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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 June 2007, London**

Project: **Leases**

Subject: **Measurement of the Lessee's Liability to the Lessor (Agenda paper 4A)**

Introduction

1. The purpose of this paper is to analyze alternative approaches for the initial and subsequent measurement of a lessee's liability for its obligation to make payments to the lessor arising under a simple lease contract. That is, a non-cancellable lease with a fixed term, no options to extend or purchase, and no residual value guarantees. Lease payments are due at regular intervals over the lease term after the item has been delivered. These are fixed amounts that are specified in the original agreement and are payable in advance. No maintenance or other arrangements are entered into. The Boards have tentatively concluded (IASB March 2007; FASB March 21, 2007) that under such a lease, the lessee's contractual obligation to make payments to the lessor meets the definition of a liability.

2. This paper first considers the nature of the lessee's liability—whether it is financial or non-financial in nature. Next, this paper explores the implications of that determination on measurement. Finally, this paper develops alternatives for

the initial and subsequent measurement of the lessee's liability to the lessor and describes the staff's recommendations.

3. It should be emphasized that this paper considers only the simple lease contract described above. More complex leases, for example, leases that include contingent rentals, will be considered later. Furthermore, this paper does not attempt to fully analyze the treatment of various transaction costs. Those issues will be considered at a later date.

4. Board members also should consider that decisions reached about the date the lessee's liability is initially recognized could affect the amount of the initial measurement (and possibly subsequent measurements). The initial recognition date is analyzed in IASB Agenda Paper 4C / FASB Memorandum #11.

Nature of the Liability

5. The lessee's liability to the lessor arising from a simple lease contract represents its obligation to make specified cash payments to the lessor over the term of the lease. This section considers the nature of the lessee's obligation to the lessor, specifically whether it should be considered a financial liability.

6. The IASB and the FASB have similar definitions of a financial liability. Paragraph 11 of IAS 32, *Financial Instruments: Presentation,* states that a financial liability is "any liability that is a contractual obligation to deliver cash or another financial asset to another entity…." Paragraph 364 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* defines a financial liability as "a contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity…."

7. The lessee's liability to the lessor clearly meets the IASB's definition, as it is a contractual obligation to deliver cash to another entity. However, if one looks only at the FASB's definition, one could conclude that the lessee's liability to the lessor does not meet the FASB's definition of a financial liability in the strictest sense. Although the IASB and FASB definitions of a financial liability are similar, they are written from a slightly different unit-of-account perspective. The unit of account is "a contractual obligation" under the IASB's definition, while the unit of account under the FASB's definition is "a contract." One could conclude

that since the lessee's liability to the lessor does not represent "a contract," but merely a component of a contract, then it fails to meet the FASB's definition of a financial liability.

8. Yet such a strict application of the FASB's definition of a financial liability would be inconsistent with guidance elsewhere in Statement 140. Paragraph 89 of Statement 140 states that "minimum lease payments are requirements for lessees to pay cash to lessors and meet the definition of a financial asset." There the FASB makes clear that a lessor's asset for the right to receive cash flows from the lessee is a financial asset. Therefore, by the same logic a lessee's liability for the obligation to make cash flows to the lessor also must meet the definition of a financial liability. Thus, any confusion as to whether a lessee's liability to the lessor is a financial liability comes from the wording, but not the intent of the FASB definition.

9. In summary, the lessee's liability to the lessor for specified cash payments over the term of the lease meets the definition of a financial liability under both the IASB and the FASB definitions.

Implications of the Obligation's Nature

10. Because a lessee's liability to the lessor is a financial liability, the Boards' guidance for other financial liabilities may inform the Boards' decisions on its initial and subsequent measurements. This section summarizes the existing guidance in IFRS and U.S. GAAP for measuring financial liabilities.

11. Under IFRS, most financial liabilities are within the scope of IAS 39, *Financial Instruments: Recognition and Measurement*, which classifies a financial liability as either "at fair value through profit or loss" or "not at fair value through profit or loss." Financial liabilities at fair value through profit or loss are initially measured at fair value and subsequently measured at fair value with changes recognized in profit or loss. Those liabilities include:

    - A financial liability held for trading, including derivatives (except a financial guarantee contract or a derivative in a designated and effective hedging relationship)
    - A financial liability designated by the entity as at fair value through profit or loss, when doing so results in more relevant information, because either:

i. It eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases; or

ii. A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about that group is provided internally on that basis to the entity's key management personnel (IAS 39, paragraph 9).

12. Financial liabilities not at fair value through profit or loss are initially measured at fair value plus transaction costs[1] that are directly attributable to the issue of the financial liability (IAS 39, paragraph 43). Those liabilities are generally subsequently measured at amortized cost using the effective interest method, with some exceptions involving transfers of financial assets, financial guarantee contracts, loan commitments at below market rates, and designated hedged items (IAS 39, paragraph 47).

13. For a financial liability, the effective interest method described in IAS 39 is a method of calculating the amortized cost of the financial liability and allocating the interest expense over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash payments on the liability to the initial net carrying amount of the financial liability. When calculating the effective interest rate, an entity estimates the cash flows based on the terms of the contract, but does not consider future changes in its own credit risk. That calculation also includes all transaction costs (IAS 39, paragraph 9). If the estimate of the future cash flows changes, the entity recalculates the carrying amount by computing the present value of the estimated future cash flows at the original effective interest rate. That adjustment is recognized as income or expense in profit or loss (IAS 39, paragraph AG8).

14. Some liabilities under IFRS may meet the definition of a financial liability but are explicitly scoped out of IAS 39. Those include lease obligations, employee

[1] Note that the treatment of transaction costs associated with a lease contract will be considered at a later date.

benefit obligations, insurance obligations, and share-based payment awards (IAS 39, paragraph 2). Only the guidance for leases will be considered in this section.

15. Under IAS 17, *Leases,* a lessee's liability to make payments to the lessor under a finance lease is initially measured at the fair value of the leased property or, if lower, the present value of the minimum lease payments. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate is used (IAS 17, paragraph 20). For subsequent measurements, minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability. The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability (IAS 17, paragraph 25).

16. The interest rate implicit in the lease is the rate that sets the payments to be received by the lessor and the lessor's estimate of the future residual value of the item equal to the current fair value of the leased item. The lessee's incremental borrowing rate is the rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to make the required payments to the lessor.

17. Under U.S. GAAP, the guidance for measuring financial liabilities is not as consolidated, nor as prescriptive, as under IFRS, but the same general approaches apply. Some financial liabilities, particularly derivatives not in a hedging relationship (FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*) and financial liabilities to which the fair value option has been elected (FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) are initially and subsequently measured at fair value with changes reported in earnings. Many other financial liabilities, such as notes exchanged for property, goods, or services, are initially measured at an amount that reasonably approximates the market value of the note and subsequently measured using an interest method or another method of amortization if the results are not materially different from the interest method. Issue costs are reported on the balance sheet as deferred charges (APB 21, paragraphs 11–16).

18. Paragraph 97 of FASB Statement of Financial Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, identifies three different techniques that can be used to address changes in estimated cash flows under an interest method:

    - The prospective approach, where a new effective interest rate is computed based on the carrying amount and remaining cash flows.
    - The catch-up approach, where 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.
    - The retrospective approach, where a new effective interest rate is computed based on 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.

19. In paragraph 98 of CON 7, the FASB indicates a preference for the catch-up approach. However, other approaches are used elsewhere in U.S. GAAP. The catch-up approach is consistent with the effective interest method under IAS 39.

20. Under FASB Statement No. 13, *Accounting for Leases*, a lessee's liability for payments to the lessor under a finance lease is initially measured at the present value at the beginning of the lease term of the minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, together with any profit thereon. However, if that amount exceeds the fair value of the leased property at the inception of the lease, the amount recorded is that fair value (Statement 13, paragraph 10). The discount rate used to determine the present value is the lessee's incremental borrowing rate, unless it is practicable to learn the implicit rate computed by the lessor and the implicit rate is less than the lessee's incremental borrowing rate. If both of those conditions are met, the implicit rate is used (Statement 13, paragraph 7(d)).

21. The Boards have stated publicly that they share a long-term goal of requiring that all financial instruments be measured at fair value with realized and unrealized gains and losses recognized in profit or loss (earnings) in the period in which they

occur. A joint Financial Instruments project is currently on the Boards' agendas and is in the staff research phase. The staff questions whether a lease contract should be considered a financial instrument because it gives rise to both financial and non-financial assets and liabilities. For instance, under the simple lease contract described above, the lessee has both a financial liability (obligation to make payments to the lessor) and a non-financial asset (right to use the item). However, the staff interprets the Boards' statement of its long-term goal for financial instruments as effectively being a long-term goal to measure all financial assets and financial liabilities at fair value.

Initial Measurement

22. This section describes two approaches for the initial measurement of a lessee's liability for its obligation to make payments to the lessor:

- Present value calculated by discounting expected cash flows using the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate is used.
- Fair value.

23. Neither approach described in this section is intended to specify the treatment of transaction costs, as those issues will be brought to the Boards at a later date. In other words, the Boards could later decide to include or exclude some or all transaction costs as part of the initial measurement (i.e., "fair value" could become "fair value plus transaction costs").

Present Value Using the Implicit Rate in the Lease, If Practicable; Otherwise Lessee Incremental Borrowing Rate

24. Under this approach, a lessee's liability to the lessor is initially measured similarly to how a lessee's liability under a capital/finance lease is initially measured under current GAAP. The liability is initially recognized at the present value of the expected cash flows to the lessor over the lease term, discounted using the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate is used (see paragraph 16). (Under U.S. GAAP, the interest rate implicit in the lease also has to be less than the lessee's incremental borrowing rate for it to be used. If the Boards were to choose this alternative, they would have to decide whether that additional restriction should apply.)

Fair Value

25. Under this approach, a lessee's liability to the lessor is initially recognized at the fair value of the obligation to the lessor.

26. IFRS and U.S. GAAP currently define *fair value* differently and contain different additional guidance for measuring fair value. In November 2006, the IASB issued a discussion paper entitled *Fair Value Measurements*. Part 1, Issue 2 of that paper analyzes the differences between the definitions of fair value in FASB Statement No. 157, *Fair Value Measurements,* and IFRSs. Constituents were asked to comment on whether the exit price measurement objective in Statement 157 differs from fair value measurements in IFRS as applied in practice (Q6 of the Invitation to Comment).

27. However, the Boards may resolve the convergence issues with respect to fair value measurements prior to the effective date of a new leasing standard.

Analysis and Staff Recommendation

28. The first approach may be attractive to some constituents because they are already familiar with it in the context of leases. It also may be less costly to initially measure a lessee's liability under the first approach, as the lessee does not have to make assumptions about market participants.

29. However, the first approach also has some disadvantages. One disadvantage is that this approach leads to different rates being used depending on whether the interest rate implicit in the lease is known. Often, the interest rate implicit in the lease is not known by the lessee because it does not know the lessor's estimate of the residual value. Under a fair value approach, the discount rates inherent in the measurement would not depend on any calculations of implicit lease rates. This makes conceptual sense, as it is unclear why the lessor's estimate of the future residual value of the leased item should have any bearing on the lessee's initial measurement of its obligation.

30. The Boards have publicly stated that fair value is the most relevant measure of a financial liability. That is because a fair value measurement considers all factors that a market participant would consider in valuing the financial liability. Initially measuring at fair value is also consistent with the Boards' long-term objective related to the measurement of financial assets and financial liabilities. In addition,

the fair value of contractual cash flows owed to a lessor can usually be measured reliably.

31. Initially measuring at fair value is consistent with the Boards' other guidance for the measurement of many other financial assets and liabilities (although transaction costs are often included in the initial measurement). There appears to be no conceptual reason for treating a lease obligation differently than similar financial liabilities. Also, if the Boards decide to initially measure a lessee's right to use asset at the fair value of the consideration given, then the fair value of the lessee's liability would have to be ascertained anyway.

32. Therefore, the staff recommends that the lessee's liability for its obligation to make payments to the lessor be initially measured at fair value.

Question for the Boards

1. How should a lessee's liability for its obligation to make payments to the lessor be initially measured?

    a. Present value calculated by discounting expected cash flows using the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate is used.

    b. Fair value.

Subsequent Measurement

33. This section describes three approaches to the subsequent measurement of a lessee's liability for its obligation to make payments to the lessor:

    - Fair value
    - Amortized cost using the effective interest method
    - Amortized cost using the effective interest method with an option to fair value.

34. Again, the approaches described in this section are not intended to specify the treatment of transaction costs, as those issues will be brought to the Boards at a later date. Also, although "amortized cost" is the terminology used in IAS 39, the staff notes that those approaches might be better described as "amortized initial

measurement." Recall that the initial measurement under current IFRS is fair value plus transaction costs.

Fair Value

35. Under this approach, a lessee would be required to measure its liability to the lessor at fair value each period. Changes in fair value would be recognized in profit or loss (earnings). While the IASB and FASB currently have different definitions of fair value and related guidance, those differences are being resolved through separate convergence initiatives.

36. The Boards have publicly stated that fair value is the most relevant measure of a financial liability. That is because a fair value measurement considers all factors that a market participant would consider in valuing the financial liability. Initially measuring at fair value is also consistent with the Boards' long-term objective related to the measurement of financial assets and financial liabilities. In addition, the fair value of contractual cash flows owed to a lessor can usually be measured reliably.

37. However, requiring fair value for subsequent measurements would be more costly than using the effective interest method because fair value measurements require both current expected cash flows and current market rates to be used. Because a lessee's liability to the lessor is secured by the item being leased, current market rates would have to reflect the degree to which the liability is secured. The degree of security could be different from lease to lease and from period to period depending on the fair value of the lessee's right to use the leased item relative to the fair value of the liability. The effective interest method requires only the contractual cash flows to be updated each period. Thus, under a simple lease contract with fixed contractual cash flows (no contingent rent), a lessee would generally not have to assess current market rates, including the degree the liability is secured, each period.

38. Subsequently measuring the lessee's liability at fair value would result in potentially significant gains and losses, caused by changes in the lessee's credit quality, being reported in profit or loss (earnings). Decreases in an entity's credit quality would lead to reported gains, while increases in an entity's credit quality would lead to reported losses. Reporting those gains and losses would be a new practice for many entities because the Boards do not currently require most

entities' liabilities to be subsequently measured at fair value. Some question the relevance of reporting those gains and losses, and others do not think that the current format of financial statements allows those gains and losses to be reported in an understandable way.

39. Requiring fair value might also contribute to lease liabilities being measured differently than similar non-lease financial liabilities, which reduces comparability. Under both IFRS and U.S. GAAP, many similar financial liabilities are subsequently measured using an interest method.

Amortized Cost Using the Effective Interest Method

40. Under this approach, the lessee's liability to the lessor would be subsequently carried at amortized cost (or amortized initial measurement) using the effective interest method. The effective interest method would be the same method that is already required under IFRS for financial liabilities not at fair value, which was described above. The same method would be required for U.S. GAAP. The lessee's liability to the lessor would not be eligible for the fair value option under this approach.

41. The effective interest method does provide relevant information to a user about the liability. However, the effective interest method does not consider changes in market interest rates, including the effects of changes in the lessee's credit quality and changes in the degree the liability is secured, in the subsequent measurement of the liability. Thus, subsequent measurements using the effective interest method may be incrementally less relevant than subsequent fair value measurements.

42. Over the term of the liability, both the effective interest method and the fair value method would result in the same aggregate expense. The difference between the two methods is that the fair value method results in a more volatile pattern of net income due to period-to-period fluctuations in market interest rates and the credit quality of the lessee. The question is whether measuring and reporting that volatility results in incrementally more decision-useful information where the benefits exceed the costs.

43. As described in the previous section, subsequent measurements using the effective interest method would typically be less costly because the lessee would not have to assess current market interest rates at the end of each reporting period.

44. However, this approach would create an apparent inconsistency because similar financial liabilities not at fair value would be eligible for the fair value option (although that would be no more an inconsistency than currently exists because a lessee's liability to the lessor is not currently eligible for the fair value option).

Amortized Cost Using the Effective Interest Method with an Option to Fair Value

45. This approach is identical to the one described immediately above. However, at the inception of a lease the lessee could elect to measure at fair value its liability to the lessor with changes in fair value recognized in profit or loss (earnings) each period over the term of the lease. Note that the restrictions on electing to subsequently measure at fair value contained in IAS 39 (see paragraph 11(b) of this paper) would continue to apply under IFRS.

46. This approach has all of the advantages and disadvantages of the previous approach, except that it would not be inconsistent with the option to measure at fair value that exists under current IFRS and U.S. GAAP.

Staff Recommendation

47. The staff recommends that a lessee's liability to the lessor be subsequently measured using the effective interest method (employing a "catch-up approach" for changes in cash flow estimates) with an option to measure at fair value. The staff recommends this approach for the following reasons:

    - This approach is more consistent with how similar financial liabilities are subsequently measured under existing IFRS and U.S. GAAP, increasing the comparability of the financial reports.
    - This approach is less costly for lessees than requiring fair value, particularly because assessing current market rates would involve ascertaining the degree that the lessee's liability is secured by the item being leased.
    - This approach does not require lessees to report prior to the new reporting framework being developed in the Boards' joint financial statement presentation project significant earnings volatility caused by changes in discount rates. While that volatility may more faithfully represent the liability, the current financial statement format does not allow a user to separate changes in price due to changes in interest rates from changes in price due to changes in contractual cash flows. The financial statement

presentation project will not eliminate the volatility, but it may make the volatility more understandable.

- This approach permits a lessee to elect to measure at fair value its liability to the lessor if it believes that would result in more transparent reporting or reduce its cost of capital.

Question for the Boards

2. How should a lessee's liability for its obligation to make payments to the lessor be subsequently measured?

    a. Fair value

    b. Amortized cost using the effective interest method

    c. Amortized cost using the effective interest method with an option to fair value.