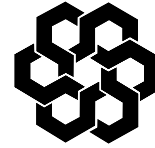

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **18 October 2007, London**

Project: **Leases**

Subject: **Other Lessee Obligations (Agenda paper 12A)**

Introduction

1. At meetings in March 2007, the Boards tentatively concluded that a lessee's obligation to return the leased item at the end of the lease term does not meet the definition of a liability. However, a number of Board members noted that the terms of the lease contract might give rise to other obligations that meet the definition of a liability. For example, an obligation to return the leased item in a specified condition may meet the definition of a liability.
2. This paper analyses a number of lessee obligations to determine if they meet the definition of a liability and makes recommendations regarding their accounting treatment. In particular, this paper considers:
   - Lessee obligations to incur costs to return the leased item.
   - Lessee obligations to return the leased item in a specified condition.
   - Lessee obligations to maintain the leased item.

3. This paper analyses:
    - Whether these obligations meet the definition of a liability and when the liability arises
    - How the debit arising on recognition of a liability should be treated
    - How any liabilities arising out of these obligations should be measured
    - Whether these obligations give rise to assets for the lessor.

Analysis of Obligations

4. This section of the paper analyses whether some of the common lessee obligations relating to the return of the leased item meet the definition of a liability under FASB Concepts Statement No. 6, *Elements of Financial Statements* or the IASB *Framework for the Preparation and Presentation of Financial Statements*. This paper also considers when these liabilities arise.
5. Although the wording of the current IASB and FASB liability definitions are different, the basic concepts underpinning them are very similar. The *Framework* and CON 6 have the following characteristics of a liability in common:
    - There exists a present obligation
    - The obligation arises out of a past event
    - The obligation is expected to result in an outflow of economic benefits.
6. The staff has used these common characteristics to identify whether a number of common lessee obligations meet the definition of a liability.
7. The Boards have tentatively concluded that in a simple lease, the lessee's obligation to return the leased item to the lessor at the end of the lease does not meet the definition of a liability as the lessee has no rights over the leased item at the end of the lease. Consequently, although there exists a present obligation (the obligation to return) that arises out of a past event (the signing of the lease contract), there is no expected outflow of economic benefits.
8. However, a lease contract may impose obligations upon the lessee that result in an outflow of economic benefits. Where this is the case, information about the existence of such obligations would be relevant to the users of the financial

statements. Examples of common lessee obligations that may result in an outflow of economic benefits from the lessee include:

- **Type 1–Lessee obligations to incur costs to return the leased item** – The lease contract may specify at the end of the lease that the leased item should be returned to a particular location (for example, the lessor's premises). To meet this obligation, the lessee may be required to incur transportation costs. Similarly, if a lessee has installed a machine into its production line, the lessee may need to incur significant costs to extract the machine from the production line in order to return it.
- **Type 2–Lessee obligations to return the leased item in a specified condition** – For example, many real estate leases will specify the expected condition of a building at the end of the lease. The lessee will be required either to vacate the building in the agreed upon condition or make additional payments to the lessor to compensate the lessor for the cost of restoring the building to the contractually agreed condition.
- **Type 3–Lessee obligations to maintain the leased item** – These may take several different forms. The lease agreement may simply state that the leased item should be maintained in working condition throughout the lease term. Alternatively, the lease contract may specify a particular schedule of maintenance for the item (including details of when and how the item is to be maintained).

9. Whether these obligations meet the definition of a liability and when the liability should be recognized is considered below.

Type 1–Lessee Obligations to Incur Costs to Return the Leased Item

10. A lessee obligation to incur costs to return the leased item is associated with the obligation to return the leased item. Although there is no outflow of future economic benefits for the obligation to return the leased item, there could be an outflow of future economic benefits for any costs incurred to return the leased item. This obligation to incur costs to return the leased item is associated with extinguishing the obligation to return the leased item. The lessee's obligation to incur costs associated with the return of the leased item may be explicit in the lease contract. For example, a lease contract may require the lessee to return the

leased item to a specified location and incur the transportation costs associated with its return.

11. There is little doubt that the lessee has an obligation (the obligation to return the leased item) that arises out of a past event (the delivery of the leased item to the lessee) and that there will be an outflow of economic benefits to meet the costs of returning the leased item. The staff consider these explicit obligations to incur costs to return the leased item to meet the definition of a liability for the lessee.

12. A lease contract may not explicitly state that the lessee must incur costs. However, an obligation to incur costs might be implicit in the lease contract. For example, if a lessee installs a machine into its production line, it may need to incur costs to remove the item from the production line in order to return it at the end of the lease.

13. Even though obligations of this type are not explicit in the lease contract, the staff consider that they also meet the definition of a liability. There will be an outflow of economic benefits from the lessee at the end of the lease (the costs associated with dismantling the leased item from the production line). The lessee has a present obligation to incur these costs at the end of the lease. That is, the obligation is unconditional–the lessee cannot avoid incurring these costs. The present obligation arises out of a past event (the original installation of the machinery into the production line).

14. The first question, then, is about when the liability arises. That is, when does the obligation to incur these costs to return the leased item become a present obligation?

Conceptual Analysis

15. For these types of obligations, the lessee will not have an outflow of economic benefits until the end of the lease term or the lease is otherwise terminated. However, from the date that the leased item is delivered to the lessee, the lessee is unable to avoid that outflow of economic benefits. Only the passage of time is required to make performance due; the lessee has an unconditional obligation to incur transportation costs. Therefore, under CON 6 and the *Framework,* the lessee has a present obligation to incur the costs of returning the machinery as soon as the leased item is delivered/made available to the lessee. Consequently, a liability arises on this date.

16. The staff notes that this paper is still considering a "simple lease" and acknowledges that if a lease contract provides the lessee with an option to purchase the leased item, the lessee may not in fact have an unconditional obligation to incur transportation costs, etc., if they intend to purchase the leased item at the end of the lease. Purchase and renewal options (which may affect the timing of the obligation) and their impact on the liabilities discussed in this paper will be discussed at a future Board meeting.

Current Standards

17. When this issue was discussed at a recent Board advisors meeting, some Board members considered these costs similar in nature to asset retirement obligations described in FASB Statement No. 143, *Accounting for Asset Retirement Obligations* and decommissioning or restoration liabilities described in IFRIC 1, *Changes in Existing Decommissioning Restoration and Similar Liabilities.* Similarly, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* provides general guidance on the recognition of provisions (see appendix for a summary of the current required accounting for asset retirement obligations).

18. FAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. If these costs are viewed as similar to asset retirement obligations, the recommendation could follow the guidance in FAS 143. FAS 143 requires an entity to recognize a liability for an asset retirement obligation in the period in which it is incurred (when the definition of a liability has been met and a reasonable estimate of fair value can be made). FAS 143 currently excludes certain asset retirement obligations relating to leased property from its scope [FAS 143, paragraph 17]. However, as noted in the basis for conclusions, this scope exemption was incorporated into FAS 143 to avoid having to make substantial amendments to the leasing standard [FAS 143, paragraph B66]. IAS 37 provides similar guidance and requires a liability to be recognized when the definition of a liability has been satisfied and the liability can be measured reliably. However, the staff notes that it is currently unclear whether the proposed revisions to IAS 37 would change this position. The current accounting for asset retirement obligations is consistent with the conceptual analysis provided above.

Staff Recommendation

19. The staff recommends that obligations to incur costs to return the leased item meet the definition of a liability for the lessee when the lessee obtains access to the leased item (in the case of transportation costs) or when the machinery is installed (in the case of an obligation to dismantle). This recommendation is consistent with both a conceptual analysis of the obligation as well as with an analysis of current accounting guidance for similar obligations.

Questions for the Boards

- Do obligations to incur costs to return the leased item meet the definition of a liability for the lessee?
- If so, when does the liability arise?
    - When (1) the lessee obtains access to the leased item (in the case of transportation costs) or (2) the machinery is installed (in the case of an obligation to dismantle)?
    - At the end of the lease term?

Accounting for the Debit

20. At the most recent Board advisors meeting, some Board members recommended analyzing the debit side of the entry when considering whether a liability exists for these obligations. If it is agreed that a lessee has a liability to incur the costs of returning the machinery as soon as the leased item is delivered/made available to the lessee, then a follow-up question is how to treat the debit that arises upon the recognition of the liability. Measurement of the liability is discussed later in this paper, and it is assumed that the debit will be measured at the same amount as the liability.

21. The staff has considered two possible ways in which the debit arising could be recognized.

View A–As an Expense in Profit or Loss

22. Proponents of View A consider that these costs do not give rise to future economic benefits and do not meet the definition of an asset and, therefore,

recommend that these costs be recognised as an expense in profit or loss. Proponents of this view consider these costs similar to transaction costs in that they must be incurred to obtain the right of use. This view would be consistent with a fair value approach to initial measurement where, in general, transaction costs are recognised in profit or loss. This view does not consider these costs similar in nature to asset retirement obligations.

23. At the Board advisors meeting, some Board members reasoned that because the outflow of economic benefits does not necessarily flow to the lessor, these costs should be treated as operating expenses. In addition, some Board members stated that if these costs do not increase the value of the leased item, then they should be treated as an expense in profit or loss.

View B–As Part of the Cost of the Right to Use Asset

24. This approach considers costs associated with the return of the leased item integral to or as a prerequisite for operating the leased item and necessary to prepare the leased item for its intended use, and therefore includes these costs in the initial measurement of the right to use asset. This alternative views these costs similar in nature to asset retirement obligations and would result in accounting that is similar to the guidance in FAS 143 and IAS 16, *Property, Plant and Equipment* (IAS 16), which is more of a historical cost approach, and includes the debit in the initial measurement of the right to use asset.

25. The staff notes that at its June 2007 meeting, the IASB tentatively decided to account for the lessee's right of use asset in accordance with the nature of the underlying leased item. That is, in most cases the right of use asset will be accounted for as Property, Plant, and Equipment (PP&E).

26. IAS 16 requires items of PP&E to be measured initially at cost [IAS 16, paragraph 15]. The cost of an item of PP&E comprises (amongst other things):

> …the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. [IAS 16, paragraph 16(c)]

27. FAS 143 similarly requires an entity to capitalise an asset retirement cost by increasing the carrying amount of the related long-lived asset [FAS 143, paragraph 11]. In the basis for conclusions, the FASB noted that reporting the

asset retirement obligation as a liability with a corresponding increase in the carrying amount of the asset has the same net effect as incorporating the fair value of the costs to settle the liability in the valuation of the asset.

28. The staff notes that at its June 2007 meeting, the FASB did not reach the same tentative conclusion as the IASB regarding the initial and subsequent measurement of the lessee's right of use. Most FASB members preferred that a new model for the initial and subsequent measurement of the lessee's right to use asset be developed. Although, there was no clear consensus on what that model should be.

Staff Recommendation

29. The staff does not believe that these costs meet the definition of an asset in CON 6 and the *Framework* in their own right. However, they could form part of the costs of the right to use asset, if a cost-based measurement is to be used for the right of use asset. The staff have not yet developed a recommendation on the accounting for the debit for the FASB because the FASB has not reached a conclusion on its initial and subsequent measurement of a lessee's right of use asset. The issues described in this paper will be brought back for discussion in connection with the staff's further analysis of those measurement issues.

30. The IASB has tentatively decided that the right of use asset should be accounted for in the same manner as the underlying leased asset. In that case, the staff would consider these costs a cost of acquiring the right of use asset. Theses costs are similar to asset retirement obligations and current GAAP would account for the debit arising on recognition of these liabilities as part of the right to use asset because these costs are integral to or are a prerequisite for operating the leased item. This would result in recognizing the lessee's asset and liability at an amount that more closely reflects the lessee's total "investment" in the leased item. These costs are not a separate asset because there is no specific and separate future economic benefit that results from the costs. The future economic benefit of these costs lies in the right to use the leased item that is used in the entity's operations.

Question for the Boards

- How should the debit arising on recognition of a liability for costs associated with the return of the leased item be accounted for?
    - As an expense in profit or loss?
    - As part of the cost of the right to use asset?

Type 2–Lessee Obligations to Return the Leased Item in a Specified Condition

31. A lease contract may specify a certain minimum condition for the leased item upon return. For example, a lease may require a piece of machinery to be returned in working condition or a real estate lease may specify the expected condition of the property at the end of the lease.

32. In both of these examples, if the leased item falls below the condition specified in the lease, the lessee would expect an outflow of economic benefits. This outflow may involve the lessee incurring costs to restore the item to the contractually specified condition or (as commonly seen in real estate leases) paying monetary damages to the lessor.

33. Once again, the question is when the obligation to transfer economic benefits arises. There appears to be three points at which the obligation could arise:

    - At the end of the lease term
    - When the leased item falls below the contractually specified condition
    - When the leased item is delivered/made available to the lessee.

View A–At the End of the Lease Term

34. If there is an obligation for the lessee to incur costs to return the leased item in a specified condition at the end of the lease term, then there must have been an obligating event at some point in time prior to the end of the lease term. However, if there is no obligating event (for example, the leased item is in its specified condition), then there is no obligation for the lessee to incur costs to return the

leased item at the end of the lease term. Therefore, the staff did not consider this view any further.

View B–When the Leased Item Falls below the Contractually Specified Condition

35. Both CON 6 and the *Framework* state that for a liability to exist, the reporting entity must have little or no discretion to avoid an outflow of economic benefits [CON 6, paragraph 36; *Framework*, paragraph 61]. Therefore, to ascertain when the liability arises it is necessary to ascertain whether the reporting entity has little or no discretion to avoid a future outflow of economic benefits.

36. Once the leased item falls below the contractually specified condition (for example, the machinery breaks down), the lessee will be unable to avoid an outflow of economic benefits. Hence, the lessee clearly has a present obligation that meets the definition of a liability when the leased item falls below the contractually specified condition (that is, a liability arises before the end of the lease term).

37. However, the situation is not always so clear. Consider, for example, a reporting entity that leases a car. The lease contract may state that if the car has damage to its paint, it must be repainted before it is returned. Experience has shown that 10 percent of cars leased by the entity require repainting before they are returned. If the paint of the car is damaged, the lessee will be required to repaint the car. However, the entity may have discretion to avoid damage to the paint in the first place.

38. During the lease term, the lessee controls the use of the car. Consequently, the lessee can minimise the risk of damage to the car by driving it carefully or not using the car at all. Hence, it can be argued that until damage actually occurs, the lessee has the discretion to avoid an outflow of economic benefits (the cost of repainting the car). Therefore, no liability arises until the damage occurs.

39. This view follows a conceptual analysis of when a liability exists and notes that if the lessee can avoid an outflow of economic benefits there is no liability. The staff does not believe it is meaningful to ignore the fact that the lessee will almost certainly continue to use the leased item even though it theoretically has a choice not to. That is, although the lessee may have the ability to avoid an outflow of economic benefits, doing so is not consistent with rational economic behavior (it

likely would not be rational for a lessee to cease using the leased item to avoid some future costs.)

40. The staff also question whether, in these situations, the lessee is in a similar position to an insurer. The insurance project is focusing on in-substance insurance arrangements rather than insurance contracts. This may be an area that the staff should explore further.

View C–When the Leased Item Is Delivered/made Available to the Lessee

41. It can be argued that the lessee has a present obligation even before the leased item falls below the contractually specified standard. It can be argued that once the lessee obtains access to the leased item it has a stand-ready obligation to repair the leased item if it falls below the contractually specified standard.

42. Consider the example in paragraph 37. Although, through its actions, the lessee can minimise the risk of damage to the car it cannot completely remove the risk. Consequently, the lessee has little or no discretion to avoid the risk of damage to the car. The lessee's obligation to repaint the car is a conditional obligation; it is conditional upon damage occurring to the car. Associated with this conditional obligation is an unconditional obligation–the obligation to stand ready to repaint the car if the paint is damaged. Under this view, a liability arises when the lessee obtains access to the car. Any uncertainty about whether the car will actually require repainting will be reflected in the measurement of the liability.

43. In some situations, it will be clear that the lessee has little or no discretion to avoid an outflow of economic benefits. For example, if a car lease requires the lessee to repaint the car one month before the end of the lease term (regardless of its condition), the lessee has no discretion to avoid this cost and a liability arises when it obtains access to the car.

44. In effect, the lessee has provided the lessor with a guarantee as to the condition of the car upon taking delivery. This guarantee requires the lessee to stand ready to make good any defects in the car during the lease term. This approach is consistent with the requirements of FASB Interpretation No. 45 *Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. However, the staff notes that a lessee guaranteeing its own future performance is generally not within the scope of FIN 45.

45. In addition, obligations to return the leased item in a specified condition are similar in some ways to residual value guarantees. Under a residual value guarantee, the lessee guarantees both the condition of the leased item and its market price at the end of the lease. Under an obligation to return the leased item in a specified condition, the lessee guarantees only the condition of the item (and is guaranteeing its own performance). However, in both situations the lessee provides the lessor with some protection over the value of the leased item at the end of the lease. The Boards have not yet discussed the treatment of residual value guarantees. Consequently, any tentative decisions reached on the treatment of obligations to return the leased item in a specified condition may need to be reconsidered once the Boards have discussed residual value guarantees.

46. The staff notes that the rentals paid by the lessee will reflect the fact that the lessee bears the risk that there is damage to the car. If the lessee did not assume that risk, the basic lease rentals would be higher to compensate the lessor for bearing that risk. The staff questions whether it is representationally faithful to recognize this obligation when the lessor bears the risk of damage to the car, but not to recognise it when the lessee bears the risk.

47. Conceptually, it seems that there should be a liability at lease inception, although the measurement of that liability may be too small to account for in some cases.

View D–Not in the Scope of the Leases Project

48. Some question whether the costs to return the item in a specified condition should be considered when accounting for a right to use a leased item, as these are repairs and maintenance costs that should be accounted for in accordance with other applicable GAAP and not debated in a project on lease accounting. This alternative would recommend identifying these maintenance costs, excluding them from the measurement of the right of use asset, and would account for them separately in accordance with other applicable GAAP. The determination of when to record a liability (and whether or not to expense the cost incurred) would also be made in accordance with other applicable GAAP.

49. Proponents of this view note that if the lessee owned the leased item, they would not accrue their own maintenance costs. Proponents also note that repair and maintenance costs would not be capitalized if the lessee owned the asset instead of leasing it. View D proponents do not believe that whether an entity leases an asset

or purchases it should determine how repairs and maintenance obligations are accounted for.

50. View D would still require consideration of the substance of payments required under the lease. For example, if a lease agreement includes payments that are ostensibly for maintenance, the reasonableness of payments labeled as "maintenance" would still need to be considered. View D would also require a lessee to consider if an obligation to return a leased asset in a specified condition creates other obligations that are akin to Type 1 obligations. For example, View D would require obligations for a lessee to return a leased building in "broom clean" condition or to perform general repairs and maintenance to be accounted for in accordance with other applicable GAAP. However, an obligation for a lessee to remove pre-existing (at the beginning of the lease term) carpets and interior walls at the end of the lease term would be more akin to a Type 1 obligation.

51. Opponents of this view are not bothered by different accounting for repairs and maintenance costs depending on whether the item is lease or owned because of the nature of the lease contract. That is, the lessee is obligated to someone else (the lessor) to return the leased item in a specified condition and may not be able to avoid these costs, whereas an owner of the leased item has more discretion.

Staff Recommendation

52. Some staff think that obligations to return the leased item in a specified condition meet the definition of a liability when the lessee obtains access to the leased item (View C). Although it might be argued that the lessee does not have a liability under CON 6 and the *Framework* because the lessee has the discretion to avoid a future outflow of economic benefits, they think that that argument is inconsistent with rational economic behaviour and, thus, is not persuasive. Although current accounting for maintenance, such as planned major maintenance, would not accrue these costs in advance, the staff views the contract with the lessor (coupled with the assumption that the lessee would not avoid using the leased item) as the obligating event, as opposed to waiting for the leased item to fall below a specified condition. Said differently, some staff think that conceptually, signing a lease contract creates an obligation to another entity that meets the definition of a liability and should be recognized at that date (although the measure might be quite small). Recognizing a liability when the lessee obtains access to a leased

item reflects some of the Boards' current thinking on liabilities (that is, there is a stand-ready obligation when the lessee obtains access to the leased item, and that obligation may meet the definition of a liability). Some of those staff members think that practical reasons (cost-benefit considerations) might justify a simpler accounting treatment at the standards level.

53. Other staff recommend that, except in situations such as that described in paragraph 43, no liability is recognized until the event that would require an outflow of economic benefits actually occurs (View B) for the following reasons:

- Estimating the probability of damage occurring to a leased item may be difficult for a lessee particularly if the lessee is leasing an item for the first time or there is only one of the item. Measuring the liability (until the damage actually occurs) may be difficult.
- As the lessee has control over the leased item it has some discretion to avoid the leased item falling below the contractually specified standard.
- There is no liability under CON 6 and the *Framework* until the lessee has little or no discretion to avoid a future outflow of economic benefits.

Questions for the Boards

- Do obligations to return the leased item in a specified condition meet the definition of a liability?
- If so, when does the liability arise?
    - At the end of the lease term?
    - When the leased item falls below the contractually specified condition?
    - When the lessee obtains access to the leased item?

Accounting for the Debit

54. Once the Boards decide whether (and when) the lessee has an obligation to return the leased item in a specified condition, then a follow-up question is how to treat the debit that arises upon the recognition of the liability. The debit could be recognized in two possible ways.

View A–As an Expense in Profit or Loss

55. Proponents of this view consider that these costs do not give rise to future economic benefits and do not meet the definition of an asset and, therefore, recommend that these costs be recognized as an expense in profit and loss. Proponents of this view consider costs to return the leased item in a specified condition akin to repair and maintenance costs. Generally, maintenance costs are recognized in profit or loss as they are incurred. This is the case whether the related asset is measured at fair value or on a historical cost basis. It could be argued that maintaining an asset simply preserves its value. It does not enhance its value above its previously assessed level of performance.

View B–As Part of the Cost of the Right to Use Asset

56. This view recommends capitalizing the costs to return the leased item in a specified condition as part of the right to use asset. Proponents of this view argue that agreeing to return the leased item in a specified condition is part of the lessee's cost of obtaining the right to use the leased item. This alternative views these costs similar to asset retirement obligations; however, the staff notes that neither FAS 143 nor IAS 16 directly address the costs associated with an obligation to maintain the leased item.

57. At the Board advisors meeting, Board members considered whether the right to use asset should be componentized between the right to use asset and the related asset for maintaining the leased item. Each of these assets could be depreciated over different lives.

Staff Recommendation

58. The staff intends to perform additional analysis as to the accounting for the debit for the costs to return the leased item in a specified condition in order to make a recommendation. At this meeting, the staff would appreciate broad Board reactions to the alternatives discussed above.

Questions for the Boards

- How should the debit arising on recognition of a liability for costs associated with the return of the leased item in a specified condition be accounted for?
    - o As an expense in profit or loss?
    - o As part of the cost of the right to use asset?

Type 3–Obligations to Maintain the Leased Item

59. Obligations to maintain the leased item imposed by the lease contract are very similar to obligations to return the item in a specified condition. The only difference may be a matter of timing of the outflow of economic benefit from the lessee to the lessor. If a lease contract includes an obligation for the lessee to maintain the item, the lessor may have the right to force the lessee to undertake maintenance or pay damages during the lease term rather than at the end of the lease. However, when an outflow of economic benefits occurs should not affect whether a liability exists.

60. Under current accounting standards, an entity does not normally provide for the costs associated with maintaining its own assets. This is because with owned assets, the lessee can choose not to incur an outflow of economic benefits (that is, there is no present obligation). Even in situations where the owner is statutorily required to maintain an item in order to continue using it (for example, aircraft), the owner could stop using the item and avoid paying the costs of maintaining the item. However, the staff does not find this a compelling argument for not recognizing a liability.

61. The situation with a leased item may be different if the contract includes a requirement for the lessee to maintain the item. Once again, the question is when the obligation to transfer economic benefits arises. There appears to be two points at which the obligation to maintain the leased item could arise:

- When the leased item falls below the contractually specified condition
- When the leased item is delivered/made available to the lessee.

View A–When the Leased Item Falls below the Specified Maintenance Standard

62. Once the leased item falls below the specified maintenance standard and maintenance is required, the lessee has a contractual obligation to either incur costs to maintain the item or to pay damages to the lessor. This will be the case whether or not the lessee continues to use the item. Consequently, when the item drops below a contractually agreed level of maintenance a liability may exist.

63. It is interesting to compare this conclusion to the current treatment of full service leases. Under a full service lease, the lessor provides maintenance services on the leased item during the lease term. A fee for maintenance services will be included in the rentals due under the lease contract. Under current accounting requirements, the lessee separates the maintenance element from the lease contract and accounts for the maintenance element as an executory contract. No liability for maintenance is recognised. However, in a full service lease, the lessor provides maintenance services to the lessee. Consequently, the obligation to pay for those services may not arise until the lessor performs under the contract. This is different from a lessee's contractual obligation to maintain the leased item.

View B–When the Leased Item Is Delivered/made Available to the Lessee

64. The lease contract may impose certain maintenance requirements that the lessee has little or no discretion to avoid. For example, the lessee may be required to repaint an office building every two years during the lease (regardless of its condition). Again, the lessee has little or no discretion to avoid these costs. Therefore, it can be argued that a liability for these costs arises at the start of the lease.

65. In other situations, the lessee may have discretion to avoid maintenance costs. For example, the lessee may be able to avoid incurring maintenance costs by stopping use of the leased item.

66. Where this is the case, the lessee is in a similar position to a lessee that is required to return the leased item in a specified condition. It can be argued that no liability arises until the leased item drops below an agreed maintenance standard. Alternatively, it can be argued that the lessee has no discretion to avoid the risk of incurring maintenance costs. Hence, it has a stand-ready obligation to maintain the leased item from the date it obtains access to the leased item.

View C–Not in the Scope of the Leases Project

67. Some question whether the costs to maintain the leased item should be considered when accounting for a right to use a leased item, as these are maintenance costs that should be in the scope of other applicable accounting literature and not debated in a project on lease accounting. This alternative would recommend identifying these maintenance costs and accounting for them separately in accordance with existing applicable GAAP.

Staff Recommendation

68. Given the similarity between obligations to return the leased item in a specified condition and obligations to maintain the leased item, the staff considers they should be accounted for in the same way.

Questions for the Boards

- Do obligations to maintain the leased item meet the definition of a liability?
- If so, when does the liability arise?
  - When the leased item falls below the specified maintenance standard (except where the lease contract imposes an obligation to carry out specified maintenance as described in paragraph 64, in which case a liability arises at the beginning of the lease)?
  - When the lessee obtains access to the leased item?

Accounting for the Debit

69. If it is agreed that a lessee has a liability to maintain the leased item when the lessee obtains access to the leased item, then a follow-up question is how to treat the debit that arises upon the recognition of the liability. The alternatives and support for each of the two alternatives are the same as the analysis for type 2 obligations discussed above.

View A–As an Expense in Profit or Loss

70. Proponents of this view consider that these costs do not give rise to future economic benefits and do not meet the definition of an asset and, therefore, recommend that these costs be recognized as an expense in profit and loss.

71. Proponents of this view consider costs to return the leased item in a specified condition maintenance costs. The normal treatment for maintenance costs is to recognise them in profit or loss as they are incurred. This is the case whether the related asset is measured at fair value or on a historical cost basis. It is argued that maintaining an asset simply preserves its value. It does not enhance its value above its previously assessed level of performance. If this approach were taken, the debit arising upon recognition of an obligation to maintain a lease item would be recognised in profit or loss.

View B–As Part of the Cost of the Right to Use Asset

72. This view recommends capitalizing the costs to maintain the leased item as part of the right to use asset. It could be argued that agreeing to maintain the leased item to a specified standard is part of the lessee's cost of obtaining the right to use the leased item. If this argument is accepted, the debit arising upon recognition of an obligation to maintain the leased item would be added to the carrying value of the related right to use asset. Although this treatment is similar to the treatment of asset retirement obligations, neither IAS 16 nor FAS 143 directly address the costs associated with an obligation to maintain the leased item.

Staff Recommendation

73. Given the similarity between obligations to return the leased item in a specified condition and obligations to maintain the leased item, the staff considers they should be accounted for in the same way.

Question for the Boards

- How should the debit arising on recognition of an obligation to maintain the leased item be accounted for?

Measurement of the Liability–Initial Measurement

74. The next section of this paper will consider two approaches to initial measurement of the liabilities identified in this paper: (a) fair value and (b) expenditure required to settle the present obligation.

View A–Fair Value

75. In many accounting pronouncements, the Boards have concluded that fair value information is relevant, and users of financial statements have generally agreed.

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.

76. However, the obligations discussed in this paper may not all be financial liabilities. Still, the staff considers that measuring liabilities of the type described in this paper at fair value provides the most relevant information to users of financial statements.

77. Measuring these liabilities initially at fair value would be consistent with the required accounting for asset retirement obligations under FAS 143. In developing FAS 143, the FASB considered two alternatives to fair value measurement at initial recognition—an entity specific measurement basis and a cost accumulation basis. However, the FASB rejected both approaches, as they would lead to identical liabilities being measured at different amounts by different entities.

78. FAS 143 indicates that a present value technique is often the best available technique with which to measure the fair value of a liability and states that the expected cash flow approach will usually be the only appropriate technique for an asset retirement obligation. FAS 143 also states that an entity shall discount the estimated cash flows using a credit-adjusted risk-free rate.

79. Measuring these liabilities initially at fair value would be consistent with the tentative decision reached at the June meeting to measure the lessee's obligation to pay for the right to use asset at fair value.

View B–Expenditure Required to Settle the Present Obligation

80. If the Boards decide not to measure these liabilities initially at fair value, then another alternative to consider is initial measurement at the expenditure required to settle the present obligation. This view is consistent with IAS 37, which requires obligations of this type to be measured initially at the expenditure required to settle the present obligation at the balance sheet date discounted using a current market interest rate. Although in many situations fair value and the measurement required by IAS 37 will be the same (particularly if discounted cash flow techniques are used to estimate fair value), this may not always be the case. The required accounting for asset retirement obligations under IAS 37 is described in detail in the appendix to this paper.

Staff Recommendation

81. Consistent with the analysis in paragraphs 75-79, the staff recommends initial measurement of these liabilities at fair value.

Question for the Boards

- How should liabilities identified in this paper be initially measured?
    - Fair value?
    - Expenditure required to settle the present obligation?

Measurement of the Liability-Subsequent Measurement

82. This section describes three approaches to the subsequent measurement of the liabilities identified in this paper:

    - Fair value
    - Adjusted subsequently for changes in estimated timing or amount (FAS 143)
    - Expenditure required to settle the present obligation (IAS 37)
    - Amortized cost (with an option to fair value).

View A—Fair Value

83. Under this approach, a lessee would be required to measure its liability to the lessor at fair value each period; and all changes in that fair value, including those associated with changes in interest rates, would be recognized in the financial statements. This would preserve the advantages of a fair value measurement objective; that is, fair value being viewed as the most relevant measure of a financial liability. However, requiring fair value for subsequent measurements would be more costly than using an amortized cost method because fair value measurements require both current expected cash flows and current market rates to be used. The staff notes that the Boards currently do not require most entities' liabilities to be subsequently measured at fair value; therefore subsequent measurement at fair value might lead to lease liabilities being measured differently than similar non-lease financial liabilities, which reduces comparability.

View B—Adjusted Subsequently for Changes in Estimated Timing or Amount (FAS 143)

84. A liability recognised under FAS 143 is adjusted subsequently for changes in estimated timing or amount. Instead of subsequent measurement at fair value, an accounting convention would be employed to measure period-to-period changes in the liability resulting from the passage of time and revisions to cash flow estimates. Those changes would then be incorporated into a remeasurement of the liability. That convention would not include changes in market interest rates in that remeasurement. In FAS 143, the FASB agreed that conceptually fair value would be preferable to an interest method of allocation; however, the Board did not want to require a fair value measurement until fair value is required for more (or all) liabilities.

View C— Expenditure Required to Settle the Present Obligation (IAS 37)

85. Liabilities recognised under IAS 37 are subsequently measured at the expenditure required to settle the present obligation at the balance sheet date discounted using a current market interest rate (that is, the same basis as initial measurement). The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party.

View D—Amortized Cost (With an Option to Fair Value)

86. This approach might be better described as "amortized initial measurement". Under this approach, a lessee would be required to amortize the initial liability 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. 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.

87. The staff notes that the Boards have tentatively concluded that the lessee's obligation to pay rentals that meet the definition of a financial liability should be measured subsequently at amortized cost (with an option to fair value). Although obligations of the type described in this paper are different from the obligation to pay rentals, requiring them to be measured subsequently at fair value would

introduce a measurement inconsistency among liabilities arising from lease contracts.

Staff Recommendation

88. The staff's view is that subsequent measurement of liabilities of the type described in this paper at fair value provides the most relevant information to users of financial statements.

89. However, the staff notes that some Board members have tentatively concluded that the lessee's obligation to pay rentals that meet the definition of a financial liability should be measured subsequently at amortised cost (with an option to fair value). Although obligations of the type described in this paper are different from the obligation to pay rentals, requiring them to be measured subsequently at fair value would introduce a measurement inconsistency among liabilities.

Question for the Boards

- How should obligations of the type described in this paper be measured subsequently?
    - Fair value?
    - Adjusted subsequently for changes in estimated timing or amount (FAS 143)?
    - Expenditure required to settle the present obligation (IAS 37)?
    - Amortized cost (with an option to fair value)?

Do Lessee Obligations Give Rise to Assets for the Lessor?

90. Terms in a lease contract that require a lessee to either return the leased item to the lessor in a specified condition or maintain the leased item would appear to create valuable rights for the lessor.

91. Requiring a lessee to maintain a leased item or return the item in a specified condition will protect the lessor's interest in the leased item at the end of the lease term. In effect, the lessee has provided the lessor with a guarantee as to the minimum condition of the leased item. A lessee requirement to maintain a leased item also ensures that, should the lessor need to recover the item due to default by the lessee, the leased item will be in a working condition. Consequently, requiring

the lessee to maintain the leased item enhances the security of the lessor's receivable and the value of the lessor's interest in the leased item at the end of the lease. Therefore, one can argue that these rights meet the definition of an asset. As with the lessee's liability, whether the asset arises when the lessee obtains access to the leased item or at some later point (for example, when the leased item falls below a particular standard of maintenance) can be debated.

92. However, although these rights are valuable to the lessor, they are only valuable when combined with either the lessor's interest in the leased item at the end of the lease or its right to receive payments from the lessee. That is, these rights enhance the value of the lessor's other assets.

Staff Recommendation

93. The staff considers that these rights are not a separate asset, but would impact the measurement of the lessor's interest in the leased item at the end of the lease and should therefore be combined with the asset representing the lessor's interest in the leased item at the end of the lease.

Question for the Board

- Should lessor rights arising out the lessee's contractual obligations discussed in this paper be combined with the lessor's right to receive rentals and/or the lessor's interest in the leased asset at the end of the lease?

Appendix–Accounting for Asset Retirement Obligations

94. The obligations discussed in this paper could be considered similar in nature to asset retirement obligations described in FAS 143 and decommissioning or restoration liabilities described in IFRIC 1 *Changes in Existing Decommissioning Restoration and Similar Liabilities*. Consequently, this appendix reviews the current accounting required under IFRS and U.S. GAAP for asset retirement obligations.

Accounting for Decommissioning, Restoration, and Similar Liabilities under IFRS

95. Decommissioning, restoration, and similar liabilities are not defined in IFRS. However, they are described in IFRIC 1 as "…obligations to dismantle, remove and restore items of property, plant and equipment" [IFRIC 1, paragraph 1].

96. There is no specific guidance on when an obligation to dismantle, remove, or restore an item of PP&E should be recognised. However, IAS 37 provides general guidance on the recognition of provisions.

97. IAS 37 defines provisions as liabilities of uncertain timing or amount, and a liability is defined as a present obligation arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits [IAS 37, paragraph 10].

98. A provision is recognised when:

    - An entity has a present obligation (legal or constructive) as a result of a past event.
    - It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
    - A reliable estimate can be made of the amount of the obligation [IAS 37 paragraph 14].

99. Consequently, when the conditions in paragraph 11 of IAS 37 are met, a liability is recognised for obligations to dismantle, remove, or restore the item of PP&E.

100. The liability is measured (both initially and subsequently) at the best estimate of the expenditure required to settle the present obligation at the balance sheet date, which is the amount that an entity would rationally pay to settle the

obligation at the balance sheet date or to transfer it to a third party at that time [IAS 37, paragraphs 36 and 37]. Where the effect of the time value of money is material, the amount of the provision is the present value of the expenditures [IAS 37, paragraph 45]. The discount rate used to calculate the present value of the expenditures is revised at each reporting date to reflect current market conditions.

101. IAS 16 requires items of PP&E to be measured initially at cost [IAS 16, paragraph 15]. The cost of an item of PP&E comprises (amongst other things):

> …the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. [IAS 16, paragraph 16(c)]

102. Consequently, the cost of an item of PP&E includes the amount recognised as a liability in accordance with IAS 37 for an obligation to dismantle, remove, or restore that item.

103. IFRIC 1 describes the accounting required for changes in the measurement of existing decommissioning, restoration, or similar liabilities that are both recognised as part of the cost of an item of PP&E and as a liability in accordance with IAS 37.

104. Changes in the estimated timing or amount of the expected outflows and changes in the discount rate used are all treated in the same way. However, the treatment of these changes required by IFRIC 1 depends upon whether the related asset is measured using the cost model or the revaluation model in IAS 16.

105. If the related asset is measured using the cost model, changes in the liability are added to or deducted from the cost of the related asset (subject to the constraint that any amount deducted from the cost shall not exceed the carrying amount of the asset). If an adjustment results in an addition to the cost of the asset, the entity is required to consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If there is an indication that the new carrying amount may not be fully recoverable, the entity is required to test for impairment in accordance with IAS 36 [IFRIC 1, paragraph 5].

106. If the related asset is measured using the revaluation model, changes in the liability will alter the revaluation surplus or deficit previously recognised on the asset (subject to a number of detailed rules – see paragraph 6 of IFRIC 1).

Accounting for Asset Retirement Obligations under U.S. GAAP

107. FAS 143 addresses the required accounting for asset retirement obligations. Asset retirement obligations are obligations associated with the retirement of tangible long-lived assets [FAS 143, footnote 1]. *Retirement* is defined as the other-than-temporary removal of a long-lived asset from service. Retirement encompasses sale, abandonment, recycling, or disposal in some other manner [FAS 143, footnote 2].

108. FAS 143 applies to legal obligations associated with the retirement of tangible long-lived assets. Legal obligations are those obligations that an entity is required to settle as a result of existing or enacted law or statute, ordinance, or written or oral contract, or by legal construction of a contract under the doctrine of promissory estoppel [FAS 143, paragraph 2].

109. FAS 143 does not currently apply to obligations of a lessee in connection with leased property that meet the definition of minimum lease payments or contingent rentals in FAS 13. However, obligations that do not meet these definitions are required to be accounted for in accordance with FAS 143 [FAS 143, paragraph 17].

110. FAS 143 requires the recognition of a liability for asset retirement obligations in the period in which the obligation is incurred if a reasonable estimate of the fair value of the liability can be made [FAS 143, paragraph 3].

111. Upon initial recognition of an asset retirement obligation, an entity is required to capitalise the asset retirement cost by increasing the carrying amount of the related long-lived asset [FAS 143, paragraph 11].

112. Changes in an asset retirement obligation due to the passage of time are recognised as an expense in the statement of income. The interest rate used to measure the change is the credit adjusted risk-free rate that existed when the liability (or portion thereof) was initially measured [FAS 143, paragraph 14].

113. Changes in the asset retirement obligation resulting from revisions to the timing or amount of the original estimate of the cash flows are recognised as an increase or decreasing in the carrying amount of the liability and the related long-lived asset. Upward revisions are discounted using the current credit adjusted risk-

free rate. Downward revisions are discounted using the rate that existed when the original liability was recognised [FAS 143, paragraph 15].

Comparison of IFRS and U.S. GAAP

114. Although the requirements of IFRS and U.S. GAAP in this area are broadly comparable, a number of potential differences do exist. In particular:

- IAS 37 requires recognition of a liability if (amongst other things) there is a legal or constructive obligation. FAS 143 applies to legal obligations that an entity is required to settle as a result of existing or enacted law or statute, ordinance, or written or oral contract, or by legal construction of a contract under the doctrine of promissory estoppel.

- IAS 37 requires the liability to be measured initially at the best estimate of the expenditure required to settle the obligation. FAS 143 requires the liability to be measured initially at fair value.

- The interest rate used to measure changes in the liability due to the passage of time is the current market interest rate under IAS 37. FAS 143 requires the use of the credit-adjusted risk-free rate that existed when the liability was initially measured.

- Changes in the estimated timing or amount of the expected cash flows are discounted using current market interest rates under IAS 37. FAS 143 requires these changes to be discounted using the current credit-adjusted risk-free rate (if the change is upward). Downward revisions are discounted using the rate that existed when the original liability was recognised.