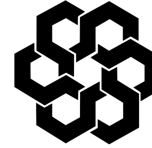

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

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:	**24 July 2008, London**
Project:	**Leases**
Subject:	**Lessee's measurement of the right of use asset and obligation to make rental payments (Agenda Paper 13D)**

Introduction

1. The purpose of this paper is to ask the Boards to make decisions regarding the initial and subsequent measurement of a lessee's right to use a leased item and its obligation to pay rentals. The staff's recommendation is to measure leases classified as operating leases in the same way that leases that are currently classified as finance leases are measured. This is consistent with the project's approach as described in IASB agenda paper 13A (FASB memorandum no. 16).
2. The staff proposes to base the measurement of the right-of-use asset and the liability to pay rentals on the present value of the minimum lease payments. The purpose of this paper is not to define what is meant by the term *minimum lease payments*; it is to get Board agreement on a general approach to measurement. Agenda papers 13B and 13C (FASB Memorandum Nos. 17 and 18) discuss

whether rentals payable in optional periods and contingent rentals should be included in minimum lease payments.

Initial Measurement of Lessee's Right-of-Use Asset

3. The Boards have already agreed that the lessee's right to use a leased item meets the definition of an asset that should be recorded on the lessee's balance sheet.
4. The IAS 17 approach for the initial recognition of a lessee's asset is to recognize an asset in the lessee's balance sheet at an amount equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, which is determined at the inception of the lease. The requirements of Statement 13 are similar.
5. IAS 17 and Statement 13 both refer to the fair value of the leased item rather than the fair value of the right to use the leased item.
6. For leases currently classified as operating leases, the present value of the minimum lease payments will always be less than the fair value of the leased item because the lease term is significantly shorter than the economic life of the leased item.
7. The initial measurement of a lessee's right to use a leased item could be recorded at the fair value of the right to use the leased item as opposed to fair value of the leased item itself. This may be a more conceptually sound requirement. However, the fair value of the right to use the leased item may be difficult to measure and/or costly to determine. This is because most leases are negotiated between the lessee and the lessor and there is no current "observable" market for leases due to the individual facts and circumstances that are independently negotiated for each lease. Measuring the fair value of the right to use a leased item would be a new requirement that is not currently applied in practice. There is a possibility that if a fair value of the right of use is able to be determined, that amount could be different than the initial measurement of the lessee's liability, which could result in a gain or loss upon initial measurement.
8. In addition, requiring fair value of the right of use would either require a change to the current finance lease accounting if there is no distinction between operating

and finance leases or result in different measurement attributes for operating and finance leases (and the classification criteria would have to remain in place to distinguish between operating and finance leases).

9. A decision to require initial measurement of the lessee's right-of-use asset at fair value is inconsistent with the basic approach to the project and could have implications for the timetable outlined in the tech plan.

Staff Recommendation

10. The staff proposes that the right-of-use asset should initially be measured in the same way as leases currently classified as finance leases. That is, the staff recommends that the initial measurement of the lessee's right-of-use asset should be the lower of the obligation to pay rentals or the fair value of the leased item;

Question 1 for Board Members

Do Board Members agree that the right-of-use asset should be initially measured at the lower of the obligation to pay rentals or the fair value of the leased item?

Initial Measurement of Lessee's Obligation to Pay Rentals

11. The Boards have already agreed that the obligation of a lessee to make rental payments for its right to use the leased item meets the definition of a liability that should be recorded on the lessee's balance sheet.

12. IAS 17 requires the liability to be initially measured at the lower of the fair value of the leased item or the present value of the minimum lease payments. Statement 13 provides similar guidance. This ensures that the asset and liability are always equal upon initial recognition. For leases currently classified as operating leases, the present value of the minimum lease payments will always be less than the fair value of the leased item because the lease term is significantly shorter than the economic life of the leased item. This approach works for finance leases under current accounting literature and ensures consistency between finance leases and

operating leases, which users of financial statements may find attractive. This recommendation also is consistent with the staff's overall approach to the project.

13. An alternative might be to measure the lessee's obligation at fair value. However, under the model currently proposed, the rentals due for payment during the substantive lease term are recognised as the lessee's obligation; the fair value of these cash flows is simply their present value discounted at the appropriate rate and will not be significantly different from the present value discounted at the incremental borrowing rate. In contrast, the fair value of the whole lease contract will include the expectations of exercise of options and the possibility of additional rentals being paid if options are exercised.

Staff Recommendation

14. The staff recommends that the initial measurement of the lessee's obligation to make rental payments be recorded at the lower of the fair value of the leased item or the present value of the minimum lease payments as determined at the inception of the lease.

Question 2 for Board Members

Do Board members agree that the initial measurement of a lessee's liability for rental payments should be at the present value of the minimum lease payments?

Discount Rate

15. IAS 17 states that the discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Statement 13 requires a lessee to use its incremental borrowing rate unless it is practicable to determine the implicit rate computed by the lessor and that implicit rate is lower than the incremental borrowing rate. If so, than the implicit rate shall be used.

16. The current definition of the interest rate implicit in the lease in IAS 17 is "the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor." The IAS 17 definition of the lessee's incremental borrowing rate is "the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset."
17. Some may consider the interest rate implicit in the lease the "better" rate to use as it is the rate that the lessor is charging in the transaction and is specific to the liability being measured; however, in many instances the lessee will not know or be able to determine the implicit rate as computed by the lessor. The implicit rate is affected by the lessor's estimate of the residual value of the leased property, in which the lessee usually will have no knowledge of or interest in, and may be affected by other factors extraneous to the lessee.
18. The staff notes that it is more common for entities applying IAS 17 to use the rate implicit in the lease than for entities applying Statement 13 that, in general, use the incremental borrowing rate to discount the lease payments.
19. Determining the interest rate implicit in the lease is more difficult for operating leases than for finance leases because the residual value is much more significant when the lease is an operating lease. The interest rate implicit in the lease will be more subjective as it will be hard for the lessee to determine the residual value estimated by the lessor.
20. As a consequence, the Boards could decide to require all entities to use the incremental borrowing rate. This approach is supported by most working group members and would represent a simplification of the existing standard. However, the staff does not recommend this approach because if the Boards decide to abolish the classification requirement, it would result in a change in accounting for leases currently classified as finance leases.

Staff Recommendation

21. Consistent with the overall approach to this project, the staff recommends retaining the current guidance for discounting the minimum lease payments. This recommendation would discount the minimum lease payments at either the implicit rate, assuming it is determinable, or the incremental borrowing rate.

Question 3 for Board Members

Do Board members agree that the discount rate to be used in calculating the present value of the minimum lease payments should be the interest rate implicit in the lease if this is practicable to determine; if not the lessee's incremental borrowing rate should be used?

Subsequent Measurement of Lessee's Right-of-Use Asset

22. Subsequent accounting for the asset under IAS 17 is to allocate the depreciable amount of the leased item each accounting period during the period of expected use on a systematic basis consistent with IAS 16 and IAS 38. IAS 16 and IAS 38 generally require straight-line depreciation/amortization over the asset's useful life. For leased items, under both IAS 17 and Statement 13, when it is reasonably certain that the lessee will obtain ownership at the end of the lease, the period of expected use is the useful life of the asset; otherwise, the asset is depreciated over the shorter of the lease term and its useful life.
23. An alternative view for the subsequent accounting of the lessee's asset was proposed by the ELFA in its unsolicited comment letter to the Boards, dated May 12, 2008. The ELFA recommends amortizing the asset using mortgage amortization based on initial accounting, using the incremental borrowing rate to create the amortization schedule. It also recommends using the same method to amortize the liability. This would result in the asset and liability balance remaining equal over the lease term. Its proposal is to net the amortization of the asset and the liability. The ELFA then proposes recording the rental payments as rental expense over the lease term at an amount equal to the cash rental payments.

This alternative view would essentially leave the income statement impact for operating leases the same as under current operating lease guidance. The ELFA thinks this linked methodology generally reflects the underlying economics in a decision-useful manner. The ELFA maintains that lease pricing for current operating leases involves pricing that results in level rents over the lease term. Accounting for these leases similar to finance leases would result in a higher expense in the early periods than in the later periods of a lease. The ELFA's view would result in assets and liabilities being recognized in the balance sheets, but the current income statement treatment for operating leases would remain unchanged. The benefits of this view are (a) simplicity and (b) no additional book-tax temporary differences. Opponents of this view do not believe that it has conceptual merit and would prefer no alternative accounting treatments between finance and operating leases.

24. A third alternative for the subsequent measurement of a lessee's right to use a leased item is fair value. However, as noted previously, fair value may not be reliably determinable as most leases are negotiated between the lessee and the lessor and there is not a current "observable" market for leases because of the individual facts and circumstances that are independently negotiated for each lease. Measuring the fair value of the right to use a leased item would be a new requirement that is not currently applied in practice. Therefore, the staff does not recommend subsequently measuring a lessee's right to use asset at fair value because (a) of the difficulty in reliably measuring such an asset, (b) it would be costly to continuously fair value a right of use asset, and (c) it would be a significant change to practice.

Staff Recommendation

25. The staff recommends that the lessee's right-of-use asset subsequently be accounted for by allocating the depreciable amount of the right-of-use asset each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. The right-of-use asset would be depreciated over the shorter of the

lease term or the economic life of the leased item. For leases of items in which it is reasonably certain that the lessee will obtain title at the end of the lease term, the "period of expected use" would be the economic life of the leased item.

26. The staff also recommends that the right-of-use asset be considered for impairment under either IAS 36 or Statement 144.

27. This recommendation is consistent with the current finance lease accounting model and is consistent with the basic approach to the project.

Question 4 for Board Members

Do Board members agree with the staff recommendation (see paragraphs 26–28)?

Revaluation

28. Another area that needs to be explored is whether revaluation of the right-of-use asset should be permitted. It is unclear whether revaluation of assets held under finance leases is permitted by IAS 17. IAS 16 and IAS 38 permit the revaluation of assets (although revaluation under IAS 38 is restricted to those assets for which there is an active market). However, practice has developed such that some assets held under finance leases are revalued, for example, long-term leases of buildings where the lease terms can be in excess of 100 years. There is no revaluation currently permitted under Statement 13.

29. The staff will address this issue at a later stage of the project.

Subsequent Measurement of Lessee's Obligation to Make Payments

30. Subsequent accounting for finance leases under IAS 17 and Statement 13 apportions the minimum lease payments between the finance charge and the reduction of the outstanding liability. The finance charge is allocated to each period during the lease term so as to provide a constant periodic rate of interest on the remaining balance of the liability.

31. An alternative view proposed by the ELFA in its unsolicited comment letter to the Boards recommends subsequent measurement of the liability consistent with current finance accounting (reducing the obligation at each accounting period under a mortgage amortization model). However, its proposal would not break the lease payment into a principal and interest component. Instead, the reduction to the right-of-use asset each accounting period would equal the reduction to the obligation each accounting period so that the liability would always equal the asset. Therefore, instead of an interest component, the ELFA recommends a charge to rental expense as rental payments are made each accounting period. The staff notes that this view is inconsistent with the treatment of other interest-bearing liabilities under IAS 39 where the interest expense is recognized in the income statement. This view would result in different accounting for operating and finance leases and would, therefore, require the classification criteria to remain. Therefore, the staff does not support this approach.

32. A third alternative for the subsequent measurement of the lessee's obligation to make payments is fair value. However, the staff does not recommend this approach because it would be (a) costly and (b) a change to practice to subsequently fair value the remaining minimum lease payments. This approach is not consistent with the basic approach to the project.

Staff Recommendation

33. The staff recommends that the payments for the minimum lease payments be apportioned between a finance charge and a reduction of the outstanding liability, consistent with the treatment of finance leases currently in place. The finance charge would be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Question 6 for Board Members

Do Board members support the staff's recommendation (see paragraph 33)?