30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **22 March 2007, London**

Project: **Leases**

Subject: **Analysis of different accounting models for a simple lease (Agenda paper 12B)**

Introduction

1. The purpose of this paper is to describe a number of alternative accounting models that have been suggested for lease contracts and compare the assets and liabilities recognised under these models to those identified in paper 12A/2. The conclusions reached in this paper are based upon a conceptual analysis of the assets and liabilities arising in the simple lease contract described in paper 12A/2 and may be modified in the light of analysis of more complex leases and consideration of measurement issues. Nevertheless, the staff proposes that a single accounting model applicable to all types of leases and based on the right of use model should form the basis of the next stages of development of the project. The staff are therefore seeking the Boards' views on the initial conclusions set out at the end of this paper.

2. This paper considers the following models:

   a. The right of use model;

   b. The whole asset model;

c. The executory contract model;

d. The model adopted in current standards.

3. Appendix 1 to this paper illustrates each of these models with a numerical example.

4. This paper is based on paper AP6 discussed at the Leasing Working Group meeting on 15 February 2007. The comments of Working Group members on the models are summarised at the end of the paper.

The right of use model

Description of the model

5. The right of use model[1] is based upon the premise that once the physical item (the machinery in the simple lease example in agenda paper 12A/2) has been delivered, the lessee has an unconditional right to use that machinery during the lease term. Consequently, under the right of use model the lessee recognises as an asset its right to use the machinery during the lease term.

6. Similarly, the lessee is considered under the right of use model to have an unconditional obligation to pay for this right of use. As a result, the lessee recognises a liability for the rentals payable under the lease.

7. The lessee only recognises as an asset its right to use the machinery for the lease term. It does not recognise any rights in respect of the physical item beyond the lease term. Consequently, the lessee does not recognise a liability under the simple lease example in respect of its obligation to return the physical item as this obligation does not give rise to an outflow of economic benefits from the lessee.

8. Under the right of use model, the lessor recognises two assets: (1) its right to receive rental payments (a contractual right under the lease); and (2) its interest in the machinery (the residual property rights).[2]

9. The assets and liabilities recognised in a simple lease can be summarised as follows:

[1] This model was discussed and recommended in the two G4+1 reports into leases that were published in 1996 and 1999.
[2] This paper does not consider whether these assets should be presented separately or as a single asset. This will be considered at a later stage of the project.

Assets and liabilities recognised by lessor	Assets and liabilities recognised by lessee
	Asset representing the lessee’s right to use the machine during the lease term
Receivable in respect of payments over lease term	Liability to make payments over lease term
Interest in the residual after the end of the lease term	

Analysis of right of use model

10. Current leasing standards treat the physical item that is leased—the machinery in this example—as either wholly an asset of the lessee (under a finance lease) or wholly an asset of the lessor (under an operating lease).

11. The rights that a lessee obtains under a lease contract are different from the rights obtained through outright ownership of the machinery. In some leases, the contractual rights obtained are similar to ownership (or property) rights, but they are usually not exactly the same. In other leases the rights are very different from ownership rights but the lessee, nevertheless, has rights that meet the definition of an asset.

12. The right of use model reflects the fact that in all leases the lessee is granted some rights over the item that is the subject of the lease.

13. The right of use model recognises as an asset of the lessee only those rights the lessee has actually obtained under the lease agreement, which are generally less than the full rights of ownership of the machinery. For a five year lease of an item of machinery, the right that is acquired is the right to use the machinery for five years, which may be significantly less than its total estimated economic life.

14. Under the lease the lessee obtains a bundle of rights that may be considered similar to the rights of outright ownership—for example, a lease for the full estimated economic life of the machinery—the asset that is recognised by the lessee will be very similar to, but not exactly the same as, the asset that an owner would recognise. However, where the rights are substantially different from those of an owner, the recognised asset will be very different from that recognised by an owner. Nevertheless, there is no cut-off point at which the rights fail to qualify as an asset—the asset recognised is merely “smaller” if the rights of use are less.

15. As discussed in paper 12A/2, the staff have tentatively concluded that the lessee has an unconditional obligation to make payments under the lease once the machinery has been delivered. Under this model, this obligation is recognised as a liability.

16. The right of use model treats the lessor as having exchanged some of its ownership rights over the physical machinery, specifically, the right to use the machinery, for a contractual right to receive payments under the lease.

17. The staff have tentatively concluded that the right of use model therefore results in the recognition of the assets and liabilities identified in paper 12A/2.

The whole asset model

Description of model

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

19. The lessor recognises as an asset its right to receive payments under the lease and an asset representing its right to have the machinery returned at the end of the lease term.[3]

20. The lessor does not recognise its contractual obligation to permit the use of the machinery during the lease term. Instead, the lessor derecognises the machinery.

21. The assets and liabilities recognised in a simple lease can be summarised as follows:

---

[3] Included in this right is the right to the economic benefits deliverable from the use of the machinery in the period after the lease term.

Assets and liabilities recognised by lessor	Assets and liabilities recognised by lessee
Receivable in respect of payments over lease term	Liability to make payments over lease term
	Asset representing: • Right to use the machine during the lease term • Possession of the machine at the end of the lease term
Right to the return of the machinery at the end of the lease term	Obligation to return the machinery at the end of the lease term

Analysis of whole asset model

22. The main advantage of the whole asset approach is that it is simple to apply. The lessee recognises a single asset representing the full economic potential of the machinery. This asset is measured at the fair value of the machinery, which in many cases can be readily obtained. Options to extend, etc., are not presented separately. The lessee recognises two obligations: a liability in respect of the minimum rentals under the lease and a return obligation. The liability in respect of the minimum rentals also can be measured easily; the return obligation is essentially a balancing figure.

23. The whole asset approach is also easy to understand. The assets and liabilities recognised are easily explained. A lease of an aircraft, for example, results in the recognition of an aircraft, a liability to pay rentals and an obligation to return the aircraft at the end of the lease.

24. However, physical possession of an item is not the same as having a present right to the economic potential of the machinery for the whole of its life. The lessee does not have any contractual or other rights to the economic potential derivable from the machinery after the end of the lease term. For example, the lessee has no right to use the asset or sell the machinery after the end of the lease term. It must simply return the machinery to the lessor. The position of the lessee at the end of the lease term can be compared to that of an asset custodian. The lessee is holding the machinery on behalf of a third party (the lessee) but has no rights to the economic benefits embodied in the machinery. Physical possession of an item without any rights to obtain economic benefits from the item does not meet the definition of an asset. Consequently, if the lessee recognises the full economic

potential of the machinery as an asset, the financial statements will overstate the assets of the lessee, and may imply that the lessee has legal ownership of the machinery.

25. The whole asset model results in the lessee recognising a liability in respect of its obligation to return the machinery at the end of the lease term. However, as discussed above, the lessee has no rights over the machinery after the end of the lease term. Consequently, there is no outflow of economic benefits from the lessee when it returns the machinery. As there is no outflow of economic benefits, the obligation to return the machinery does not meet the definition of a liability.

26. Under the whole asset model, the lessor recognises two assets: a right to receive payments from the lessee over the lease term; and a right to have the machinery returned at the end of the lease.

27. Under a simple lease, the lessor has given the lessee the right to use the machinery for the lease term in return for the lessee's promise to make payments. Consequently, recognising an asset that represents the lessor's right to receive payments faithfully represents the contractual position. However, the lessor has not transferred any property rights to the lessee in respect of the period after the end of the lease term. Therefore, recognising an asset for the return of those rights does not faithfully represent the position of the lessor.

28. The staff have tentatively concluded that the whole asset model 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 machinery after the end of the lease term—a right not obtained by the lessee in this simple lease example. This model also overstates the liabilities of the lessee as a liability is recognised for the lessee's obligation to return the physical item. The assets and liabilities of the lessor are not overstated under this model. However, the lessor's interest in the residual asset is mischaracterised as a right to the return of the machinery.

The executory contract model

Description of model

29. Under this model, all leases are treated as executory contracts. This model is based upon the premise that the lessee's right to use the machinery is conditional upon

making payments under the lease. Similarly, the lessee's obligation to make payments is assumed to be conditional upon the lessor granting the lessee quiet enjoyment of the machinery throughout the lease term. The executory contract model is also supported by those who argue that the lessee's right to use the asset should be presented net of its obligation to pay for that right.

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

31. Similarly, the lessor does not recognise assets or liabilities in respect of the lease contract. However, the lessor continues to recognise a physical asset in respect of the machinery.

Analysis of executory contract model

32. This model relies upon the argument that the lessee's right to use the machinery is a conditional right. That is, the right is conditional upon the lessee making payments under the lease. The lessee's obligation to make payments under the lease is viewed as conditional upon the lessor's continued delivery of the right to use the asset. Unless the lessee continues to deliver the right to use the asset, the lessee has no obligation to pay for that right of use.

33. However, the staff have tentatively concluded that under a non-cancellable lease the right to use the machinery and the obligation to pay for its use are unconditional once the machinery has been delivered to the lessee. Under a non-cancellable lease, the lessee has no contractual right to return the machinery to the lessor and stop making payments. Consequently, the lessee's obligation to make payments under a non-cancellable operating lease is very similar to a borrowing.

34. Upon entering into a non-cancellable lease contract, the lessee obtains a valuable right—the right to use the leased item for the lease term. The lessor has no right to demand the return of the leased item during the lease term. As discussed in paper 12A/2 the staff have tentatively concluded that the lessee's right to use the machinery meets the definition of an asset. If this right is not reflected in the financial statements, the rights of the lessee will be understated.

35. The executory contract model does not reflect the fact that the lessor has in effect exchanged the right to use the physical asset for a period of time for a right to receive cash from the lessee.

36. The staff have tentatively concluded that the executory contract model fails to recognise significant assets and liabilities of the lessee. That is, it fails to recognise the lessee's right to use the leased item and its obligation to pay for that right. In addition, the executory contract model misrepresents the assets of the lessor, in that it fails to recognise that the lessor has in effect exchanged some of its rights over the physical asset for a contractual right to receive cash.

The model adopted in the current standards

Description of model

37. Current leasing standards adopt a hybrid model. Leases are classified as either finance leases or operating leases, depending on whether substantially all the risks and rewards of ownership of the physical item are transferred to the lessee by the lease arrangement.[4] A finance lease is treated as substantially equivalent to the sale of the physical item to the lessee, and accordingly, the lessee recognises this as an asset together with a liability to make the payments over the lease term (as though this was a borrowing financing the purchase of the item). This is similar to the "whole asset" approach described above except that a separate liability for the obligation to return the item at the end of the lease term is not recognised. Leases classified as operating leases are accounted for as executory contracts.

38. The nature of the assets recognised by the lessor also depends upon lease classification. Where the lease is classified as a finance lease, the lessor recognises a single financial asset that includes both the lessor's right to receive payments over the lease term and the lessor's interest in the residual value of the leased item. If the lease is an operating lease, the lessor carries the physical asset on its balance sheet (usually as property, plant and equipment).

Analysis of model

39. Where a simple lease is classified as a finance lease, the assets and liabilities recognised by the lessee are similar to those identified in paper 12A/2. That is, the

[4] This broad principle is supported by more specific tests for determining the classification of the lease.

lessee recognises an asset in respect of the right to use the machinery and a liability for rentals payable.

40. However, if the lease is classified as an operating lease, the assets and liabilities recognised by the lessee are different from those identified in paper 12A/2.

41. The operating lease model is similar to the executory contract model described above. The lessee recognises no assets or liabilities. However, as discussed above, a lease that does not transfer substantially all the risks and rewards of ownership nevertheless confers to the lessee valuable rights and corresponding obligations that meet the definitions of assets and liabilities. For example, the obligation to make payments under a non-cancellable operating lease meets the definition of a liability and the right to use the machinery in such a lease meets the definition of an asset.

42. It has been suggested that many of the problems with the existing hybrid model could be eliminated if the criteria for classifying leases as finance leases were changed. For example, finance leases could be redefined as leases that transfer the majority of risks and rewards of ownership of the physical asset to the lessee. Although this approach would result in more leases being classified as finance leases, there would still be leases that convey valuable rights and obligations that would be treated as operating leases.

43. Some have argued that the economic substance of “true” operating leases is different from the economic substance of finance leases. That is, “true” operating leases are executory contracts whilst finance leases are, in substance, secured borrowings. Consequently, it is argued that a hybrid model is appropriate. However, even short-term leases convey to the lessee a right to use the leased item and a corresponding obligation to pay for that right. The value of that right is much smaller for a short-term lease than for a lease for most of the economic life of an asset, but the right still exists.

44. The physical asset recognised by a lessor under an operating lease does not reflect the fact that the lessor has in effect exchanged the right to use the physical asset for a right to receive cash from the lessee.

45. When the lease is a finance lease, the lessor’s interest in the residual and its right to receive rentals are combined. This approach, arguably, results in the loss of some information about the nature of the lessor’s assets and liabilities. A

contractual right to receive rentals has different risks attached to it than a residual interest in a physical item.

46. When a lease is classified as an operating lease, the staff have tentatively concluded that the current accounting model fails to represent the contractual position of the lessee. The lessee's right to use the leased item and its obligation to pay for it meet the definitions of assets and liabilities but are not recognised.

47. Although the lessee's rights and obligations are recognised when the lease is classified as a finance lease, the staff do not think that the rights and obligations arising under an operating lease are conceptually any different from those arising under a finance lease.

Working Group comments

48. This paper is based on a paper discussed at the first Working Group meeting. The principal comments made by Working Group members were as follows:

 a) although the right of use model reflects the assets and liabilities identified in the analysis, this is based on a very simple lease example, which ignores many of the complexities of real life leasing transactions;

 b) whilst the right of use model may be appropriate for leases themselves, it will be necessary to distinguish these from contracts for services, which should be accounted for as executory contracts; in many cases service arrangements are bundled together with lease contracts;

 c) vendor leases, where the lessor is the manufacturer of the leased item, and has continuing obligations to support the product (including warranty obligations), are more complicated;

 d) sub-leases, especially in property/real estate, give rise to additional complications;

 e) different legal and tax jurisdictions need to be considered;

 f) clear principles underpinning the standard, rather than detailed rules trying to deal with all variations and complexities in leasing transactions, will help;

g) much of the complexity in existing standards relates to the determination of the lease term and minimum lease payments; these difficulties will still arise with the right of use model;

h) some suggested that disclosure of leasing obligations in the notes would provide sufficient information to users; others disagreed, and felt that recognition on the balance sheet was important;

i) the whole asset model was regarded by one member as superior to the right of use model (for long-term leases, at least) because it provided comparability between entities that purchased assets and entities that leased them;

j) the executory contract model was suggested by some as being most appropriate for short-term and immaterial leases.

Staff conclusions and recommendation

49. The staff's preliminary conclusions are that:

a) the right of use model results in the recognition of the assets and liabilities that were identified in paper 12A/2, and is therefore consistent with the Framework and CON 6; consequently, this model should be developed further;

b) the whole asset model overstates the assets and liabilities of the lessee, and mischaracterises the lessor's right to the return of the machinery; however, staff intend to consider further the comments made in support of this model to assess whether it provides more relevant information for users before reaching a conclusion on whether it should be developed further;

c) the executory model fails to recognise significant assets and liabilities of the lessee, and misrepresents the assets of the lessor; staff do not recommend further consideration of this model for leases, but note that it may remain appropriate for other types of contracts such as service contracts, including service contracts incorporated in a lease contract, and it will therefore be necessary to define carefully the scope of the leasing standard;

d) the rights and obligations arising under short term leases and leases currently classified as operating leases are conceptually no different from those arising under leases currently classified as finance leases; consequently staff do not support a model that results in different accounting depending on the classification of the lease.

50. The staff acknowledges that as the project progresses these decisions may need to be reconsidered (especially if practical or operational problems are encountered when measurement is considered).

Questions for the Boards

- **Do Board members have any other suggestions for lease accounting models that should be considered?**
- **Do the Boards agree with the staff's preliminary conclusions set out above, and in particular that the right of use model should be developed further?**

Appendix 1 - Summary of lease models

Note:
The measurement basis used in each of these examples is for illustration purposes only. The figures used have been extracted from a more comprehensive example that will be used when discussing measurement issues.

This example assumes the following fact pattern:

- Five year lease of an item of machinery
- Initial cost = CU 10,000
- Annual rental = CU 2,474 (in arrears)
- Residual value = CU 1,000
- Present value (PV) of rental payments at beginning of lease = CU 9,378 (at an interest rate of 10%)
- PV of residual = CU 622 (at an interest rate of 10%).

Model:	**Right of use**	**Whole asset**	**Finance lease**	**Operating/ Executory**
LESSEE				
Machinery[5]	9,378	10,000	9,378	nil
Obligation for rentals	(9,378)	(9,378)	(9,378)	nil*
Obligation to return		(622)		
LESSOR				
Right to receive rentals	9,378	9,378		nil*
Interest in residual	622	622		
Net investment in lease			10,000	
Machinery				10,000

* accrues daily

[5] The nature of the asset recognised will depend upon the accounting model adopted.