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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 July 2006, London**

Project: **Leases**

Subject: **Agenda Proposal - Leasing (Agenda Paper 9A)**

INTRODUCTION

1. This paper sets out proposals for a project on lease accounting to be added to the Board's technical agenda. The paper proposes to 'restart' the previous research project on lease accounting, picking up from the work carried out by the ASB and, further in the past, the G4 + 1.

2. Covering lessee accounting, lessor accounting and leases of real estate, the proposed project would reconsider all aspects of lease accounting. The staff believe that it is not possible to significantly improve the accounting for lease contracts through minor amendments to the current leasing model (for example, by changing the criteria for determining whether a lease is a finance/capital lease). Consequently, this paper proposes a fundamental review of the rights and obligations conveyed by lease contracts.

3. The proposed project would work towards a discussion paper to be issued jointly by the IASB and FASB, no earlier than 2008. Given the significance of the changes that are anticipated, staff are of the view that it is not appropriate to move directly to an exposure draft.

4. This paper considers whether the proposed project would meet the IASB's agenda criteria (paragraphs 8 to 35); and sets out a draft project plan (paragraphs 39 to 49). **[Remainder of paragraph omitted from observer notes]**

5. **Staff recommendations:**
   - **that the commencement of a leasing project is approved, jointly with the FASB if that Board also agrees, with the initial target of issuing a discussion paper setting out preliminary views on the issues (paragraph 37);**
   - **that the draft project plan be approved (paragraphs 39 to 49).**

BACKGROUND

6. The issues relating to lease accounting that need to be addressed are much the same as those considered in the G4 + 1 papers of 1996 (*Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts*) and 1999 (*Leases: Implementation of a New Approach*). Similarly, an approach that is broadly the same as that set out in these earlier discussion papers will be considered. However, the new discussion paper would analyse these issues in terms that are consistent with current projects, in particular those on revenue recognition, non-financial liabilities, derecognition and the conceptual framework.

7. The overall approach originally proposed in the G4 + 1 papers is to develop a single model that applies to all leases, in place of the operating/finance lease split that is currently adopted. Rather than recognising the physical asset on the balance sheet of the lessee, the 'right of use' of the physical asset for the period of the lease is recognised as an asset, with a liability recognised for the obligation to make payments for the lease period. Lessors would report financial assets (representing amounts receivable from the lessee) and residual interests as separate assets. These concepts are developed further in Appendix 1, and the Board's previous discussions on the ASB project summarised in Appendix 2 **[Appendix 2 omitted from observer notes].**

IASB AGENDA CRITERIA

8. The draft due process handbook sets out five criteria to be considered in deciding whether to add a potential item to the agenda:
    - the relevance to users of the information involved and the reliability of information that could be provided;
    - the existing guidance available;
    - the possibility of increasing convergence;
    - the quality of standards to be developed; and
    - the extent of any resource constraints.

Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided

Importance of leasing business

9. Leasing is a major international industry, and a very important source of finance for a wide range of entities. Total leasing volume in 2004 is reported as US$ 579 billion, an increase of some 14% over the previous year. The US accounted for 42% of this, Europe 37% and Asia 14%.[1]

10. Lease accounting is important not only for the large number of equipment lessors (for example, the US Equipment Leasing Association (ELA) has over 850 members; the UK Finance & Leasing Association (FLA) over 100); a large proportion of commercial and other property is held on a leased basis; and most business entities and public bodies are lessees in some form or other. Accordingly, accounting for leases affects entities across all categories.

11. Leasing finance is often influenced by tax benefits and incentives, financing costs and (particularly where the lessee or lessor is a regulated entity) capital requirements. The accounting treatment by both parties to the lease can be a significant factor in balancing these elements, and therefore determine the viability or otherwise of a particular type of business. Changes in lease

[1] Source: World Leasing Yearbook; excludes property leasing.

accounting might affect this balance and, therefore, cause significant changes in the leasing marketplace.

Criticisms of current accounting standards

12. The basis for the current model for lease accounting was originally established in FAS 13, issued in 1976, and followed by other standards (e.g. IAS 17 in 1982, UK's SSAP 21 in 1984). The introduction of this model reflected the increasing use of long-term leases as an alternative to other forms of debt finance. Leases which are regarded as transferring substantially all the risks and rewards of ownership of the leased item are accounted for by recognising the leased item as an asset of the lessee, with a corresponding liability to the lessor for the lease rentals. However, leases that do not meet this test are accounted for only as rental obligations accrue. The leasing standards contain tests to determine whether a lease is regarded as transferring substantially all the risks and rewards of ownership (a finance lease or capital lease).

13. The main concerns with this current model are set out below.

(a) The dividing line between finance leases and operating leases is difficult to define in a principled way; current standards adopt a mixture of subjective judgements ('transfer substantially all the risks and rewards of ownership') and bright-line definitions ('90% tests'). As a result, the opportunities for structuring transactions so that they fall just to the operating lease side of the dividing line arise, thus providing what might be regarded as off-balance-sheet financing. IAS 17 (unlike FAS 13 and the UK's SSAP 21) does not include a '90% test'; as a result the judgement of whether a particular lease is a finance or operating lease is so subjective that the tests specified in the other leasing standards are used as guidance on the interpretation.

(b) More fundamentally, even if a revised and principled basis for determining what constituted a finance lease was developed, it would be possible to devise lease arrangements that gave rise to rights and obligations of the lessee that were very close to, but not quite the same as, rights and obligations under a lease that would be classified as a finance lease. There would therefore inevitably be similar transactions resulting in very different recognised assets and liabilities (and consequential differences in the income statement).

(c) A non-cancellable lease gives rise to obligations of the lessee that are often regarded as little different from borrowings, but which in the case of operating leases are not recognised as liabilities. As a result, analysts and other users of financial statements sometimes make estimated adjustments to reflect these obligations in their analysis.

(d) Fourthly, there are significant and growing differences between the lease accounting and other standards. For example, lease arrangements are scoped out of the derecognition and measurement requirements of IAS 39, resulting in inconsistencies between the accounting for arrangements that meet the definition of a lease and arrangements that give rise to similar rights and obligations but which do not qualify as a lease.

(e) Finally, lessor accounting is based on concepts of deferral and matching that are very different from the asset/liability measurement approaches to revenue recognition that underpin the Board's developing standards.

14. These inadequacies of the current leasing standards were noted by the SEC in its June 2005 Report under the Sarbanes-Oxley Act into off-balance-sheet arrangements. This report noted:

> "The lease accounting standards rely extensively on bright lines, greatly increasing the potential for similar arrangements to be portrayed very differently. Indeed, for a lessee, the accounting can flip between recording no assets and liabilities at a lease inception to recording the entire leased asset and entire loan price with only a very small change in economics. As discussed previously, the bright line tests have served to facilitate significant structuring of leases to obtain particular financial reporting goals. The extensive structuring further erodes the effectiveness of the standards." (page 106)

15. The Report went on to recommend that FASB should undertake a project to reconsider the leasing standards, preferably as a joint project with IASB.

Improved relevance and reliability of information

16. As noted above, the bright line distinction between operating and finance leases in current leasing standards can result in very different accounting for transactions that are economically very similar; and is seen as encouraging the structuring of transactions to achieve a preferred accounting treatment. Furthermore, although IAS 17 and national leasing standards are based on similar principles, they have differences that result in significantly different accounting, both as regards the timing of recognition of expenses and revenue and how they are classified.

17. The staff believe that the development of a leasing standard based on conceptually sound and consistent principles could avoid the bright line distinction and result in the recognition of assets and liabilities that more accurately reflects the rights acquired and obligations assumed in a leasing transaction.

18. Given the size of the leasing industry and the importance of leasing as a source of finance to a wide range of entities, the improved relevance and reliability of reporting of leasing transactions that would result would be a major improvement in financial reporting.

Criterion 2: Existing guidance available

19. As noted above, there are significant concerns with the current leasing standard, IAS 17, which requires a distinction to be drawn between operating and finance leases. The standard defines a finance lease as one which transfers ‘substantially all the risks and rewards incidental to ownership’. Although the standard sets out some indicators of when a lease is a finance lease, it provides no objective test for determining the point at which the ‘substantially all’ test is met. Lease terms can be readily devised to share the risks and rewards associated with the physical asset between the parties in any desired proportion. Consistent interpretation of ‘substantially all’ is very difficult, and reliance is often placed on the ‘bright line’ 90% tests used by US, UK and other standards. This results in similar transactions being accounted for differently, and provides an incentive to structure transactions to achieve the preferred accounting treatment.

20. In addition, the approach originally developed in the 1970s is inconsistent with the principles underlying other more recent and developing accounting standards. For example, the assets and liabilities recognised by the lessor and lessee under IAS 17 are not necessarily those that meet the definitions in the Framework (or the proposed revised definitions currently being considered by the Board). In addition, the principles underlying the measurement of the assets and liabilities, and the recognition of revenue, differ from those currently being developed by the Board.

Criterion 3: Possibility of increasing convergence

21. As noted above, existing leasing standards are generally based on the principles developed for the US standard FAS 13. The primary driver for this project is therefore the improvement of existing standards rather than convergence.

22. Work done with national standard setters at the G4 + 1, and subsequently in the development of the ASB's project on leasing (which included discussions at National Standard Setters meetings), indicates that there is widespread agreement amongst standard setters that a revision of the leasing standards is due and also with the basic principles that might underlie the new approach. Accordingly, the staff believe that there is a good prospect that the proposed project on leasing will gain support from national standard setters and regulators and that a single standard would be adopted world-wide. In order to achieve this, it will be important that the project is a joint one with the FASB.

Joint project with FASB

23. At present, the same basic model for lease accounting underpins leasing standards in most major jurisdictions. However, there are many differences in detail that lead to significant differences in accounting outcomes. Given the significance of the leasing industry and lease finance, these apparently minor differences can give rise to very substantial differences in financial statements.

24. The staff believe that it is essential that any final standard is developed jointly with the FASB, to avoid creating a major reconciliation difference between

IFRS and US GAAP. It is therefore proposed that – subject of course to approval by the FASB Board – the project should be a joint project working towards a discussion paper that would incorporate the preliminary views of both Boards.

25. The staff therefore believe that although the main driver of the project is improvement rather than convergence, the proposed project could nevertheless achieve an important convergence objective.

Criterion 4: Quality of standards to be developed

26. Considerable work has been undertaken by the G4 + 1 and in the joint project with the ASB in developing a conceptually sound approach to lease accounting, over a period of many years. The staff believe that this work has shown that the approach is likely to be able to be developed to form the basis of a comprehensive and consistent standard for leasing. The proposed project would analyse the rights acquired and obligations assumed in leasing transactions and result in assets and liabilities that more closely reflected these rights and obligations, thus improving the relevance and reliability of financial statements. This, together with the removal of the arbitrary distinction between finance and operating leases, would enhance the understandability and comparability of those statements.

Cross-cutting issues

27. Many of the issues that arise in this project are closely related to issues in other projects. Those identified are:

(a) Control – analysis of the lessee's asset involves consideration of what constitutes control, particularly in relation to options to extend the lease term, acquire the asset at the end of the lease term, or to early termination of the agreement. These issues are related to control issues arising in the business combinations project.

(b) Definitions of asset and liability – analysis of both the lessor's and lessee's assets and liabilities depends on the Framework definitions, which are currently under review in the conceptual framework project. Since the conceptual framework project is primarily aimed at clarifying rather than changing the definitions, it would seem appropriate for the analysis of leasing to follow the latest proposed definitions.

(c) Measurement – the appropriate basis for measuring the assets and liabilities that arise must be consistent with conclusions in the measurement phase of the conceptual framework project; the distinction between those attributes that are taken into account in determining what assets are recognised, and those that are taken into account in determining the measurement of the asset once it has met the recognition criteria, must also be explored.

(d) Revenue recognition – lessor accounting raises issues that are specific applications of the principles developed in the revenue recognition project; these include the pattern of recognition of revenue over the lease term, and the relationship between revenue recognition and the other cash flows of the lessor (such as interest and capital payments on financing for the loan, timing of tax payments and receipts, etc.). Where leases also include arrangements for the provision of services by the lessor (such as maintenance services) the principles of the revenue recognition project will apply to the way in which the contract is separated into components.

(e) Non-financial liabilities – although the lessee's obligations to pay rentals under the lease may be seen as a financial liability, other obligations of both the lessee and the lessor under the lease may be non-financial and the principles developed in the revision of IAS 37 will be applicable.

(f) Derecognition – some transactions involving leases (such as sale and leaseback transactions) raise issues of derecognition similar to those addressed in the financial instruments project.

28. The analysis of these cross-cutting issues should ensure that the project develops in a way that is consistent with other current projects. The

development of a leasing standard that does not accord ‘special accounting rules’ for leases but treats them consistently with other types of transactions would be a significant improvement to current IFRS.

Cost benefit analysis

29. An important aspect of the quality of a new standard is the balance between the benefits of the information produced in accordance with the standard and the costs to entities of providing such information. The staff do not think that a new accounting model for leases will necessarily be more costly than existing finance lease models, although for more complex leases it may be necessary to separate out some features of the transaction and account for these separately. Furthermore, the proposed approach might result in more complex accounting for leases that are currently operating leases and accounted for on a simple accruals basis for the lease rentals. This cost/benefit balance will need to be borne in mind as the project develops.

30. It is important that the Boards can show that they have balanced the costs and benefits of the new model that is being developed. The benefits will largely be in terms of improved financial reporting, and in financial statements that more clearly reflect the true nature of the transactions entered into. In addition, there are currently inconsistencies between the accounting for items that qualify as leases and other similar transactions that do not. Reduction of such inconsistencies will represent a major improvement in the quality of reporting.

31. Although the purpose of this project is primarily to improve existing standards rather than convergence, removal of the existing differences between different national leasing standards and IFRS will increase comparability and reduce the need to users to make estimated adjustments in analysing entities in different jurisdiction. In addition, this would reduce costs for entities reporting under more than one GAAP.

32. Cost for preparers will fall into two categories:

    (a) The costs of applying a new standard; both lessees and lessors currently need complex accounting systems to record lease transactions and calculate the amounts currently shown in financial statements –

this is particularly true for lessors. Although the new model may not be any more complex, changing from one to another is likely to involve significant systems costs; and a greater use of fair values in measurement of leasing transactions may also result in additional ongoing costs. In addition, the new proposals might result in more complex accounting for leases that qualify as operating leases under existing standards.

(b) The accounting treatment of a lease transaction is often perceived as being a significant factor determining whether, and on what terms, the parties enter into the transaction. As a consequence, a new accounting model may significantly alter the balance between the various alternatives for financing; whilst this will produce both 'winners' and 'losers', this will be perceived as a cost to the losers.

Criterion 5: Resource constraints

33. Although much work has been done in developing the G4 + 1 papers and in the subsequent joint project with the ASB, there are many complex issues to be addressed in this project:

(a) the Board will need to reconsider and reaffirm its previous preliminary analysis in the light of its consideration of other recent projects;

(b) in particular, the cross-cutting issues referred to above are areas where the Board is developing its thinking and may wish to revise previous conclusions reached in the leasing project;

(c) previous projects have not addressed all issues relating to complex lease arrangements, and have not covered disclosures and lessor accounting, both of which will need full consideration; further research into user needs may also be necessary;

(d) the issues will also need to be considered by the FASB as the discussion paper is developed (if this is carried out as a joint project) or as the proposals are taken forward to an exposure draft; and it will also be important that other national standard setters are involved so that a broad consensus is achieved;

(e) there are also many variations on the basic leasing theme, and further research might be needed to ensure that these do not raise issues that undermine the model being developed.

34. Current resources allocated to this project are expected to be sufficient in the early stages of the project, but additional resources might be necessary as it develops, particularly if extensive research or field testing are necessary.

35. If a joint project is approved, it would be run with a joint project team. Staff currently assigned to the project are:

IASB: Simon Peerless (on part-time secondment from ASB)
Rachel Knubley

FASB: Danielle Zeyher

Staff recommendation

36. The staff consider that this is an important project that would address an area where the current standard provides information that is inconsistent with other more recent standards and does not provide users with sufficiently transparent and useful information, as well as being open to structuring opportunities.

37. The staff therefore recommend that the Board approves the commencement of this project, jointly with the FASB if that Board also agrees, with the initial intention of issuing a discussion paper setting out preliminary views on the issues.

38. The rest of this paper sets out a proposed outline of the contents of such a discussion paper, together with a preliminary discussion of the main issues.

PROPOSED PROJECT PLAN

39. The initial objective of the project would be to produce a discussion paper exploring the issues and setting out the preliminary views of the Board.

40. It is proposed that the Discussion Paper will develop a single model for recognition and measurement of assets and liabilities arising under lease arrangements. This would apply to all leases, removing the current finance/operating lease split (although an exemption for very short-term or immaterial leases might be considered). The Discussion Paper would set out the Board's preliminary views on the issues (together with FASB preliminary views if a joint project is undertaken).

41. The discussion paper would cover the following areas:
    - History of lease accounting and types of lease
    - Current lease accounting standards
    - Criticisms of current standards and need for a revised approach
    - Conceptual analysis of the lessee's asset and liability
    - Appropriate measurement attribute for the lessee's asset and liability
    - Recognition and measurement of the lessor's asset
    - More complex leases:
        - Rights and obligations arising from options to renew or terminate the lease
        - Residual value guarantees and similar arrangements
        - Contingent and variable rentals
        - Sale and leasebacks
        - Manufacturer and dealer lessors
    - Lessor accounting
    - Disclosures by lessees and lessors

    Initial discussion of these issues is set out in Appendix 1.

Working Group

42. This is a major project with very significant implications for the accounting treatment of many substantial transactions, and will affect the financial position statements and reported profits of a wide range of entities, both in the financial sector and in other industries. Leasing is a major source of finance for businesses, public sector bodies and others, and there is a perception that the current accounting model for leases, and in particular the finance lease/operating lease split, is a major feature of financial management and control in many entities.

43. It is important that the Boards demonstrate their willingness to understand the ramifications of the proposals from the beginnings of the project. Consequently, the staff propose that a Working group would be set up to act in an advisory capacity. The purpose of the working group – covering users as well as preparers – would not be to develop proposals, but as a means of testing ideas and concepts developed by the Boards and their staff. This would enable the Boards to check their understanding of the transactions being considered, the implications of the new accounting model being developed, and the practicality of the proposals, against the experience of a range of advisors with leasing industry experience.

Work plan and timetable

44. There are many complex issues for the Board to discuss before it can reach conclusions to be published as preliminary views in the discussion paper. The need to consider issues in tandem with the FASB will need to be borne in mind. Time must also be allowed for proposals to be discussed with the working group and its comments summarised for the Board.

45. It is proposed that the project be carried out in five sections. Each section would be discussed at a Working Group meeting (lasting one or two days), followed by discussion at two (or more) meetings of each Board.

46. Accordingly, the following timetable is proposed:

Section 1: Rights and obligations, Assets	WG December 2006, Board discussions

and Liabilities	February and April 2007
Section 2: Measurement	WG March 2007, Board discussions May and July 2007
Section 3: Scope	WG June 2007, Board discussions September and November 2007
Section 4: Lessor accounting[2]	WG June 2007, Board discussions December 2007 and March 2008
Section 5: Disclosures	WG November 2007, Board discussions February and April 2008
Issue of Discussion Paper	Third quarter 2008

47. Meetings of Board advisors and discussions with resource groups would be held as appropriate, probably before papers are finalised for each Working Group meeting, and in advance of Board meetings where necessary. The Board discussion on each section would be followed by a pre-ballot draft of that section of the Discussion Paper.

48. The above timings assume that no delays in the timing arise, that convenient dates for WG meetings can be found when planned, and that Board discussions reach conclusions within the two meetings planned for each group of issues.

49. A more detailed timetable, together with more details on the issues that would be covered in each section of the project, is set out in Appendix 3 **[appendix omitted from observer notes]**.

[2] Lessor rights, obligations, assets and liabilities will also be discussed in sections 1-3. However, detailed analysis of lessor specific issues (e.g. revenue recognition) will be deferred to section 4.

APPENDIX 1

PROPOSED DISCUSSION PAPER – OUTLINE OF MAIN ISSUES TO BE ADDRESSED

A1. The term 'lease' is used to cover a wide range of arrangements between contracting parties. The term generally implies that one party to the arrangement (usually referred to as the lessor) owns a physical item of plant, property or equipment and gives the other party (the lessee) rights to use the item of PPE for a specified period in exchange for periodic payments.

A2. An example of a simple lease, as the basis for the following discussion and analysis, would be:

- the lessor owns a piece of machinery
- the lessee takes possession of the machinery at the beginning of the lease period, and has the right to use it for the period of the lease term
- the lessee makes regular payments over the lease term
- at the end of the lease term the lessee has the obligation to return the machinery to the lessor, in reasonable working order
- the lease term is for several years, but is for a period that is shorter than the expected useful economic life of the machinery; the machinery is therefore is expected to have a significant residual value at the end of the lease term
- neither party has any other rights or obligations under the arrangement.

What is the lessee's asset?

A3. The lease agreement gives the lessee certain rights over the asset, in exchange for assuming obligations to pay rentals.

A4. In order to determine how the lessee should account for the leased asset, the nature of the acquired rights needs to be analysed. Two approaches are possible:

- 'physical asset' approach
- 'bundle of rights' approach.

Physical asset approach

A5. Where an entity owns an item of PPE, this is recognised as an asset. A lease agreement might transfer rights to the leased item that are sufficiently close to those that arise if the asset is owned for the item to qualify for recognition as though it were owned. However, where the lessee's rights are significantly less than those that would arise if the asset were owned, then the item does not meet the definition of an asset of the entity. The project could analyse more fully exactly what rights (and risks) arise from ownership of an asset, and which of these would need to be transferred to the lessee for the lease to be equivalent to ownership for accounting purposes.

A6. However, the rights under a lease will always be slightly different from the rights of an outright owner of an item of PPE. Under the 'physical asset' approach, it is therefore necessary to decide how close the lessee's rights need to be to those of an owner for the item to qualify as an asset.

A7. This approach can be categorised as an 'all or nothing' approach, in that if the lessee's rights are sufficiently close to those of an owner, the whole of the item is recognised as an asset; if the arrangement is successively modified to reduce the lessee's rights, there comes a point when the line is crossed, and the remaining rights are no longer considered 'sufficiently close' – at which point, the item would not qualify for recognition as the lessee's asset at all. Thus the item is either fully an asset, or not an asset.

A8. To some extent this can be a unit of account issue. The lease of part of a building can be seen as either a partial right to the whole building, or full rights to part of the building. By separating the overall property into separate units, the 'physical assets' approach can still allow recognition of an asset in these circumstances.

A9. More debatable is the situation where the lessee's rights are similar to those of an owner, but for a limited period – for example, a five-year lease of an item of PPE that has an expected life of ten years. To regard this as a unit-of-account issue seems more difficult – the physical asset would need to be divided into 'bricks with a life of five years' and 'bricks with a life of five years starting in five years time'. Conceptually, this seems closer to the 'rights' approach discussed below than a division of the physical asset into its smaller physical components. Alternatively, the full asset could be recognised by the lessee together with a liability representing the obligation to deliver the residual asset to the lessor at the end of the lease.

Bundle of rights approach

A10. Under this approach the various rights acquired by the lessee under the lease agreement are identified, and this 'bundle of rights' is considered for recognition as an asset. If these rights are close to those of an owner, the recognised asset will be similar to the asset that an owner would recognise. If the rights are significantly less, the asset recognised will also differ from that recognised by an owner. However, there is no cut-off point at which rights fail to qualify as an asset – the asset recognised is merely "smaller" if the rights are less.

A11. An item of PPE is an economic resource – it can be used in the production of goods or provision of services (or otherwise used in economic activities) in such a way as to generate economic benefits to the entity using it. Under the lease, the lessee acquires a right to use the item and thereby has the right to the economic resource. This right to the resource may be limited in several ways. Principally, the term of the lease imposes an obligation to cease using the item of PPE at a specified date and deliver the item to the lessor – or, under some lease contracts, to sell the item and deliver the proceeds to the lessor (and possibly with a minimum amount guaranteed).

A12. In particular, if the lessee acquires rights to part only of the leased item's expected life, the asset recognised by the lessee will represent that part of the useful life.

A13. Other restrictions on the use of the item of PPE might apply – in a property lease, there will usually be restrictions on the nature of changes to the building that the lessee is permitted to make, and an obligation to obtain permission from the lessor for even minor changes. There might be other obligations to the lessor – for example, obligations to maintain the item to a specified level (and there may be a requirement that maintenance is carried out by the lessor or lessor's nominated service supplier). Such obligations might be seen as either a limitation on the right to use of the asset (thus resulting in a 'smaller' asset); or as a separate obligation to the lessor.

A14. Conceptually, what is recognised as an asset under this approach is not the physical item itself, but the bundle of rights acquired by the lessee. The *Framework* definition of an asset is 'a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise'. In applying this definition, it is necessary to regard the resource as being those parts of the underlying physical item that the entity controls by means of the rights obtained under the lease.

A15. It is clearer that the bundle of rights meets the FASB asset definition, which defines an asset as being the future economic benefits themselves; and also the ASB Statement of Principles, and the revised asset definition being considered in the conceptual framework project, which define an asset in terms of rights or other access to resources.

Liabilities of the lessee

A16. The lessee enters into two principle obligations under the simple lease arrangement described above:

- to make payments to the lessor during the lease term
- to return the machinery at the end of the lease term.

A17. In this simple lease contract, the lease payments represent a series of fixed amounts on fixed dates, and therefore can be seen as similar in nature to a financial liability.

A18. Alternatively, however, the lease can be portrayed as an executory contract under which the obligation to make payments arises only as the lessor delivers its side of the bargain – that is, as the lessor, day by day, continues to provide the machinery for the use of the lessee, the lessee becomes obliged to pay the rent for that day's use. Thus at any point in the lease the lessee has an actual obligation for any rental relating to its past use of the asset, and a stand-ready obligation to make payments for its future use. This analysis sees the lease as similar to contracts to provide services, or ‘take-or-pay’ contracts for commodities, both of which are treated as executory contracts with no obligation for future payments recognised.

A19. In the case of a lease of machinery, the lessor will generally have neither the right (provided the lessee makes payments when they fall due) nor the ability (short of force majeure) to deprive the lessee of the machinery until the end of the lease term; it can be argued, therefore, that there is therefore no continuing obligation of the lessor to provide the asset, but merely an initial obligation to deliver the asset to the lessee. However, for other types of lease (for example, the lease of a single office in a building where the access is controlled by the lessor) this is less clear cut.

Obligation at the end of the lease term

A20. At the end of the lease term, the lessee has the obligation to return the leased item. Under the ‘physical asset’ approach, it can be argued that the asset recognised by the lessee represents the whole of the physical item; accordingly, the obligation to return the item is not a reduction in the asset but a separate obligation which should be presented as a liability rather than offset against the asset.

A21. Under the ‘bundle of rights’ approach to the asset, the obligation to return the item of PPE may be seen as either a separate obligation, or as a limitation on the rights acquired under the lease (and thus the lessee acquires a limited right that is recognised as an asset, with no separate liability).

What measurement attribute is appropriate for the asset and liability recognised?

A22. Once the nature of the lessee’s assets and liabilities has been considered, the question of the appropriate measurement attribute needs to be addressed. This could be:

- fair value
- some entity-specific current value
- some cost-based value.

A23. A lease arrangement might give rise to several assets and liabilities of differing types, and for which different measurement attributes might seem appropriate:

- recognition of the physical asset, or a right to use an asset for substantially all of its useful life may be seen as similar to an asset that is recognised when an item of PPE is owned; and similar measurement attributes to those of IAS 16 (depreciated cost, with a revaluation option) could be adopted;
- recognition of an asset representing the right to use an item for substantially less than its useful life may be seen as different from direct ownership and therefore different measurement attributes might be appropriate;
- optional rights under a lease arrangement (e.g. option to extend the lease term) are again a different type of asset;
- liabilities representing the obligation to pay rentals under the lease are similar to financial instruments under IAS 39, and similar measurement attributes might be adopted – amortised cost or fair value;
- other obligations under the lease, if recognised as a liability, may be non-financial liabilities and an 'expected value' attribute may be consistent with IAS 37.

A24. Once the measurement attribute is decided upon, the means of determining the amount of that attribute will also need to be considered. There are many practical difficulties in measuring both cost and fair value attributes which will need to be considered.

Lessor's assets

A25. The appropriate measurement of the lessor's assets raises more complex issues that are set out in paragraphs A46 to A57 below.

MORE COMPLEX LEASES

A26. The analysis of the simple lease discussed above must be extended to cover more complex leasing arrangements. Three main types of lease features are summarised below:

- options to extend the lease term or terminate the lease early
- variable rentals
- residual value guarantees.

Rights and obligations arising from options to renew or terminate the lease

Lessee's options to renew/terminate

A27. In some lease arrangements the lessee is given the right to extend the lease term in exchange for additional lease payments, or to terminate the lease at 'break points' specified in the contract.

A28. When the lessee has the right to extend the lease, the rights and obligations of the lessee under a 'bundle of rights' approach can be summarised as follows:

- the right of use for non-optional period
- the option to extend right of use for the optional period
- an obligation to pay rental for non-optional period
- an obligation to return the item of PPE at the end of *non-optional* period if the option is *not* exercised
- an obligation to return the item of PPE at the end of the *extended* period if the option *is* exercised

A29. The following questions arise:

(a) Should the lease be accounted for as an asset representing the right to use the asset for the non-optional period, and a separate asset representing the option to extend the lease; or does the lessee obtain control of the asset for the *whole* of the extended period at the outset? Does the nature of the lease agreement alter this – for example, if the rentals for the optional period are set at a very low level (so the option is heavily 'in the money' and therefore it could be argued is almost certain to be exercised)?

(b) What measurement attribute is appropriate for the option to renew at initial recognition? One suggestion is to measure it at its fair value at the commencement of the lease. It is not clear how lessee can determine this (it is not always practicable to get 'with and without' quotes from the lessor, and anecdotal evidence indicates that these do not show a consistent value attributable to such options). Are there alternative approaches based on some other method of apportioning the value of the consideration that would be practical? Would these lead to a different answer?

(c) Is an option to cancel treated in the same way as a shorter lease with an option to renew – for example, is a 5-year lease with an option to cancel after 3 years the same as a 3-year lease with an option to extend to 5 years? In the first case, there is a *present* right of use of the item of PPE for 5 years, conditional on the lessee not exercising its option to terminate; in the second case, there is a *present* right of use for 3 years only, and a contingent right to the extension period. Is this distinction relevant to the accounting treatment even though the two are commercially the same?

(d) How are cancellation penalties to be accounted for? Are they equivalent to higher rental in the period before cancellation option is exercised, or a cost on cancellation?

(e) Is it necessary to distinguish between 'genuine' and 'non-genuine' options – that is, should there be a requirement to ignore the elements of an option included in the lease arrangement that are on such terms that it would never be commercially sensible to exercise them (or alternatively, on such terms that it would always be commercially sensible to exercise them). It could be argued that if the lease accounting model that is proposed is correct, it should not be necessary to distinguish these (ie if the analysis properly reflects the nature of the rights and obligations of the parties, the inclusion of non-genuine options will not affect the analysis)

Lessor's options to terminate the lease

A30. If the *lessor* has an option to terminate the lease, the lessee has no unconditional rights beyond the non-optional period. In such cases the lessee's asset cannot be greater than the right of use for the *non-optional* period – but the lessee has an obligation for the rentals for the full period unless the lessor cancels. Should this be accounted for as a conditional obligation (conditional on the lessor not cancelling), together with an unconditional ‘stand ready obligation’ to pay rental for the optional period?

Residual value guarantees and similar arrangements

A31. Lease arrangements (particularly those that are of a long-term ‘financing’ nature) often include a guarantee of the residual value of the item of PPE at the end of the lease term, to protect the lessor against a fall in this value. Where this guarantee is provided by a third party (an entity not connected to either the lessor or the lessee) this would normally be a ‘stand ready’ obligation of the guarantor to pay the shortfall in value if it arises, and the normal accounting (consistent with IAS 37) would be for the guarantor to show these as ‘net’, i.e. recording an obligation for any shortfall only, rather than a gross obligation of the amount guaranteed and an asset of the expected value of the item of PPE at the end of the lease term. Would this still apply if the guarantor was paid a substantial sum for the ‘guarantee’, and the guaranteed value was significantly higher than the expected value at the end of the lease? What other circumstances might cause a gross presentation? For example, if the guarantor has the obligation to purchase the asset at the end of the lease, might this be shown as an obligation and an asset representing the remaining useful life of the item of PPE? But delivery is usually the trigger for such recognition of asset/liability.

A32. Different considerations might apply when the guarantee is given to the lessor by the lessee, rather than a third party. In some cases it would seem that the guarantee is more in the nature of a put option enabling the lessor to require the lessee to acquire the item of PPE at the end of the lease term.

A33. From the lessor’s point of view, the existence of residual value guarantee arrangements might be such that they transform its residual interest in the item of PPE from a tangible asset to something more in the nature of a financial asset, and it may be appropriate to account for it as such.

Contingent and variable rentals

A34. Under the lease agreement, the amounts payable may be fixed, or the lessee may have the obligation to pay rentals that may vary in some specified way. Variable rentals fall into the following main categories:

(a) Index-linked (or other external factor such as market rentals; the ‘upward-only’ rent revision clauses common in property leases in some jurisdictions will also need to be considered) – the lessee’s liability could be measured based on the expected future level of rentals; these are likely to be embedded derivatives that in some cases will be required to be bifurcated;

(b) Usage-based: for example, lease payments for a car lease may assume a maximum mileage over the lease term, and additional lease payments become due if that mileage is exceeded.

(c) Turnover leases and similar arrangements – for example, rentals may be based on a proportion of the turnover achieved with the leased asset (e.g. shop premises), or seat occupancy (in a leased stadium)

A35. The following issues arise:

(a) In each case, should the measurement of the lessee’s liability and the lessor’s asset be based on the *expected* lease payments?

(b) If so, should they be remeasured each year as estimates change?

(c) Should changes in the measurement of the lessee’s obligation be reflected as changes in the carrying value of the related asset representing the right to use, or through profit and loss?

A36. An alternative analysis of turnover leases is that, rather than being an *additional obligation* of the lessee, the payments based on future turnover should be seen as a *reduction in the right* acquired by the lessee (ie the lessee obtains a ‘restricted’ right to the economic resources, since for every CU1 generated from use of the asset, a proportion must be paid to the lessor. This approach might be seen as having some similarities with the derecognition of ‘pass-through’ arrangements for financial assets under IAS 39.

Scope and definition of lease

A37. Most of the discussion above has been about things that are clearly ‘leases’; more complex arrangements might incorporate the transfer of rights and obligations in a way that is similar to a lease, but also include additional rights and obligations.

A38. For example, many leases include the provision of services (for example, an agreement that the lessor carries out regular maintenance of the leased asset). In some such cases, it will be relatively straightforward to split the contract into a lease and a contract for the provision of services. If the lessee is able to obtain equivalent services from alternative providers, or the lessor offers the same leased asset in both 'with-maintenance' and 'without-maintenance' alternatives, it will be possible to separate the two elements of a combined contract. However this will not always be the case. Principles for separating the two parts of the contract might need to be developed, consistent with the approach developed in the revenue project.

A39. Other arrangements might transfer indirect or restricted rights to assets (for example, where the lessee has the right to use the item of PPE for a specific purpose only; or where the lessor has rights to receive some portion of the production resulting from use of the asset, or services delivered by use of the asset).

A40. The current lease accounting standard applies only to leases of tangible assets; however, similar arrangements for leasing of intangible assets also arise. Whilst the same basic analysis and principles might apply to both tangible and intangible asset leases, there may be many practical considerations that arise if the scope is extended to cover leases of intangible assets.

A41. The scope of application of the proposed model may therefore need careful analysis, to avoid on the one hand trying to solve too wide a range of issues; and on the other hand addressing too narrow a range so that inconsistencies arise with between leases in the scope of the new proposals and arrangements outside the scope.

A42. Normally it would be expected to define the scope of a project at an early stage, before addressing how to account for transactions within that scope. In this case, however, it is thought better to explore the accounting model for a standard form of leasing transaction, and consider how that accounting model could then be applied to arrangements that were not so clearly a lease.

Sale and leasebacks

A43. An entity that owns a item of PPE (usually property) might enter into an arrangement to sell it to a finance house and at the same time enter into a lease of the item. IAS 17 includes guidance on the accounting for such transactions, and in particular the recognition of any excess of the sales proceeds over the previous carrying amount of the item of PPE. Such excess is amortised over the life of the lease if the lease is a finance lease, but recognised immediately in an operating lease unless the sale is not at fair value.

A44. When an entity enters into a sale and leaseback, it retains some or all of the rights of use relating to the item of PPE; the following issues arise:

- under a 'physical asset' approach, no gain should be recognised if the item remains recognised by the entity, but should be recognised as a gain on disposal if the item is derecognised;
- under a 'bundle of rights' approach, should the right of use retained be remeasured to fair value (or a price determined by the transaction), or kept at historical cost?
- should a change in value of the right retained be recognised as revenue or a gain other than revenue?
- should revenue be recognised in relation to the rights disposed of?

Disclosures

A45. Lease arrangements can give rise to a range of rights and obligations for the parties that cannot be captured fully in the primary financial statements, whatever the accounting model. Requirements to ensure full disclosure, particularly in the case of complex arrangements, will need to be developed once the accounting model is agreed.

Lessor accounting

A46. The above issues have focused more on the lessee than the lessor. More specialised issues arise in determining the lessor's accounting – and in particular, the measurement of the lessor's asset, with its consequential impact on the timing of profit recognition by the lessor over the period of the lease.

A47. From the commencement of the lease period the lessor has an asset representing the future lease payments; this asset could be regarded as being similar in nature to a loan or similar financial asset, and therefore accounted for in accordance with IAS 39 – that is, initially at fair value, and subsequently either at amortised cost, or fair value.

A48. An alternative approach would be to consider how the lessor discharges its obligation to the lessee over the period, and to recognise revenue in a pattern that reflects this.

A49. However, both of these approaches would be very different from current lessor accounting models, which are closely tied in to the valuation models used by the lessor in pricing lease transactions. These accounting models are driven by principles that attempt to recognise the total profit that the lessor derives from the lease being allocated over the term of the lease in a way that gives a constant rate of return on the lessor's net investment in the lease – and some methods make this allocation on a basis that incorporates expected tax cash flows in the model.

A50. The discussion paper will therefore need to consider which of the above approaches is most appropriate – the financial asset model, the revenue recognition model, or the profit allocation model.

A51. Variable rentals add a further complication. Under a financial instrument model a fair value measurement attribute could be adopted, but might give rise to practical difficulties in estimating future cash flows. An amortised cost basis could also be adopted, although it may not always be clear how this is determined where the variable is based on turnover or occupancy levels in future years.

A52. The lessor's residual interest in the leased item is essentially the same as a deferred interest in an item of PPE, and could be accounted for in the same way as tangible assets, subject to impairment tests and with revaluation permitted.

A53. The ‘written option’ for the lessee to extend the lease, or to terminate early, can give rise to significant risks for the lessor; measurement of this on a fair value basis would ensure that potential losses arising were recognised immediately, but would give rise to practical problems in determining the fair value at each reporting date.

Sub-leases, back to back leases and leveraged leases

A54. In a straightforward sub-lease arrangement, a lessee in turn enters into a lease of the same item of PPE with a sub-lessee. Where the first lease and the sub lease are arranged separately, no new issues arise. However, where both leases are part of a single three-party arrangement, further analysis of the rights and obligations of each party might be needed. Through leases involve an intermediate lessee/lessor that acts essentially as an agent, passing rentals received from the sub-lessee through to the ultimate lessor. However, the intermediary may retain significant obligations in the event of default by the sub-lessee, on early termination of the lease, or in relation to residual value guarantees.

A55. Leveraged leases are very important in some jurisdictions (especially the US). These involve a lender providing finance to the lessor on a non-recourse basis. The same analysis of assets and liabilities should be applied to these leases.

Manufacturer and dealer lessors

A56. Where the lessor is a manufacturer of the leased item, the question arises as to whether entering into the lease is equivalent to a sale and should result in recognition of revenue. Similarly, where the lessor is a dealer in such items, and purchases them in order to make a dealing profit, does the lease trigger the recognition of such dealing profit? IAS 17 provides guidance to the effect that a normal selling profit should be recognised, but that when artificially low interest rates in the lease contract give rise to an apparently inflated profit, this should be deferred and amortised over the lease term.

A57. These questions are essentially issues of revenue recognition that need to be addressed within the context of the revenue recognition project and the general principles developed there.

CROSS-CUTTING ISSUES AND RELATIONSHIP TO OTHER PROJECTS

A58. Many of the issues that arise in this project are closely related to issues in other projects. Those identified are:

(a) *Control* – analysis of the lessee's asset involves consideration of what constitutes control, particularly in relation to options to extend the lease term, acquire the asset at the end of the lease term, or to terminate early. These issues are related to control issues arising in the business combinations project.

(b) *Definitions of asset and liability* – analysis of both the lessor's and lessee's assets and liabilities depends on the Framework definitions which are currently under review in the conceptual framework project.

(c) *Measurement* – the appropriate basis for measuring the assets and liabilities that arise must be consistent with conclusions in the measurement project; the distinction between those attributes that are taken into account in determining what assets are recognised, and those that are taken into account in determining the measurement of the asset once it has met the recognition criteria, must also be explored.

(d) *Revenue recognition* – lessor accounting raises issues that are specific applications of the principles developed in the revenue recognition project; these include the pattern of recognition of revenue over the lease term, and the relationship between revenue recognition and the other cash flows of the lessor (such as interest and capital payments on financing for the loan, timing of tax payments and receipts, etc.). Where leases also include arrangements for the provision of services by the lessor (such as maintenance services) the principles of the revenue recognition project will apply to the way in which the contract is separated into components.

(e) *Renewal options* – many of the complex issues relating to lease accounting derive from the inclusion of renewal, cancellation and other options in lease arrangement. Similar issues arise in other projects, in particular in revenue recognition and insurance.

(f) *Non-financial liabilities* – although the lessee's obligations to pay rentals under the lease may be seen as a financial liability, other obligations of both the lessee and the lessor under the lease may be non-financial and the principles developed in the revision of IAS 37 will be applicable.

APPENDIX 2

SUMMARY OF PREVIOUS BOARD DISCUSSIONS ON LEASING

[Appendix omitted from observer notes]

APPENDIX 3

TECHNICAL PLAN AND TIMETABLE

[Appendix omitted from observer notes]