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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**24 July 2008, London**
Project:	**Leases**
Subject:	**Overview of Approach for Discussion Paper (Agenda Paper 13A)**

Introduction

1. This paper sets out staff proposals to amend lease accounting to achieve significant improvements in the standards by June 2011. As discussed at the April 2008 joint Board meeting, the staff proposes following a revised project approach. In particular:
   - the project should address lessee accounting and defer consideration of lessor accounting;
   - the current financial lease model should be applied, adapted where necessary, to leases currently classified as operating leases; and
   - the requirement for lessees to classify leases as finance leases or operating leases should be removed.

2. The technical plan presented to the Boards in June 2008 was based upon this revised approach.

Background

3. In their previous discussions on the leasing project the Boards have accepted that there are significant problems with existing leasing standards and there are urgent steps that should be taken to address them.

4. The main concerns were set out in detail in the papers for the agenda decision discussion (July 2006). In summary, the concerns that led the Board to take on the project were:

- the dividing line between finance and operating leases is hard to define in a principled way.
- any dividing line means that similar transactions are accounted for differently.
- obligations under non-cancellable leases are little different from borrowings, but for operating leases are not recognised as liabilities.
- assets used in the business that are held under operating leases are not shown on the statement of financial position, thereby overstating return on assets.
- leases are scoped out of financial instruments standards, leading to inconsistencies with other similar transactions.
- lessor accounting is based on a deferral and matching model inconsistent with the direction the revenue recognition project is likely to take.

5. Although these concerns relate to both lessee and lessor accounting, the main driver for the project was the very substantial obligations arising under operating leases, and the corresponding assets hired under these leases, were omitted from lessee balance sheets, leading to ‘rule of thumb’ adjustments by analysts and other users. Furthermore, some of these operating leases were economically very similar to finance leases and purchase agreements that *would* be recognised in the statement of financial position.

6. Since then the Boards have discussed an analysis of the rights and obligations that arise under a lease and have reached tentative conclusions that the lessee should recognise an asset representing the right to use the leased property for the lease term, together with a liability for the obligation to pay rentals for this term.

7. However, for more complex lease agreements that incorporate options to terminate or extend the lease term, no firm conclusions have been reached on whether the options represent a separate asset of the lessee or whether they should be taken into account in determining the lease term. The Boards have also discussed other obligations arising under a lease, and contingent rentals, but have not reached conclusions on many of these issues.

8. The staff consider that further detailed analysis of these issues is unlikely to result in a practical working approach to lessee accounting by June 2011. At the April 2008 joint meeting staff proposed an alternative approach that has the potential to achieve significant improvements in lessee accounting within the proposed timetable. This approach will address many of the concerns noted in paragraphs 3 and 4 above, in particular:

- assets and liabilities arising under leases currently classified as operating leases will be recognised in the statement of financial position; and
- the problems associated with lessees classifying leases as finance or operating will disappear.

9. The proposed approach is to:

- address lessee accounting, and defer consideration of lessor accounting;
- apply the finance lease model in current IAS 17, adapted where necessary, to the lessee's accounting for leases currently classified as operating leases; and
- remove the requirement for lessees to classify leases as finance leases or operating leases and require all leases to be accounted for in the same way.

10. The remainder of this paper considers the first two of these proposals. Further papers address particular issues arising in adapting the finance lease model to all leases. A final paper recommends removing the requirement for lessees to classify leases as operating or financial leases.

11. The staff notes that even this approach requires a tight timetable if a revised standard is to be issued by June 2011. It is proposed that a Discussion Paper setting out these proposals and any preliminary views of the Boards be issued in November of this year. Any decision to move away from this proposed approach is likely to result in the project being delayed beyond mid-2011.

Deferral of Consideration of Lessor Accounting

12. The staff does not believe it is possible to produce a lease accounting standard that deals with both lessee and lessor accounting by June 2011. Because lessee accounting is a far more pervasive issue than lessor accounting (there are far more lessees than lessors), and because the changes are more significant for lessee accounting than lessor accounting, the staff believes a greater overall benefit to users of financial reporting can be produced by first developing a new standard for lessees.

Disadvantages of Considering Lessor Accounting at the Same Time as Lessee Accounting

13. Lessor accounting raises issues that relate to other projects the Boards are currently considering—in particular, derecognition and revenue recognition. Developing in the short term a standard that deals with lessor accounting would mean making decisions on these issues that might turn out to be at variance with the main projects on derecognition and revenue.

14. Even if a lessor accounting project moved ahead of these other projects, it would involve resolving difficult issues in these areas, and the staff believes it is unlikely that these would be resolved satisfactorily within the timetable of the current project plan.

15. Any project dealing with lessor accounting will also need to consider how to account for investment property. There are significant economic differences between lessors of real estate and other lessors that will require detailed analysis to determine if one lessor accounting model could be operational for real estate leases and equipment leases. Consideration of these issues is likely to add further delay to a project addressing lessor accounting.

Advantages of Dealing with Lessor Accounting

16. A consequence of the recommendation to defer lessor accounting is that there may be a lack of symmetry and a different unit of account between lessee and lessor accounting for some time. One consequence of this lack of symmetry will be the need to produce guidance for situations in which an entity acts as both the lessee and lessor of the same asset. Furthermore, continuing to develop lessor accounting might provide additional insights into lessee accounting; deferring

analysis of lessor accounting might lead to further changes to lessee accounting when lessor accounting is eventually addressed.

17. The staff also notes that the Boards have already received constituent opposition to the proposed approach. The UK Finance and Leasing Association (FLA), the British Vehicle Rental and Leasing Association (BVRLA), Leaseurope, and the Equipment Leasing and Finance Association (ELFA) have all written comment letters expressing their objection to any decision to delay consideration of lessor accounting. In addition to the concerns discussed above, some of these constituents stated that different accounting standards for the lessee and lessor could result in structuring opportunities. These constituents also expressed a general concern that evaluating a leasing transaction from the point of view of only one party to the transaction could result in an incomplete picture of the economics of the transaction.

Staff Recommendation

18. The staff believes that the benefit of an improvement to lessee accounting (in particular, requiring lessees to recognise assets and liabilities arising from operating leases) outweighs the disadvantages of a different accounting model for lessors and lessees. They note that the only way in which an improvement to lessee accounting can be made before June 2011 is if lessor accounting is deferred in accordance with the June 2008 technical plan.

19. Lessee accounting affects a wide range of entities across all industries for which current standards significantly understate the extent of the entity's obligations and amount of its assets. Improvements to lessee accounting would be of benefit to a large number of users. Lessors are, in general, relatively specialised financial businesses for which the current accounting is reasonably well understood.

20. Consequently, the staff recommends the Boards defer consideration of lessor accounting; accordingly, lessors would therefore continue to apply the guidance in IAS 17 and Statement 13 in their financial statements.

21. FASB staff will present a separate memorandum to their Board addressing the issue of whether lessors should continue to apply Statement 13 or whether to propose new guidance converging with IAS 17. The staff notes that if the FASB

wishes to produce converged guidance for lessors, there could be implications for the proposed timetable as a number of additional issues will need to be addressed (for example, accounting for leveraged leases).The conclusion reached may affect the form of the final standard—whether to have a single standard addressing both lessee and lessor accounting or to have separate lessee and lessor standards—but will not have a significant influence on the substance of the lessee accounting guidance that is developed.

Question 1 for Board Members:

Do Board Members agree that consideration of lessor accounting should be deferred and that the new standard should deal only with lessee accounting?

Applying the IAS 17 Finance Lease Model to Operating Leases

22. The staff consider that most of the current criticisms of lessee accounting can be addressed by applying the current IAS 17 accounting model for finance leases, adapted where necessary, to apply to leases that are currently classified as operating leases.

23. The finance lease model treats the lease as an in-substance purchase of the physical asset by the lessee. Under this model the lessee records:
    - an asset representing the physical asset, which is then depreciated over its useful life (or the lease term if shorter) as though it were a tangible asset; and
    - a liability for the present value of the rentals due under the lease.

24. This model has worked well in practice and is generally understood by constituents.

25. Applying this model to operating leases is straightforward; the lessee recognises (a) an asset representing the right of use of the leased item for the lease term and (b) an obligation for the present value of the rentals for that term. This is consistent with the analysis of the assets and liabilities, in accordance with the definitions in the Framework, that the Boards have previously tentatively agreed.

26. The staff are seeking preliminary views on several issues that arise if the IAS 17 finance lease model for lessees is adapted to apply to all leases. The following issues are dealt with in separate papers:

- options to extend or terminate a lease;
- contingent rentals; and
- initial and subsequent measurement of the lessee's asset and liability under the lease.

27. Where possible, staff proposes solutions to the issues that are consistent with the existing requirements of IAS 17. This has the advantage of building on a model with which preparers and users are already familiar. Therefore, the model is less likely to give rise to new implementation issues.

28. If the Boards accept the staff recommendations, the need for lessees to classify leases as finance leases or operating leases will be removed (as the required accounting will be the same). However, if the Boards decide to modify the finance lease model when applying it to operating leases, the Boards must decide either: (a) to apply these new requirements to finance leases; or (b) retain the lease classification requirement.

29. The Boards should also be aware that the analysis and development of alternative proposals may be time-consuming and would have implications for the completion of the project within the timetable envisaged.

Question 2 for Board Members

Are Board Members aware of any other issues that arise in adapting the finance lease model to apply to all leases?

Question 3 for Board Members

Do Board Members agree with the proposed approach to adapt the finance lease model to apply to all leases, as set out above?