through recognition

- 6.16 This approach would describe the lease in example 4 as either a 10-year lease or a 15-year lease. Thus, it would describe the item being recognised as an obligation to pay 10 years of rentals or an obligation to pay 15 years of rentals. The lessor's delivery of the leased property to the lessee is the triggering event that will lead to an outflow of economic resources. Under this approach the uncertainty about the lease term is addressed through recognition.
- 6.17 If the lessee decides it is recognising a 10-year lease then the measurement of the obligation to pay rentals would not include the probability that the lessee would exercise the renewal option. Likewise, if the lessee decides it is recognising a 15-year lease then the measurement of the obligation to pay rentals would include an assumption that the lessee would exercise the renewal option.
- 6.18 This approach considers the evaluation of renewal options as a question of uncertainty about what the past transaction or event was that gave rise to a present obligation. In other words, did the lessee obtain the right to use an asset for 10 years and a corresponding obligation to pay 10 years of rentals, or did it obtain the right to use an asset for 15 years and a corresponding obligation to pay 15 years of rentals?
- 6.19 It can be argued that this approach reflects the binary nature of a recognition decision. A lessee will either renew a lease or it will not. This approach would reflect that fact by either including or excluding rentals payable in an optional period in the obligation recognised.
- 6.20 A criticism of this approach is that once a decision about lease term is made, the existence of the option is effectively ignored (unless reassessment of the lease term is required). If it is decided that the lease in example 4 is a 10-year lease, the fact that the lessee has an option to use the machine in the secondary period is ignored when measuring the obligation to pay rentals. Conversely, if the lease is determined to be a 15-year lease, the possibility that the lease could be for a shorter period is ignored.
- 6.21 In addition, this approach fails to differentiate between a 10-year lease that is likely to be renewed for an additional five years and a non-cancellable 15-year lease. Under a non-cancellable lease, the lessee is required to pay 15 years of rentals. Under a lease with an option, the lessee can avoid paying rentals after the end of 10 years. This issue is discussed in paragraph 6.37.

Preliminary views

- 6.22 The boards tentatively decided to adopt approach (b). Uncertainty about the lease term should be addressed through recognition and the lessee should recognise an obligation to pay rentals for a specified lease term (either 10 years or 15 years in example 4). The boards noted that this approach avoids many of the measurement problems associated with approach (a) and consequently should be easier for preparers to apply.
- 6.23 The boards noted that additional disclosures may be required to enable users to differentiate between leases that include options and leases that do not. In addition, requiring reassessment of the lease term may alleviate any concerns that this approach ignores the existence of options. Reassessment of the lease term is discussed in paragraphs 6.42–6.47.

Determining the lease term

- 6.24 The boards considered three possible approaches to determining the specified lease term:
- (a) a probability threshold
 - (b) a qualitative assessment of the lease term
 - (c) the most likely lease term.
- 6.25 Each of those approaches is discussed in the following sections. The factors to consider when determining the lease term are also discussed below.

A probability threshold

- 6.26 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 that 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.
- 6.27 This is similar to the approach used in the existing lease accounting standards. Under those standards, optional periods are included in the lease term if it is reasonably certain (reasonably assured) that the lessee will exercise its right to use the leased item in the optional period. That approach has been criticised for using a bright-line test to determine the lease term. Under existing standards, whether an optional period is included in the lease term will often determine whether a lease is classified as an operating lease or a finance lease and, consequently,

whether the lessee recognises assets and liabilities. Under the right-of-use approach proposed in this paper, whether an optional period is included in the lease term will determine the size of the recognised asset and liability.

- 6.28 The boards discussed using different probability thresholds to determine the lease term including: virtually certain, reasonably certain, probable and more likely than not.
- 6.29 The main advantage of using a probability threshold to determine the lease term is that it is familiar to preparers.
- 6.30 However, the boards noted the following disadvantages:
- (a) there is no conceptually correct probability threshold. Each of the 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 think that setting a probability threshold would represent a rule rather than a principle-based approach.

A qualitative assessment of the lease term

- 6.31 The second approach considered by the boards was to require lessees to make a qualitative assessment of the lease term. This approach would rely on the judgement of preparers to determine the substantive lease term on the basis of reasonable and supportable assumptions. However, no quantitative guidance on what would constitute the substantive lease term would be given.
- 6.32 The advantages of this approach are:
- (a) Simplicity – preparers should be able to do this. Typically a lessee will estimate how long it will use a leased asset when signing a lease and will also assess lease terms for budgets or other internal purposes.
 - (b) It avoids the bright lines associated with a probability threshold.
- 6.33 The boards noted the following disadvantages to this approach:
- (a) It may reduce comparability for users because this approach could be interpreted to allow almost any method for estimating the lease term. As a result, different lessees in similar economic positions could account for the same lease in very different ways.

- (b) Constituents are likely to ask for additional guidance on how to make a qualitative assessment of the lease term.

The most likely lease term

- 6.34 The final approach considered by the boards was to require the lessee to recognise an obligation to pay rentals on the basis of the most likely lease term. As with the qualitative assessment approach, the lessee would determine the lease term on the basis of reasonable and supportable assumptions. However, under the most likely lease term approach the lessee would be explicitly required to determine the most likely outcome.
- 6.35 Example 5 illustrates this approach.

Example 5

A lessee enters into a five-year lease of real estate. At the end of the first five years, the lessee has an option to renew the lease at the market rental rate (at the time of renewal) for another five years (the lessee then has the same option at the end of years 10, 15 and 20). The lessee constructs significant leasehold improvements on the real estate that have a 10-year life.

| | | | | | |
|--------------------|---------|----------|----------|----------|----------|
| Lease term | 5 years | 10 years | 15 years | 20 years | 25 years |
| Probability | 10% | 35% | 20% | 20% | 15% |

This example represents a relatively mature business that has experience in expanding to new locations (eg a successful restaurant chain). The probabilities reflect the fact that the lessee generally will need more than five years to recover its investment in the location; however, there is a chance that it would be willing to bear the costs of non-renewal.

Because of the existence of the leasehold improvements, management concluded that the most likely lease term is 10 years (ie the lease term with the highest probability). Consequently, under this approach, the lessee would determine that the lease term is 10 years.

Preliminary views

- 6.36 The boards tentatively decided to require the lessee to determine the most likely lease term because it avoids many of the problems associated with the other approaches.

6.37 Some board members noted that the approach proposed by the boards would fail to differentiate between (for example):

- (a) a five-year lease with an option to extend for an additional three years that is likely to be exercised, and
- (b) an eight-year lease.

Under both leases, the lessee would recognise an obligation to pay eight years of rentals. However, under the five-year lease with an option, the lessee can avoid paying rentals in the secondary period. Consequently, those board members do not support the proposed approach. Instead they think that unless the option to renew is priced to give the lessee a significant incentive to renew, the lessee should recognise its obligation to pay rentals on the basis of the minimum contractual term.

Factors to be considered in determining the lease term

6.38 Options to extend or terminate a lease are very different from some financial options (eg 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 on factors other than the exercise price of the option. Consequently, the boards discussed whether to provide guidance on the factors to be considered when determining the lease term.

6.39 Factors that could affect the lease term can broadly be characterised as follows:

| Category | Description | Examples |
|---------------------|---|---|
| Contractual factors | Explicit contractual terms that could affect whether the lessee extends or terminates the lease | <ul style="list-style-type: none"> • 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 |
| <i>continued...</i> | | |

LEASES—PRELIMINARY VIEWS

| <i>...continued</i> | | |
|-----------------------------------|---|---|
| Category | Description | Examples |
| Non-contractual financial factors | Financial consequences of a decision to extend or terminate the lease that are not explicitly stated in the contractual terms | <ul style="list-style-type: none"> • 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 | <ul style="list-style-type: none"> • Nature of the asset (core vs non-core, specialised vs non-specialised, willingness to allow a competitor to use the leased property) • Location of the asset • Industry practice |
| Lessee specific factors | Lessee specific considerations | <ul style="list-style-type: none"> • Lessee intentions • Past practice |

- 6.40 The boards discussed 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 assumed lease terms. For example, a lessee that 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. 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 (eg a production line) is much less likely to terminate the lease early than a lessee that leases a non-core asset (eg 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 intentions 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 (eg budgets, plans, forecasts, prior actions and industry practice).

Preliminary views

- 6.41 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 business factors are considered in determining the lease term. The lessee's intentions and past practice would not be considered.

Reassessment of the lease term

- 6.42 The boards discussed whether to require reassessment of the lease term after initial recognition and the effect that reassessment would have on the recognised assets and liabilities.
- 6.43 Existing lease accounting standards do not require reassessment of the lease term unless specified conditions are met (eg 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.
- 6.44 Example 6 illustrates the statement of financial position and profit or loss effects of a lease that is not reassessed until an option to extend is exercised. At the inception of the lease, the most likely lease term is determined to be five years. On exercising the option to extend, the lessee recognises a new right-of-use asset and a corresponding liability.

Example 6 — No reassessment of the lease term

Assumptions

- Primary non-cancellable lease period — five years
- Secondary optional period — three years
- Annual rentals — CU100, paid in arrears
- Lessee's incremental borrowing rate over the entire lease period — 10 per cent
- For initial measurement, (a) 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 (b) the right-of-use asset is equal to the obligation.
- For subsequent measurement, (a) the obligation is amortised using the effective interest method over the expected lease term and (b) the right-of-use asset is depreciated on a straight-line basis over the expected lease term.
- The lessee is neither required nor permitted to exercise the renewal option until the end of the five-year period.
- At the end of five years, the lessee exercises its option to renew the lease.
- On exercise of the option, the lessee will recognise the present value of the remaining lease payments as the revised lease obligation (CU249) and adjust the right-of-use asset.

continued...

*...continued***Example 6 — No reassessment of 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 | 6 | 7 | 8 |
| Statement of financial position | | | | | | | | | |
| Right-of-use asset | 379 | 303 | 227 | 152 | 76 | 249 | 166 | 83 | – |
| Obligation to pay rentals | (379) | (317) | (249) | (174) | (91) | (249) | (174) | (91) | – |
| Cash | – | (100) | (200) | (300) | (400) | (500) | (600) | (700) | (800) |
| Profit or loss | | | | | | | | | |
| Depreciation | | (76) | (76) | (76) | (76) | (76) | (83) | (83) | (83) |
| Interest | | (38) | (32) | (25) | (16) | (9) | (25) | (17) | (9) |
| Total | | <u>(114)</u> | <u>(108)</u> | <u>(101)</u> | <u>(92)</u> | <u>(85)</u> | <u>(108)</u> | <u>(100)</u> | <u>(92)</u> |

- 6.45 Example 7 illustrates the effect of early termination on a lease whose term is not reassessed. In this lease, the most likely lease term is determined to be eight years at inception. In general, early termination of a lease whose term is not reassessed will result in the lessee recognising a gain.

Example 7 — No reassessment of the lease term with an early termination*Assumptions*

- All assumptions are the same as in example 6 except:
 - the most likely lease term at inception is eight years.
 - at the end of year 5, the option to extend the lease is not exercised.

continued...

...continued

Example 7 — No reassessment of the lease term with an early termination

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 | 533 | 467 | 400 | 333 | 267 | 200 |
| Obligation to pay rentals | (533) | (487) | (436) | (379) | (317) | (249) |
| Cash | – | (100) | (200) | (300) | (400) | (500) |
| Profit or loss | | | | | | |
| Depreciation | | (67) | (67) | (67) | (67) | (67) |
| Interest | | (53) | (48) | (43) | (38) | (32) |
| Gain/(loss) on termination | | – | – | – | – | 49 |
| Total | | <u>(120)</u> | <u>(115)</u> | <u>(110)</u> | <u>(105)</u> | <u>(50)</u> |

A gain of CU49 is recognised on early termination. This reflects the fact that the carrying amount of the asset that is derecognised is less than the carrying amount of the liability that is derecognised. This is because the asset has been depreciated more quickly than the liability has been amortised.

- 6.46 The boards noted that requiring the lessee to reassess the lease term at each reporting date is likely to provide users of financial statements with more relevant information. Lease terms, particularly in real estate leases, can be very long. Using a lease term that is based on assumptions made several years previously could be misleading. However, requiring reassessment of the lease term is more complex and is likely to be more costly for preparers.

Preliminary views

- 6.47 Because requiring reassessment of the lease term is likely to provide users of financial statements with more relevant information, the boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances.

Accounting for a change in the obligation to pay rentals

- 6.48 Requiring the lessee to reassess the lease term at each reporting date will result in a change in the carrying amount of the obligation to pay rentals. The boards discussed two ways to account for a change in the obligation to pay rentals arising from a reassessment of the lease term:
- (a) recognise any change in the liability in profit or loss
 - (b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
- 6.49 Example 8 illustrates the effect of reassessment if changes in the obligation are recognised as an adjustment to the carrying amount of the right-of-use asset. The most likely lease term is determined as five years at inception.

Example 8 — Reassessment of the lease term

Assumptions

- All assumptions are the same as in example 6 except:
 - The most likely lease term is reassessed as eight years at the start of year 4.
 - At the start of year 4, the lessee calculates the present value of the remaining lease payments (CU379) and adjusts the obligation to pay rentals and the right-of-use asset

Dr Right-of-use asset CU205

Cr Obligation to pay rentals CU205

- No adjustment is necessary for the lease obligation and the right-of-use asset when the option is exercised.

continued...

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Example 8 — Reassessment of the lease term

The following table illustrates the revised relevant portions of the statement of financial position and profit or loss assuming no further changes in 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 | – |
| Obligation to pay rentals | (379) | (317) | (249) | (174) | (317) | (249) | (174) | (91) | – |
| Cash | – | (100) | (200) | (300) | (400) | (500) | (600) | (700) | (800) |
| Profit or loss | | | | | | | | | |
| Depreciation | | (76) | (76) | (76) | (71) | (71) | (71) | (71) | (71) |
| Interest | | (38) | (32) | (25) | (38) | (33) | (25) | (17) | (9) |
| Total | | (114) | (108) | (101) | (109) | (104) | (96) | (88) | (80) |

- 6.50 Recognising a 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 does not result in a change in the carrying amount of an asset.
- 6.51 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 three years to four years, the obligation to pay rentals increases. In addition, there is a corresponding increase in the value of the right-of-use asset (assuming there is no impairment) because the lessee now expects to use the asset for four years rather than three years. In effect, the lessee has purchased an additional right of use.
- 6.52 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 in Existing Decommissioning, Restoration and Similar Liabilities* and SFAS 143 *Accounting for Asset Retirement Obligations* when the carrying amount of the recognised asset is adjusted for changes in a decommissioning liability.
- 6.53 The FASB also discussed a third approach to accounting for reassessments of the lease term. The lessee would be required to recalculate both the

obligation to pay rentals and the right-of-use asset on the assumption that the lessee originally recognised a lease term equal to the reassessed term. The net difference between:

- (a) the carrying amounts of the asset and liability on the date of reassessment, and
- (b) what the carrying amounts would have been had the lessee originally assessed the lease term as the reassessed term

would result in adjustments to the asset, liability and profit or loss. The FASB tentatively decided to reject this approach because it is too complex.

Preliminary views

- 6.54 The boards tentatively decided that changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Leases with purchase options

- 6.55 Purchase options give 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 at a fixed price.

Preliminary views

- 6.56 The boards noted that purchase options can be viewed as the ultimate renewal option. Providing a purchase option is no different from providing renewals that extend over the entire economic life of the leased item. Consequently, the boards tentatively concluded that the accounting requirements for purchase options should be the same as for options to extend or terminate the lease.
- 6.57 Therefore, the boards tentatively decided that:
- (a) purchase options should not be recognised as separate assets.
 - (b) in recognising the obligation to pay rentals, the lessee must decide whether it is likely that an option to purchase will be exercised. If the lessee decides that the option to purchase is likely to be exercised, the obligation to pay rentals will include the exercise price of the option.

- (c) the assessment of the lease term will be based on the lessee's determination of the most likely outcome.
 - (d) in deciding the most likely outcome, the lessee will consider contractual, non-contractual and business factors.
 - (e) whether a purchase option will be exercised will be reassessed at each reporting date.
 - (f) changes in the obligation to pay rentals arising from reassessing whether a purchase option will be exercised should result in a change in the carrying amount of the right-of-use asset.
- 6.58 As noted when discussing options to extend or terminate a lease, some board members disagree with the boards' proposed approach to options. Those board members note that including the exercise price of a purchase option in the rentals to be discounted may result in an overstatement of the right-of-use asset. This is because the rentals will include a premium for the option. Consequently, including both this premium and the exercise price of the option in the rentals to be discounted will lead to an overstatement of the right-of-use asset. Those board members would include the exercise price of a purchase option in the measurement of the obligation to pay rentals only if the purchase option was priced to provide a significant incentive to exercise the option. This is consistent with their views on options to extend or terminate a lease.

Applying the approach to a lease with both purchase and renewal options

- 6.59 Lease contracts will sometimes contain multiple options. Under the approach proposed in this chapter, the obligation to pay rentals recognised by the lessee must be consistent with the outcome the lessee determines is most likely.
- 6.60 For example, a lease contract may have a primary period of 10 years. At the end of the 10-year period the contract permits the lessee to purchase the leased item for a fixed price, to return the leased item to the lessor or to extend the lease for an additional five years. Under the approach described in this chapter, the lessee must determine at the start of the lease which of the three outcomes (purchase, return or extend) is the most likely and recognise an obligation to pay rentals that is consistent with that outcome. For example:
- (a) If purchase is the most likely outcome, the lessee would recognise an obligation to pay rentals equal to the present value of 10 years of

rentals plus the present value of the exercise price of the purchase option. The right-of-use asset would be amortised over the useful life of the underlying asset.

- (b) If returning the asset is the most likely outcome, the lessee would recognise an obligation to pay rentals equal to the present value of 10 years of rentals.
- (c) If renewal is the most likely outcome, the lessee would recognise an obligation to pay rentals equal to the present value of 15 years of rentals.

6.61 A reassessment of which of the three outcomes is most likely would be made at the end of each reporting period on the basis of any new facts or circumstances.

Questions for respondents

Question 13

The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Question 14

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information?

Please explain why.

Question 15

The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.

Do you agree with the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Chapter 7: Contingent rentals and residual value guarantees

Introduction

- 7.1 Contingent rentals and residual value guarantees have many features in common. Both result in leases whose payments are variable rather than fixed. Indeed, residual value guarantees can be viewed as a type of contingent rental payment; a residual value guarantee is a rental payment that is contingent on the value of the leased item at a point in time, usually at the end of the lease. The boards' preliminary views on how to account for contingent rentals and residual value guarantees as set out in this chapter reflect this similarity.

Contingent rentals

- 7.2 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. These are contingent rentals. The boards discussed how to account for leases that contain contingent rentals, and in particular:
- (a) whether the lessee's 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
 - (c) whether to require reassessment of the obligation to pay rentals for changes in estimated contingent rentals
 - (d) how to account for changes in the obligation to pay rentals arising from reassessment.
- 7.3 There are three main categories of contingent rentals:
- (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 under which the lessee pays rentals on the basis of 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.

- 7.4 In some situations, contingent rental arrangements may qualify as embedded derivatives that are required to be separated from the host lease contract and accounted for as a derivative. The proposals in this discussion paper would not change this requirement.

Recognition of contingent rentals

- 7.5 The boards considered two approaches to the recognition of contingent rentals:
- (a) follow existing lease accounting standards (generally recognise as an expense as incurred)
 - (b) reflect the obligation to pay contingent rentals in the measurement of the liability.
- 7.6 Under existing lease accounting standards, contingent rentals that are based on usage or the lessee's performance are generally excluded from the calculation of minimum lease payments and are recognised as expenses in the period in which they are incurred. Contingent rentals that are based on an existing index are included in minimum lease payments on the basis of 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 the approach used in existing standards think that the lessee's obligation to pay contingent rentals does not exist until the future event requiring the payment occurs (ie the leased asset is used, a sale is made or the level of the index changes). Consequently, they think that recognising an obligation to pay contingent rentals before the contingency is resolved would overstate the liabilities of the lessee.
- 7.8 However, there are disadvantages to this approach:
- (a) It may understate the assets of the lessee. For example, for a lease in which rentals are completely contingent on sales from the leased property, the lessee would recognise 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 on the lessee's exercising its option to extend the lease. However, the boards tentatively decided that, in some situations, the lessee's obligation to pay rentals should include rentals payable in the optional period.

- (c) It would be possible at the start of the lease 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.
- 7.9 The second approach considered by the boards was to reflect the obligation to pay contingent rentals in the measurement of the liability. Under this approach, the lessee's obligation to pay rentals is viewed as an unconditional obligation. The fact that all (or a portion) of the rentals are contingent would be reflected in the measurement of the liability.
- 7.10 This approach has the following advantages:
- (a) It is consistent with the boards' preliminary views on the recognition of options to extend or terminate the lease. The boards tentatively concluded that the lessee's obligation to pay rentals should in some situations include rentals payable in the optional period.
 - (b) It reflects the fact that even though the lessee's rental payments are contingent, the lessee has obtained an asset representing the right to use the leased item. Excluding contingent rentals from the obligation to pay rentals could lead to an understatement of that right-of-use asset.
 - (c) It improves comparability for users because it is consistent with the treatment of other asset acquisitions. For example, if an entity agrees to buy a property in return for a payment that is contingent on future sales, the acquiring entity would recognise 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. The obligation to pay rentals is unconditional and hence meets the definition of a liability. Only the amount that will be paid is uncertain.
- 7.12 However, some board members think that the treatment of contingent rental payments should depend on the nature of the contingency to which the payment is linked. They think that when payment is linked to usage or the performance of the lessee, the obligation to pay rentals should exclude the contingent element. When payment is linked to an index those board members would include the contingent element in the recognised obligation. Supporters of this approach note that when

payments vary with usage or performance, any increase in the obligation to pay rentals is matched by a corresponding increase in the lessee's economic activity. This is not the case when payment is linked to an index. Consequently, these board members think that basing the treatment of contingent rentals on the nature of the contingency provides users of financial statements with more useful information than the approach proposed by the boards.

Measurement of contingent rentals

- 7.13 The boards discussed two approaches to measuring the lessee's obligation to pay rentals when the obligation includes contingent payments:
- (a) a probability-weighted estimate of the rentals payable (an expected outcome technique)
 - (b) the most likely rental payment.

The following sections discuss those approaches.

A probability-weighted estimate of the rentals payable

- 7.14 This approach would consider the range of possible outcomes and their relative probabilities. Example 9 illustrates how this approach would be applied.

Example 9

A lessee enters into a five-year lease of a retail store. The lease is non-cancellable and the lessee has no option to extend the lease. The lessee is required to make fixed annual payments of CU100. In addition, the lessee is required to make payments equal to 1 per cent of sales from the leased store. The lessee forecasts the following sales for the store and assigns each outcome a probability:

| | | | |
|---|--------|--------|--------|
| Total forecast sales years 1–5 (CU) | 10,000 | 20,000 | 35,000 |
| Probability that forecast sales will occur | 10% | 60% | 30% |
| Total fixed rentals years 1–5 (CU) | 500 | 500 | 500 |
| Total contingent rentals 1% of forecast sales (CU) | 100 | 200 | 350 |
| Total estimated rentals years 1–5 (CU) | 600 | 700 | 850 |

Using a probability-weighted estimate of the rentals payable and ignoring the effects of discounting the lessee recognises an obligation to pay rentals of CU735 ($600 \times 10\% + 700 \times 60\% + 850 \times 30\%$).

- 7.15 This approach to measuring the obligation to pay rentals has the following advantages:
- (a) When combined with reassessment of the lease term, it provides relevant information to users of financial statements because it reflects the current state of the entity. In other words, this approach reflects the fact that the lessee has entered into an agreement to pay rentals of an uncertain amount.
 - (b) The measurement of the obligation to pay rentals reflects the fact that the probability distribution of the rental payments may be skewed. For example, the approach would take account of:
 - (i) high (or low) potential payments that have only a low probability of occurring.
 - (ii) payments that have a high probability of occurring but are not the most likely. For example, a lessee could have a 55 per cent probability of paying CU100 and a 45 per cent probability of paying CU200. A probability-weighted approach would reflect the probability of the higher payment in the measurement of the obligation to pay rentals. A most likely payment approach would not.
 - (c) It is consistent with the way some liabilities of uncertain amount are measured (eg liabilities measured in accordance with IAS 37).
- 7.16 The disadvantages of this approach are:
- (a) It may be complex and costly for preparers to apply because they will be required to consider possible outcomes and their associated probabilities in measuring the obligation to pay rentals.
 - (b) It may be difficult for the lessee to determine the probability of each of the possible outcomes. Consequently, the measurement of the liability may not be any more reliable than other less complex approaches.
 - (c) In some cases, it could result in a measurement that reflects an outcome that will never happen. For example, if a lease required the lessee to pay either CU400 or CU600 and both outcomes have the same probability, the lessee would recognise a liability of CU500—an amount that will not be paid.

The most likely rental payment

- 7.17 This approach would require the lessee to determine the most likely rental payment. In example 9, the most likely rental payment is CU700. However, in most cases it would not be necessary to formally assign probabilities to each of the possible outcomes. Instead, the lessee would be required to assess what is the most likely outcome.
- 7.18 The advantages of this approach are:
- (a) It is simpler to apply than the probability-weighted approach because it may not require a detailed assessment of all possible outcomes.
 - (b) It will not result in a measurement of the obligation to pay rentals that reflects an impossible outcome.
- 7.19 The disadvantages of this approach are:
- (a) The measurement of the obligation does not reflect the fact that the lessee has agreed to make a payment of an uncertain amount. Instead, it attempts to predict the most likely outcome.
 - (b) It ignores the fact that the probability distribution may be skewed.

Preliminary views

- 7.20 The IASB thinks that measuring liabilities of uncertain amount using expected outcome techniques provides the most useful information to users. Consequently, it tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable.
- 7.21 The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payments. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. The FASB also tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee would initially measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Changes in amounts payable arising from changes in the indices would be recognised in profit or loss.

Reassessment of contingent rentals

- 7.22 The boards discussed whether to require the lessee to remeasure its obligation to pay rentals for changes in estimated contingent rental payments.
- 7.23 Requiring remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rentals could impose a significant cost on preparers. In addition, requiring reassessment of the obligation to pay rentals would result in a more complex standard.
- 7.24 However, the boards noted the following advantages to requiring reassessment:
- (a) Requiring remeasurement of the obligation to pay rentals is likely to provide users of financial statements with more relevant information because it reflects current conditions.
 - (b) Under IFRSs, liabilities—whether they are carried at amortised cost or fair value—are generally remeasured for changes in expected cash flows.
 - (c) It is consistent with the boards' tentative decision to require the lessee to reassess the most likely lease term at each reporting date.

Preliminary views

- 7.25 The boards think that requiring remeasurement will provide more relevant information to users. Consequently, they tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.

Accounting for a change in the obligation to pay rentals

- 7.26 Having tentatively decided to require reassessment of the obligation to pay rentals for changes in estimated contingent rentals, the boards discussed how to recognise the resulting change in the obligation to pay rentals. They discussed 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 amount of the right-of-use asset.

- 7.27 A change in a recognised liability does not usually result in a change in the carrying amount of an asset. Changes in estimates are normally recognised in profit or loss. Recognising any change in the obligation to pay rentals in profit or loss would also 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.
- 7.28 In addition, a change in the obligation to pay rentals after 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.
- 7.29 However, in lease contracts, there is often a link between the right-of-use asset and the obligation to pay rentals. If expected contingent rentals increase, the obligation to pay rentals increases. It can be argued that there is a corresponding increase in the right-of-use asset (assuming there is no impairment). For example, if the obligation to pay rentals increases because of an increase in expected usage, it can be argued that the lessee has received a right to use more of the leased item and therefore the right-of-use asset has also increased.
- 7.30 In addition, 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 in IFRIC 1 and SFAS 143 in which the carrying amount of the recognised asset is adjusted for changes in a decommissioning liability.

Preliminary views

- 7.31 The FASB tentatively decided to require changes in the obligation to pay rentals arising from all changes in estimated contingent rental payments to be recognised in profit or loss. The FASB thinks that this approach is easier for users of financial statements to understand and is less complex for preparers than other approaches.
- 7.32 The IASB thinks that changes in the obligation to pay rentals are in effect changes to the originally assessed cost of the right-of-use asset. Consequently, the IASB tentatively decided to require all changes in the obligation to pay rentals arising from changes in estimated contingent rental payments to be recognised as an adjustment to the carrying amount of the right-of-use asset. The IASB also noted that this approach is consistent with the way changes to the obligation to pay rentals arising from changes in lease term are treated.

Residual value guarantees

- 7.33 Lease contracts sometimes include residual value guarantees. Under those guarantees, the lessee compensates the lessor if the value of the leased item at the end of the lease is below a specified value. Residual value guarantees are used to protect the lessor's expected return.
- 7.34 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.
- 7.35 Under US GAAP, residual value guarantees are excluded from the scope of FIN 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* when the lease is classified as a capital lease because the lessee has already recognised the maximum amount of the guarantee in accordance with SFAS 13. In addition, although a residual value guarantee could meet the definition of a derivative in SFAS 133, residual value guarantees that are subject to the leasing literature are excluded from the scope of SFAS 133. Under IFRSs, residual value guarantees embedded in lease contracts are normally accounted for in accordance with IAS 17 rather than IAS 39 or IFRS 4 *Insurance Contracts*.
- 7.36 The boards discussed how to account for leases that contain residual value guarantees and in particular:
- (a) whether residual value guarantees should be included in the lessee's obligation to pay rentals
 - (b) how residual value guarantees should be measured as part of the lessee's obligation to pay rentals
 - (c) whether to require reassessment of the obligation to pay rentals for changes in estimated payments under residual value guarantees
 - (d) how to account for changes in the obligation to pay rentals arising from reassessment.
- 7.37 The final section of this chapter illustrates how a lease that contains a renewal option and a residual value guarantee would be accounted for under the single asset and liability approach proposed in this paper.

Recognition of residual value guarantees: preliminary views

- 7.38 As discussed in chapter 3, the boards tentatively decided not to adopt a components approach to lease contracts and instead tentatively decided to adopt a single asset and liability approach. Consequently, although residual value guarantees meet the definition of a liability, the boards decided not to recognise them separately from the obligation to pay rentals.
- 7.39 Like contingent rental payments, payments under residual value guarantees are conditional on future events. However, the obligation to make a payment if the specified future events occur is unconditional. Consequently, the boards tentatively decided that the lessee's obligation to pay rentals should include payments to be made under a residual value guarantee.
- 7.40 Some board members think that because residual value guarantees are linked to the value of the leased item rather than to the right-of-use asset, they are not closely related to the host lease contract. Consequently, those board members think that residual value guarantees should be separated from the host lease contract and accounted for as derivatives.
- 7.41 The boards also discussed whether to require recognition of amounts payable under residual value guarantees only when payment under the guarantee was probable. However, they noted that this would be inconsistent with the boards' preliminary views on contingent rentals.

Measurement of residual value guarantees

- 7.42 The boards discussed three approaches to measuring the lessee's obligation to pay rentals when the obligation includes a residual value guarantee:
- (a) a probability-weighted estimate of the rentals payable (an expected outcome technique)
 - (b) the most likely rental payment
 - (c) recognition of the maximum amount payable under the residual value guarantee.
- 7.43 Approaches (a) and (b) are the same as the approaches to measurement discussed for contingent rentals. The advantages and disadvantages of those approaches are discussed in paragraphs 7.14–7.19.
- 7.44 Approach (c) (recognition of the maximum amount payable) is consistent with the approach in the existing standards.

- 7.45 The boards noted that if they decide not to include the maximum amount of the guarantee in the obligation to pay rentals, the recognised asset and liability would be less than under the existing standards. For example, a lease that includes a guarantee of all of the expected residual value of the asset at the end of the lease would be classified as a finance lease under existing standards. As such, the whole of the asset would be recognised in the statement of financial position (along with an obligation to pay for that asset).

Preliminary views

- 7.46 The boards tentatively decided that the measurement of the lessee's obligation to pay rentals when it includes a residual value guarantee should be consistent with the measurement of the obligation to pay rentals when it includes an obligation to pay contingent rentals. They noted that measuring obligations under contingent rental arrangements and residual value guarantees in the same way would make any new standard easier for preparers to apply and users to understand. Consequently:
- (a) the boards tentatively decided not to require the lessee to recognise the maximum amount payable under the residual value guarantee.
 - (b) the IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of amounts payable under residual value guarantees.
 - (c) the FASB tentatively decided that a lessee should measure residual value guarantees on the basis of the most likely rental payment. A lessee would determine the most likely rental payment by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.

Reassessment of residual value guarantees

- 7.47 The boards also discussed whether to require the lessee to remeasure its obligation to pay rentals for changes in estimated payments under residual value guarantees and how to recognise any resulting change in the obligation to pay rentals.

Preliminary views

- 7.48 Consistently with their decisions on contingent rentals:
- (a) the boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated payments under residual value guarantees.

- (b) the FASB tentatively decided to require changes in the obligation to pay rentals arising from changes in estimated payments under residual value guarantees to be recognised in profit or loss because the FASB thinks such changes do not increase or decrease the value of the right-of-use asset.
- (c) the IASB tentatively decided to require changes in the obligation to pay rentals arising from changes in estimated payments under residual value guarantees to be recognised as an adjustment to the carrying amount of the right-of-use asset because such changes represent adjustments to the originally assessed cost of the right-of-use asset.

Applying the approach in this chapter to a lease that includes an option

- 7.49 Lease contracts sometimes include both an option to extend the lease and a residual value guarantee. For example, a lease contract may have a primary period of 10 years. At the end of the 10-year period the contract permits the lessee either to extend the lease for an additional five years or return the leased item to the lessor. If the lessee decides to return the leased item at the end of the primary period, the lessee must provide the lessor with a residual value guarantee. The guarantee requires the lessee to pay the lessor the difference between the expected residual value of the leased asset at the end of 10 years and the actual residual value at the end of 10 years. Under the approach described in this chapter, the lessee must determine at the start of the lease whether it is more likely to return the leased asset or to renew the lease:
- (a) If returning the asset is the more likely outcome, the lessee would recognise an obligation to pay rentals equal to the present value of 10 years of rentals plus an estimate of the amount payable under the residual value guarantee.
 - (b) If renewal is the more likely outcome, the lessee would recognise an obligation to pay rentals equal to the present value of 15 years of rentals.
- 7.50 A reassessment of which of the two approaches is more likely would be made at the end of each reporting period on the basis of any new facts or circumstances.

Questions for respondents

Contingent rentals

Question 16

The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.

Do you support the proposed approach?

If you disagree with the proposed approach, what alternative approach would you recommend and why?

Question 17

The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.

Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Question 18

The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.

Do you support the proposed approach? Please explain your reasons.

Question 19

The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.

Do you support the proposed approach? If not, please explain why.

continued...

...continued

Questions for respondents

Contingent rentals

Question 20

The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:

- (a) recognise any change in the liability in profit or loss
- (b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.

Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

Residual value guarantees

Question 21

The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives.

Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

Chapter 8: Presentation

Introduction

- 8.1 This chapter describes the boards' preliminary views on how the assets, liabilities, expenses and cash flows arising from lease contracts should be presented in the financial statements.
- 8.2 The boards' preliminary views are based on existing presentation requirements. The effect that proposed changes to financial statement presentation (described in the boards' joint discussion paper *Preliminary Views on Financial Statement Presentation*) could have on the boards' preliminary views on leasing is discussed at the end of this chapter.
- 8.3 In developing their preliminary views, the boards noted that however lease contracts are presented, additional disclosures will be required to provide users of financial statements with a complete picture of a lessee's lease contracts.

Presentation of the obligation to pay rentals in the statement of financial position

- 8.4 The boards noted that the lessee's obligation to pay rentals is a financial liability and should be presented as such in the statement of financial position.
- 8.5 However, an obligation to pay rentals is different from many other financial liabilities in that it is linked to the right-of-use asset. Consequently, the boards considered whether to require the obligation to pay rentals to be presented separately from other financial liabilities. Presenting such obligations separately from other financial liabilities might provide useful information.
- 8.6 The boards noted that an obligation to pay rentals is similar to a secured borrowing. IAS 39 and SFAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* do not require separate presentation of secured borrowings. However, they do require additional disclosures.

Preliminary views

- 8.7 The IASB tentatively decided not to require separate presentation of the lessee's obligation to pay rentals in the statement of financial position.

- 8.8 The FASB noted that the proposed accounting for the obligation to pay rentals differs from most other financial liabilities. For example, the obligation to pay rentals includes amounts payable in optional periods. Consequently, the FASB tentatively decided to require separate presentation.

Presentation of the right-of-use asset in the statement of financial position

- 8.9 The boards discussed three possible ways to present the right-of-use asset in the statement of financial position:
- (a) present the right-of-use asset according to the nature of the underlying leased item. For example, a lease of a motor vehicle would be presented with other motor vehicles. However, owned motor vehicles could be presented as a separate line item from leased motor vehicles.
 - (b) present the right-of-use asset as an intangible asset.
 - (c) present the right-of-use asset on the basis of classification. Leases that are in substance purchases of the leased item would be presented on the basis of the underlying asset (generally as property, plant and equipment). All other right-of-use assets would be presented as intangible assets. The boards did not define which types of lease would be treated as in-substance purchases. Some would restrict the term to those leases that automatically transfer title. Others would expand the definition to include, for example, leases of an asset for its entire useful life. Some board members do not think there should be a distinction between in-substance purchases and other leases.
- 8.10 Some of the advantages and disadvantages of each approach are discussed below.

Presentation based on the nature of the underlying asset

- 8.11 The boards identified the following advantages of basing presentation on the nature of the underlying asset:
- (a) It provides users of financial statements with information about the nature of the leased asset that could be lost if the right-of-use asset is presented as an intangible asset. For example, some rights

to use may be of property, plant and equipment, whereas other rights to use may be of intangible assets. Additionally, users are interested in the productive capacity of a business to assess the ability of the business to generate positive cash flows. Presenting rights to use on the basis of the underlying asset reflects the capacity of a business to produce its products or provide its services.

- (b) It is consistent with the way in which the lessee uses the right-of-use asset in its normal course of business. For example, a lessee uses a leased motor vehicle the same way that it uses an owned motor vehicle.
 - (c) It avoids the need to specify classification requirements to distinguish between in-substance purchases and other right-of-use assets because the presentation is the same whether the lease is an in-substance purchase or a right to use the asset.
 - (d) The rights conveyed in a lease contract are similar to the rights obtained from owning the underlying asset for less than its useful life. As such, arguably, the presentation should reflect the similarities between the right to use and the underlying leased item.
- 8.12 However, the boards noted that a short-term right of use is very different from outright ownership of the leased item; failing to differentiate between the two may not meet the needs of users of financial statements. The boards noted that if this approach is adopted, it would be important to distinguish between leased assets and owned assets. This could be achieved by presenting leased motor vehicles (for example) adjacent to but separately from owned motor vehicles. Alternatively, the difference between leased assets and owned assets could be presented in the notes to the financial statements.

Presentation as an intangible asset

- 8.13 The boards noted that presenting the right-of-use asset as an intangible asset has two main advantages:
- (a) It differentiates leased assets from owned assets, which may be important to users.
 - (b) It is conceptually appealing. The asset arising in a lease contract is not the underlying asset itself; rather, it is a **right** to use the underlying asset.

- 8.14 However, this approach fails to provide users of financial statements with information about the nature of the underlying asset, such as the productive capacity of a business or information about how the lessee uses the leased asset.

Presentation based on classification

- 8.15 This approach would allow users of financial statements to differentiate between in-substance purchases and other leases. However, it has the following disadvantages:
- (a) Many leases would be classified as intangible assets. Consequently, information about the nature of the underlying asset would be lost for these leases.
 - (b) This approach would add complexity to the proposed new standard because guidance on differentiating in-substance purchases from other leases would have to be developed. As discussed above, the boards have not defined an in-substance purchase.
 - (c) If the classification requirements are similar to those in existing standards, economically similar leases may be presented differently, which would reduce comparability for users of financial statements.

Preliminary views

- 8.16 The boards tentatively decided that the right-of-use asset should be presented in the statement of financial position on the basis of the nature of the leased item. Some note that this approach provides users of financial statements with more information about the leased item than other possible approaches. However, the boards acknowledge that a leased asset is significantly different from an owned asset. Consequently, the boards tentatively decided that leased assets should be presented separately from owned assets.
- 8.17 Some FASB members think that a lease that is an in-substance purchase is significantly different from other types of lease. They think that leases that are in substance purchases should be presented separately from other leases in the statement of financial position. However, the FASB did not define which arrangements are in substance purchases.

Income statement presentation

- 8.18 The boards noted that presentation in the statement of financial position of the assets and liabilities arising in the lease contract should drive income statement presentation. Consequently, the reduction in the carrying amount of right-of-use assets that are presented as property, plant and equipment should be presented as depreciation; the reduction in the carrying amount of leased assets that are presented as intangibles should be presented as amortisation. Interest expense on the obligation to pay rentals should be presented separately in the income statement if the obligation were presented separately in the statement of financial position; otherwise it should be included in general interest expense.
- 8.19 However, as noted in chapter 5, some FASB members think that for some lease contracts the reduction in the carrying amount of the right-of-use asset should be presented in the income statement as rent expense rather than as depreciation or amortisation. Those FASB members did not define which lease arrangements should be presented in this way.

Cash flow presentation

- 8.20 The boards have not discussed how the cash flows associated with lease contracts should be presented in the statement of cash flows. However, the accounting model proposed in this discussion paper treats the obligation to pay rentals as a financial liability. Rentals paid under this model can be viewed as:
- (a) interest payments
 - (b) repayments of amounts borrowed.
- 8.21 Both IAS 7 *Statement of Cash Flows* and SFAS 95 *Statement of Cash Flows* require cash flows to be classified as operating, financing or investing. Under both standards, cash repayments of amounts borrowed are classified as financing activities. IAS 7 permits interest paid to be classified as operating, financing or investing. However, SFAS 95 requires interest paid to be classified as an operating cash flow.
- 8.22 Requiring rentals paid under a lease to be split into interest payments and repayments of amounts borrowed would be consistent with the way other repayments of obligations, including payments under finance leases, are treated in the existing cash flow standards.

Implications of proposed changes to financial statement presentation

- 8.23 In October 2008 the boards published a joint discussion paper *Preliminary Views on Financial Statement Presentation*. The purpose of that paper is to help the boards develop an exposure draft of a proposed standard on financial statement presentation.
- 8.24 The presentation model proposed in that discussion paper requires an entity to present information about the way it creates value (its business activities) separately from information about the way it funds or finances those business activities (its financing activities). An entity's business activities are further separated into investing and operating activities. Classification into those categories is based on how management views the activities of the entity.
- 8.25 The discussion paper also proposes that information in the financial statements should portray a cohesive financial picture of an entity's activities. To achieve this cohesiveness objective, line items, their descriptions and order of presentation should be aligned in the statement of financial position, the statement of comprehensive income and the statement of cash flows.
- 8.26 The boards tentatively decided that lease contracts give rise to the following assets, liabilities, expenses and cash flows:
- (a) a right-of-use asset
 - (b) an obligation to pay rentals
 - (c) amortisation or depreciation
 - (d) interest expense
 - (e) cash rental payments.
- 8.27 Under the proposed presentation model, the right-of-use asset would be treated as a business asset. The lessee must decide whether to classify it as an operating or investing asset. Following the cohesiveness principle, amortisation or depreciation of the right-of-use asset would be classified as either an operating expense or an investment expense within business activities.
- 8.28 The obligation to pay rentals would be classified by the lessee as either a business liability (operating or investing) or a financing liability depending on management's view of the obligation. Presentation of

interest expense would be consistent with the classification of the obligation to pay rentals.

- 8.29 As discussed above, cash rental payments can be viewed as payments of interest and repayments of the obligation to pay rentals. Consequently, in the proposed presentation model, classification of rentals paid in the statement of cash flows would be consistent with the classification of interest expense in the statement of comprehensive income and the obligation to pay rentals in the statement of financial position.

Questions for respondents

Question 22

Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.

What additional information would separate presentation provide?

Question 23

This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.

How should the right-of-use asset be presented in the statement of financial position?

Please explain your reasons.

What additional disclosures (if any) do you think are necessary under each of the approaches?

Chapter 9: Other lessee issues

Introduction

- 9.1 This chapter provides a brief overview of issues that the boards have not yet discussed in sufficient detail for them to reach a preliminary view. The boards will need to resolve these issues before publishing an exposure draft. This chapter discusses:
- (a) timing of initial recognition
 - (b) sale and leaseback transactions
 - (c) initial direct costs
 - (d) leases that include service arrangements
 - (e) disclosure.
- 9.2 This chapter also asks respondents to provide details of any other lessee issues that the boards will need to address before publishing an exposure draft.

Timing of initial recognition

- 9.3 The boards must decide when a lessee should 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).
- 9.4 Under existing accounting standards, the lessee recognises its assets and liabilities on the lease commencement date. However, before then (eg when the lease is signed) the lessee may obtain rights and obligations that meet the definitions of assets and liabilities.
- 9.5 If that is the case, the boards must decide:
- (a) whether to require lessees to recognise those assets and liabilities. It can be argued that before delivery of the leased item by the lessor or payment by the lessee, the contract is an executory contract. Typically, rights and obligations arising under non-financial executory contracts are not recognised in the financial statements.
 - (b) whether those assets and liabilities should be recognised 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.

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

Sale and leaseback transactions

9.7 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 entered into to generate cash flow, to reduce the risks associated with owning the asset or to obtain off balance sheet financing.

9.8 Existing accounting for sale and leaseback transactions depends on the classification of the leaseback. If the lessee classifies the leaseback as an operating lease and other specified conditions are met, any gain or loss on sale is recognised immediately. If the leaseback is classified as a finance lease, the lessee defers and amortises any gain on sale over the lease term.

9.9 US GAAP has additional requirements for sale and leaseback transactions involving real estate. SFAS 98 *Accounting for Leases* describes specific forms of continuing involvement that do not allow a seller/lessee to qualify for sale and leaseback accounting (described in paragraph 9.10). If a sale and leaseback transaction includes those provisions, sale and leaseback accounting is not allowed and the transaction must be accounted for using the deposit method or as a financing. The sale is not recognised and the asset remains in the statement of financial position of the seller/lessee. The asset and depreciation continue to be recognised and any sales proceeds are recognised as a liability.

9.10 Under existing standards, sale and leaseback transactions have 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. The seller/lessee accounts for each component separately rather than for the net effect of the combined transactions.

9.11 Accounting for a sale and leaseback transaction is difficult because the seller/lessee may be willing to pay higher than market rentals in return for increased proceeds from the sale of the asset. Similarly, the seller/lessee may be willing to accept a lower sales price for the asset if the future rentals are below market rates. That makes it difficult to classify the leaseback as either a finance lease or an operating lease in accordance with existing standards.

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- 9.12 The boards will consider a number of 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.
 - (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.
 - (c) adopting a hybrid approach. The seller/lessee would treat the sale and leaseback as a sale or a financing depending on specified criteria. For example, a lessee may be permitted to recognise a sale only if the conditions for sale in existing US GAAP and IFRSs are met.
- 9.13 A sales approach to sale and leaseback transactions is illustrated in example 10.

Example 10

A seller/lessee owns an office building with a remaining useful life of 20 years. The carrying amount of the building is CU80 and its fair value is CU100.

The seller/lessee sells the building to a buyer/lessor for its fair value (CU100) and leases it back for five years at an annual rental payable in arrears of CU8 (a fair market rental).

The lessee's incremental borrowing rate is 10 per cent. The present value of the lease rentals is CU30.

On sale of the building the seller/lessee will recognise:

| | | | |
|----|-----------------|-----|----|
| Dr | Cash | 100 | |
| Cr | Office building | | 80 |
| Cr | Gain on sale | | 20 |

To recognise the sale of the building

| | | | |
|----|---------------------------|----|----|
| Dr | Right-of-use asset | 30 | |
| Cr | Obligation to pay rentals | | 30 |

To recognise the leaseback

| | | | |
|---|---------------------------|---|---|
| In the first year of the leaseback, the seller/lessee will recognise the following: | | | |
| Dr | Obligation to pay rentals | 8 | |
| Cr | Cash | | 8 |
| <i>To recognise payment of rentals</i> | | | |
| Dr | Interest expense | 3 | |
| Cr | Obligation to pay rentals | | 3 |
| <i>To recognise interest expense</i> | | | |
| Dr | Depreciation expense | 6 | |
| Cr | Right-of-use asset | | 6 |
| <i>To recognise depreciation of the right-of-use asset</i> | | | |

- 9.14 The financing approach to sale and leaseback transactions may work for some transactions, for example, when the leaseback is for a significant proportion of the remaining useful life of the asset. However, a financing treatment may not faithfully represent the transaction when the leaseback is relatively short. If the boards decide to adopt a financing approach, they must also develop guidance on how to account for the rental payments and whether any gain or loss arises on the sale.
- 9.15 Recognising a sale of the asset when the transaction is similar to a financing also may fail to represent faithfully the economics of the transaction. However, under the new approach to leasing proposed in this discussion paper, the lessee would recognise an obligation to pay rentals even when the transaction is treated as a sale.
- 9.16 If the boards decide to adopt a sales approach to all sale and leaseback transactions, they may conclude that in some situations gains or losses arising on the sale should be deferred.
- 9.17 The hybrid approach might solve some of the problems of the other two approaches but it might be difficult to apply.
- 9.18 If the boards decide to adopt either a sales approach or a hybrid approach, they may need to develop guidance on how to deal with transactions in which the leaseback is at an above or below market rate to compensate for increased or decreased sales proceeds.

Initial direct costs

- 9.19 Lessees often incur costs when negotiating and arranging leases. Those 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.
- 9.20 At present, initial direct costs that are incurred when arranging a finance lease are added to the amount recognised as an asset by the lessee and amortised with that asset.
- 9.21 The boards could decide to retain this approach in the proposed new lease accounting standard. Including initial direct costs in the carrying amount of the right-of-use asset would be consistent with the treatment of the costs associated with acquiring property, plant and equipment or intangible assets.
- 9.22 Alternatively, the boards could decide to recognise such costs as an expense 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 that are measured initially at fair value.

Leases that include service arrangements

- 9.23 In addition to payments for the right to use the leased item, lease contracts often include payments for other services. For example, leases of real estate often require the lessee to make payments for maintenance, property taxes and insurance.
- 9.24 Existing lease accounting standards require payments for services to be separated from rental payments and excluded from minimum lease payments. That is relatively easy to do if the payments for services are separately itemised. However, separation can be difficult when payments for services are not separately itemised or the provision of services and the provision of the asset are closely related. That is less of an issue when the lease part of the contract is classified as an operating lease because both the lease payments and the payments for services are recognised in profit or loss normally on a straight-line basis.

- 9.25 Under the proposals in this discussion paper, lessees would be required to identify separately payments for services and payments for the right to use the leased item in all lease contracts. Consequently, the boards will consider the need for additional guidance on how to separate payments for services from other lease payments.

Disclosure

- 9.26 At present, disclosure requirements for leased assets and liabilities are based on the classification of the leased item.
- 9.27 The boards will review those requirements before publishing an exposure draft and will decide which disclosures to retain and whether additional disclosures are required. In particular, additional disclosures might be considered for leases that contain options, contingent rentals or residual value guarantees, when the accounting treatment is unable to convey the full extent of the rights and obligations of the lessee.

Question for respondents

Question 24

Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

Chapter 10: Lessor accounting

Introduction

- 10.1 As discussed in chapter 1, in July 2008 the boards tentatively decided to defer consideration of lessor accounting and concentrate on developing an improved lessee accounting model. Consequently, the boards have not discussed accounting for lessors in detail. This chapter sets out some of the issues that will need to be resolved in developing any proposed new standard for lessors. The boards have not yet reached a preliminary view on any of these issues. The boards will decide on the timing of any proposed new standard for lessors after publishing this discussion paper.
- 10.2 The first section of this chapter describes, at a high level, how a right-of-use model may be applied to lessors.
- 10.3 The boards discussed, but were not asked to reach a preliminary view on, how to account for subleases. Therefore, this chapter also discusses possible approaches to accounting for subleases.
- 10.4 Lastly, this chapter describes other lessor accounting issues that need to be addressed before publication of a new accounting standard for lessors.

Application of the right-of-use model to lessors

- 10.5 If a right-of-use model were applied to lessors, they would not be required to classify a lease as a finance lease or an operating lease. Existing standards, which focus on whether risks and rewards of the leased item are transferred, would be replaced with a right-of-use model for lessors. Under a right-of-use model, the lessor would recognise assets and liabilities arising from the lease contract.
- 10.6 This chapter describes two ways in which a right-of-use model could be applied to lessors. Under the first approach, the lessor is viewed as having transferred a portion of the leased item (usually a physical asset) to the lessee. Under the second approach the lease contract is viewed as creating a new right, leaving the lessor's rights relating to the leased item unchanged.

Lease contract transfers a portion of the leased item

- 10.7 Under this approach the lessor exchanges all, or a portion of, the leased item for the right to receive payments over the lease term. In addition, the lessor retains the right to the leased item at the end of the lease term.

- 10.8 The exchange results in the lessor derecognising the leased item and recognising a receivable (a financial asset) and a residual value asset (a non-financial asset). Each of these assets is discussed further below. This model is essentially the same, from a statement of financial position perspective, as the direct financing and sales-type lease models under current US GAAP and the approach used for finance leases in IFRSs. Alternatively, the lessor could derecognise only a portion of the asset and recognise a receivable for its right to receive rentals.
- 10.9 The lessor is not considered to have a liability to permit the lessee to use the leased asset because it does not result in an outflow of future economic benefits. The outflow of economic benefits took place when the leased item was delivered. The lessor has transferred a portion of the leased item to the lessee for a period of time. In effect, the lessor has sold its right to use the leased item during the lease term for a receivable from the lessee.
- 10.10 This approach is consistent with the boards' tentative conclusions on lessee accounting. Paragraph 3.16 indicates that the lessee's right to use the leased item is an economic resource that is controlled by the lessee. This conclusion implies that benefits from the right to use the leased asset are separable from the leased item and that the lessor does **not** have a liability to permit the lessee to use the leased asset. In other words, in a lease contract, the lessor has exchanged its right to use the leased item during the lease term for a receivable from the lessee. The lessor has retained the right to the leased item after the end of the lease. However, it has no right to use the leased item during the lease term.

The lessor's receivable

- 10.11 Once the leased item has been delivered to the lessee, the lessor's right to receive payments (its receivable) is unconditional. The lessee can normally avoid making payments under the lease contract only if in some way the lessor breaches the terms of the lease contract. The right to receive payments is controlled by the lessor (it is legally enforceable). It arises out of a past event (the delivery of the leased item) and gives rise to future economic benefits.
- 10.12 Consequently, this right to receive payments during the lease term meets the definition of an asset for the lessor.

The lessor's residual value asset

- 10.13 The lessor's right to the economic benefits from the leased item in the period after the lease term (the residual rights) does not arise from the lease contract. Rather this right existed before the lease contract. Control of the residual right is established through the lessor's legal rights over the leased item, which may be contractual rights (if the lessor is itself a lessee of the leased item) or legal ownership (property) rights. The past event giving rise to those rights was the original acquisition of the leased item. The lessor continues to control the right to the leased item after the end of the lease (it never surrendered that right). Future economic benefits will flow to the lessor through sale or re-lease of the leased item after the end of the lease term. Thus, this right meets the definition of an asset.

Derecognition and revenue recognition

- 10.14 Because under this approach the lessor has sold some of the leased item (the right to use the leased item during the lease term), the lessor no longer has that right and should derecognise some or all of the leased item.
- 10.15 In December 2008 the boards published a discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers*. That paper suggests that an entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer. An entity satisfies a performance obligation and, hence, recognises revenue when it transfers a promised asset (such as a good or service) to the customer. The boards propose that an entity has transferred that promised asset when the customer obtains control of it.
- 10.16 Under this approach to lessor accounting, the asset transferred by the lessor to the lessee is a discrete right to use the leased asset. Because the lessor has transferred this asset to the lessee and the lessee has obtained control of it, the lessor has satisfied its performance obligation and would thus recognise revenue representing its sale of the right to use the leased item.

Lease contract creates a new right and obligation

- 10.17 This approach to lessor accounting treats the leased item as the lessor's economic resource. The lessor has granted the lessee the **right to use** its economic resource. Under this approach, the lessor does not lose control of the leased property for the lease term and thus continues to recognise the leased item. The asset remains in the lessor's statement of financial position and the lessor is committed to allowing the lessee to use the

leased item over the lease term. The lessor remains bound by the terms of the arrangement for the entire lease term, even if prices, availability or other economic factors change. This obligation would meet the definition of a liability because it would result in an ongoing outflow of future economic benefits to the lessee.

- 10.18 This approach is also consistent with the boards' tentative conclusions on lessee accounting. The lessee has an asset representing the right to use the leased property and the lessor has a liability representing its obligation to provide that use to the lessee over the lease term.
- 10.19 It can be argued that the existence of this obligation means that the lessor does not have an unconditional right to receive payments over the lease term. However, this is not the case once the leased item is delivered to the lessee and the lessor has begun its performance. The lessee has an unconditional right to use the leased item because the lessor has no contractual rights to recall the item from the lessee unless the lessee breaches the contract. Instead, the lessor has an unconditional right to receive payments.
- 10.20 In effect, the lease contract has created a new right (an unconditional right to receive payments) with a corresponding liability (an unconditional obligation to permit use of the leased item to the lessee). The lessor would recognise a receivable for its right to receive payments during the lease term on delivery of the leased item or the signing of the lease contract.
- 10.21 The lessor has a performance obligation to deliver and continue to permit the lessee to use the leased item and honour the contractual terms of the agreement. The lessor would recognise that performance obligation as a liability on delivery of the leased item or the signing of the lease contract, and that obligation would be settled over the term of the lease.
- 10.22 Because the lessor has created a new right with a corresponding liability, the lessor would not derecognise the leased item. Those rights and obligations are separate from the ownership rights that the lessor has over the leased item.

- 10.23 Example 11 illustrates the two approaches to lessor accounting.

| | Lease contract transfers a portion of the leased item | Lease contract creates a new right |
|--------------------------|--|---|
| | CU | CU |
| Machine | – | 10,000 |
| Lease receivable | 9,378 | 9,378 |
| Residual value asset | 622 | – |
| Total assets | 10,000 | 19,378 |
| Performance obligation | – | 9,378 |
| Total liabilities | – | 9,378 |
| Net assets | 10,000 | 10,000 |

Revenue recognition

- 10.24 The discussion paper on revenue recognition suggests that an entity satisfies a performance obligation and, hence, recognises revenue when it transfers a promised asset (such as a good or service) to the customer.
- 10.25 Under this approach to lessor accounting the lessor is viewed as providing a service to the lessee (the ongoing right to use the leased item) over the lease term. Consequently, revenue is recognised as the lessor satisfies its performance obligation to the lessee (ie revenue is recognised over the term of the lease). The lessor would also recognise interest income on its receivable over the lease term.

- 10.26 The boards will need to consider the lessor's recognition of income other than financing income (eg in situations involving manufacturers or dealers that provide leasing as another means to market their product).
- 10.27 Consider the following leasing arrangements:

Example 12—Lease financing provided by a bank

A bank often offers a customer a lease that finances the use of an asset for a substantial portion of the asset's useful life (perhaps all of the asset's useful life). Typically these leases are provided by a lessor that is not in the business of selling the assets it leases and that functions essentially as a lender. Often in these leases, the lessee receives a copy of the contract by which the lessor acquires the asset before signing the lease. The bank/lessor may never take possession of the leased asset (in fact, the bank/lessor generally has no contact with the leased asset), and its legal obligation to lease the asset does not arise until the lessee accepts the asset from the supplier. The lessee generally has no rights against the bank/lessor if the leased item does not perform.

Example 13—Lease financing provided by a manufacturer/dealer of the leased asset

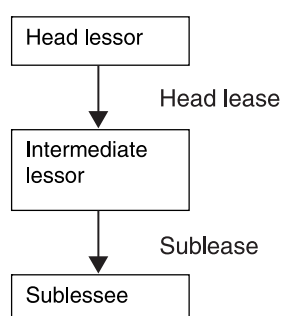
A manufacturer or dealer of leased assets offers customers leases that finance the use of an asset for a substantial portion of the asset's useful life (perhaps all of the asset's useful life). One of the main differences between this type of lease and the lease provided by a bank/lessor is that the manufacturer/dealer seeks to earn a profit on the manufacture of the asset in addition to financing income.

- 10.28 The boards may conclude that derecognising the leased asset and recognising income at the start of the lease in example 13 is appropriate, but not at the start of the lease in example 12. Instead of trying to differentiate when the substance of the transaction is a purchase/sale, criteria could be established to determine when, if ever, income should be recognised at the start of a lease.
- 10.29 The boards would need to consider how this model would affect lessors that provide short-term leases and lessors of real estate.

- 10.30 In addition, some board members think that a distinction needs to be made between leases in which the substance of the arrangement is a purchase by the lessee (and a sale by the lessor) and other types of leases. For example, a lease could be viewed as a sale when title to the leased item transfers at the end of the lease term. When a lease is a sale of the leased item, those board members think that the lessor should derecognise the leased asset and recognise a gain or loss.

Subleases

- 10.31 An entity will sometimes act as both a lessor and a lessee of the same asset. For example, an 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 sublease).



- 10.32 If the boards decide to issue a new standard that includes both lessor accounting and lessee accounting, they will discuss the issues associated with subleases as they develop a lessor accounting model.
- 10.33 However, if the boards decide to issue a new standard on lessee accounting before they issue a new standard on lessor accounting, they will need to decide how an intermediate lessor should account for the sublease.
- 10.34 The boards discussed but did not reach a preliminary view on three possible ways of addressing how an intermediate lessor should account for the sublease. The boards could:
- provide additional guidance on how to apply the existing lessor accounting standards to subleases
 - exclude the head lease from the scope of the new standard
 - develop a lessor right-of-use model for subleases only.

Provide additional guidance on how to apply the existing lessor accounting standards to subleases

- 10.35 The boards could require intermediate lessors to account for their subleases in accordance with existing lessor accounting standards (IAS 17 and SFAS 13). However, this approach would create a number of problems because different accounting models would be applied to the head lease (the lessee accounting model proposed in this discussion paper) and the sublease (existing lessor accounting standards).
- 10.36 The boards have identified four main problems with applying the existing lessor accounting standards to subleases:
- (a) determining to which asset to apply the lease classification tests. Should the tests be applied to the right-of-use asset or the underlying leased item?
 - (b) classification inconsistencies. Applying the existing lease classification tests to a sublease could result in leases that transfer substantially all the risks and rewards of the leased item being classified as operating leases.
 - (c) inconsistencies in measurement when the sublease is classified as a finance lease. The right-of-use asset and the lease receivable recognised by the intermediate lessor will be measured on a different basis.
 - (d) income statement mismatches when the sublease is classified as an operating lease. These arise because of the mismatch between the intermediate lessor's rental income from the sublease and the interest expense recognised by the intermediate lessor on its obligation to pay rentals under the head lease.
- 10.37 Because of these problems, the boards could decide to provide additional guidance on how to apply existing standards to subleases. Alternatively, the boards could decide to require additional disclosures.
- 10.38 The main advantage of providing additional guidance on how to apply the existing standards to subleases is that it ensures that similar transactions are accounted for in the same way. In other words, lessors would account for all leases in the same way whether the leased asset was acquired through purchase or through a head lease.

Exclude the head lease from the scope of the new standard

- 10.39 If the boards decide to exclude head leases from the scope of the new lessee accounting standard, the intermediate lessor would account for the head lease (as lessee) in accordance with existing lessee accounting standards. This would leave the accounting for subleases unchanged from the current position. The intermediate lessor would not recognise a right-of-use asset and an obligation to pay rentals. Instead, the intermediate lessor would classify the head lease as a finance (capital) lease or an operating lease. Classification as a finance lease would give rise to assets and liabilities in the financial statements of the intermediate lessor; operating lease classification would not. The sublease would also be classified as an operating lease or a finance lease (an operating lease, sales-type lease, direct financing lease or leveraged lease under US GAAP).
- 10.40 Excluding head leases from the scope of a new lessee accounting standard would eliminate many of the problems associated with applying existing standards to the sublease and, because it is familiar to preparers, would be simpler to implement. However, this approach has the following disadvantages:
- (a) It would reduce comparability for users of financial statements because similar transactions would be accounted for differently. Leases that are subject to subleases would be accounted for differently from leases that are not.
 - (b) Assets and liabilities arising under head leases that are classified as operating leases would not be recognised in the statement of financial position. This would understate the assets and liabilities of the intermediate lessor.
 - (c) Retaining operating lease accounting for head leases may provide structuring opportunities.
 - (d) It is unclear how this approach could be made to work if the sublease is entered into after the head lease.

Develop a lessor right-of-use model for subleases only

- 10.41 Many of the problems associated with applying existing accounting standards to subleases could be avoided if lessors applied a right-of-use model to subleases. The intermediate lessor would recognise a right-of-use asset and an obligation to pay rentals under the head lease.

The intermediate lessor would not be required to classify the sublease as a finance lease or an operating lease. Instead, the intermediate lessor would recognise a receivable that mirrors the sublessee's obligation to pay rentals.

10.42 This approach has the following advantages:

- (a) Intermediate lessors would not be required to classify leases as finance leases or operating leases.
- (b) The same conceptual model would be applied by the intermediate lessor to both the head lease and the sublease. This would be easier for users of financial statements to understand.

10.43 However, there are disadvantages to this approach:

- (a) Similar transactions would be accounted for differently. For example, a lessor of motor vehicles may choose to buy some motor vehicles and lease the rest. Under this approach, leases of vehicles that are owned by the lessor would be accounted for under IAS 17 and SFAS 13. Leases of vehicles that are themselves leased would be accounted for under the right-of-use model. This would reduce comparability for users of financial statements.
- (b) The boards will need to resolve (at least at a high level) many of the problems associated with lessor accounting described in this chapter, including when, if ever, to derecognise the right-of-use asset and when to recognise revenue arising from a sublease.
- (c) If the measurement of the intermediate lessor's receivable mirrors that of the sublessee's obligation to pay rentals, it may include cash flows arising from term options, purchase options, contingent rentals and residual value guarantees. The boards will need to decide whether this is appropriate.

10.44 The boards will analyse each of these approaches further if they decide to issue a new lessee accounting standard before they issue a new standard on lessor accounting.

Other lessor considerations

10.45 If a lessor right-of-use model is developed the following issues will also need to be resolved:

- (a) investment property (discussed further below)
- (b) initial and subsequent measurement

- (c) leases with options
- (d) contingent rentals and residual value guarantees
- (e) leveraged leases (for US GAAP)
- (f) presentation
- (g) disclosure.

Investment property

- 10.46 Investment properties are land or buildings that are held to earn rentals or for capital appreciation. US GAAP and IFRSs have different accounting for investment properties; IFRSs have a fair value option, whereas US GAAP does not.
- 10.47 Investment properties are excluded from the measurement requirements of IAS 17 and are accounted for in accordance with IAS 40 *Investment Property*. Under IAS 40, holders of investment properties are permitted to carry investment properties at cost or fair value. The fair value model requires investment properties to be carried at fair value. Gains or losses arising from a change in the fair value of an investment property are recognised in profit or loss. Under the cost model, investment properties are depreciated over their useful lives. IAS 40 requires disclosure of the fair value of investment properties carried at cost. Under US GAAP, investment properties are accounted for in accordance with SFAS 13.
- 10.48 Permitting investment properties to be carried at fair value may provide users of financial statements with more relevant information than requiring them to be carried at cost. Some argue that replacing an accounting model that permits investment properties to be carried at fair value with a model that would not allow them to do so would not be an improvement to financial reporting. Some also argue that a right-of-use model that would replace the leased item (eg the building) with two assets, a receivable and an interest in the residual value, is not as relevant to users of financial statements.
- 10.49 Therefore, any proposed new lessor accounting would need to address whether there should be any changes to the right-of-use model for lessors that hold investment property or whether investment property should be excluded from the scope of the leases project. The challenge is to devise a model that preserves the fair value information provided by IAS 40 while giving information about the underlying nature of those assets.

Questions for respondents

Question 25

Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Question 26

This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor.

Which of these two approaches do you support? Please explain your reasons.

Question 27

Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

Question 28

Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

Question 29

Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

Appendix A: Summary of questions for respondents

This appendix summarises all the questions for respondents included in this discussion paper.

Chapter 2: Scope of lease accounting standard

Question 1

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?

If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why.

Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Chapter 3: Approach to lessee accounting

Question 3

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 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:

- (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.

Appendix C describes some possible accounting approaches that were rejected by the boards.

Do you support the proposed approach?

If you support an alternative approach, please describe the approach and explain why you support it.

Question 5

The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:

- (a) a single right-of-use asset that includes rights acquired under options
- (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

Do you support this proposed approach? If not, why?

Chapter 4: Initial measurement

Question 6

Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?

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

Question 7

Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?

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

Chapter 5: Subsequent measurement

Question 8

The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.

Do you agree with this proposed approach?

If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

Question 9

Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

Question 10

Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.

If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

Question 11

In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.

Do you agree with the proposed approach taken by the boards?

If you disagree, please explain why.

Question 12

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.

Would you support this approach? If so, for which leases? Please explain your reasons.

Chapter 6: Leases with options

Question 13

The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay

10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Question 14

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

Question 15

The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.

Do you agree with the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Chapter 7: Contingent rentals and residual value guarantees

Contingent rentals

Question 16

The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.

Do you support the proposed approach?

If you disagree with the proposed approach, what alternative approach would you recommend and why?

Question 17

The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.

Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Question 18

The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.

Do you support the proposed approach? Please explain your reasons.

Question 19

The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.

Do you support the proposed approach? If not, please explain why.

Question 20

The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:

- (a) recognise any change in the liability in profit or loss
- (b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.

Which of these two approaches do you support? Please explain your reasons.

If you support neither approach, please describe any alternative approach you would prefer and why.

Residual value guarantees

Question 21

The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

Chapter 8: Presentation

Question 22

Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.

What additional information would separate presentation provide?

Question 23

This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.

How should the right-of-use asset be presented in the statement of financial position?

Please explain your reasons.

What additional disclosures (if any) do you think are necessary under each of the approaches?

Chapter 9: Other lessee issues

Question 24

Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

Chapter 10: Lessor accounting

Question 25

Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Question 26

This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor.

Which of these two approaches do you support? Please explain your reasons.

Question 27

Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

Question 28

Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

Question 29

Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

Appendix B: Scope of existing lease accounting standards

- B1 The boards' preliminary view is to base the scope of the proposed 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 issuing a new lease accounting standard.

Similarities between IAS 17 and SFAS 13

- B2 The term *lease* is used to cover a wide range of arrangements between contracting parties. Both IAS 17 and SFAS 13 define a lease as an agreement in which the lessor conveys to the lessee the right to use an asset for a period of time. 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 of time are within the scope of the existing 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 Position 85-3 *Accounting by Agricultural Producers and Agricultural Cooperatives*.

Differences between IAS 17 and SFAS 13

- B6 There are some significant scope differences between IAS 17 and SFAS 13.
- B7 SFAS 13 applies only 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 SFAS 13 and includes leases of some intangible assets.

- B8 Property held by a lessee that is accounted for as investment property and investment property provided by lessors under operating leases are accounted for in accordance with IAS 40 rather than IAS 17. However, SFAS 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 EITF 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 SFAS 13, respectively.
- B10 In determining whether an arrangement is, or contains, a lease, both IFRIC 4 and EITF 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 one 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 EITF 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) transport contracts.

Evaluating the substance of transactions

- B14 The forms of lease arrangements can vary significantly and, accordingly, can be difficult to assess. SIC-27 provides additional guidance on determining:
- (a) whether a series of transactions is linked and should be accounted for separately
 - (b) whether an arrangement meets the definition of a lease.
- 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. EITF 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 deeply in the money).
- There is no equivalent guidance in US GAAP.
- 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 approaches rejected by the boards

- C1 In developing the right-of-use approach described in this discussion paper, the boards discussed other possible accounting models. The boards rejected these approaches because they fail to solve many of the problems associated with the existing standards. This appendix describes the rejected approaches.

The whole asset approach

Description of the approach

- C2 The whole asset approach is based on the premise that during the lease term, the leased item is under the control of the lessee. Accordingly, this approach recognises the leased item 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.
- C4 Some users of financial statements argue that this approach increases comparability between companies. For example, an airline that leases aircraft would, under this approach, recognise similar assets to an airline that purchases its aircraft. The airlines would both recognise the aircraft in their statements of financial position. In addition, if the airline that purchases the aircraft funds the purchase with debt, both airlines would recognise comparable amounts in profit or loss.

Reasons for rejection

- C5 The boards rejected the whole asset approach for the following reasons:
- (a) An entity that leases its assets is in a very different economic position from an entity that purchases its assets. Entities that lease their assets on short-term leases have more flexibility to reduce their capital base than those that purchase their assets. The whole asset approach fails to reflect this flexibility.

- (b) Few who support this approach would argue that it should be applied to very short-term leases. In addition, some would argue it should not be applied to non-core assets. Consequently, defining those leases that should be accounted for under the whole asset approach is likely to be difficult.
- (c) 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.
- (d) It overstates the liabilities of the lessee because a liability is recognised for the lessee's obligation to return the physical item. Because the lessee has no right to the leased asset after the end of the lease term, there is no outflow of economic benefits from the lessee when the leased item is returned.

The executory contract approach

Description of the approach

- C6 This approach treats all leases as executory contracts. It is based on the premise that the lessee's right to use the leased item is conditional on making payments under the lease. Similarly, the lessee's obligation to make payments is assumed to be conditional on the lessor permitting the lessee to use the item throughout the lease term.
- C7 Consequently, the lessee recognises no assets or liabilities in respect of the lease. Information about the lessee's lease contracts, including amounts payable, is disclosed in the financial statements. Therefore, the executory contract approach is similar to the operating lease model used in existing accounting standards.

Reasons for rejection

- C8 The boards rejected the executory contract approach because it fails to recognise the identified assets and liabilities of the lessee, ie the lessee's right to use the leased item and its obligation to pay for that right. This is the most commonly cited weakness of the existing accounting model for leases. Users of financial statements routinely adjust the financial statements of lessees in an attempt to recognise assets and liabilities that are not recognised under the existing operating lease accounting model.

The approach adopted in the existing standards

Description of the approach

- C9 Existing 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

- C10 The boards rejected this approach for the following reasons:
- (a) When a lease is classified as an operating lease, the lessee fails to recognise the identified assets and liabilities. 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 difficult to define in a principled way.