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International Accounting Standards Board

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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:	**Lease classification (Agenda Paper 13E)**

Introduction

1. IAS 17 and Statement 13 require lessees to classify all lease contracts as either a finance (capital) lease or an operating lease. However, as discussed in agenda paper 13A / memo 16 (the overview paper), the Boards have concluded that the accounting model currently used for operating leases is broken.
2. The staff has concluded that a significant improvement to financial reporting can be achieved if the finance lease accounting model in IAS 17 is applied to operating leases. Consequently, the staff has presented a number of papers that examine how to extend the finance lease accounting model to operating leases.
3. The purpose of this paper is to ask the Boards whether they wish to retain the requirement to classify leases as operating or finance leases.

4. The staff notes that the Boards' decision on whether to retain the requirement to classify leases will be affected by the conclusions reached on the other issues presented to the Boards at this meeting.

Reason to Retain the Classification Requirement

5. The main reason to retain the classification requirement would be that the Boards believe that the accounting model for leases that are in-substance purchases should be different from other lease contracts. For example, the Boards could conclude one or more of the following:
    - The probability threshold for determining the lease term should be different for finance leases;
    - Initial measurement of the asset recognised should be different;
    - Subsequent measurement of the asset recognised should be different for finance leases (for example, the Boards may wish to permit revaluation of assets held under finance leases or require different amortisation methods for leases classified as operating leases);
    - Initial and subsequent measurement of the liability should be different for finance leases (for example, the Boards may wish to require a different discount rate to be used for operating leases);
    - The treatment of contingent rentals should be different for finance leases; and/or
    - Presentation in the financial statements of assets held under finance leases should be different from the presentation of assets held under operating leases.
6. Each of these issues (with the exception of the final bullet point) have been discussed in agenda papers 13B–13D (FASB memos No. 17–19). The staff notes that if the Boards have decided (in line with the staff recommendations) to apply the accounting required for finance leases under IAS 17 to leases currently classified as operating leases, there is little reason to retain the classification requirement for lessees.

Reasons to Remove the Classification Requirement

7. There are five main reasons to remove the requirement to classify leases for lessees.

    - The staff and Boards have previously concluded that all leases, whether they are classified as operating leases or finance leases, give rise to a right to use the leased item that meets the definition of an asset. Consequently, the staff believes that a single conceptual model for accounting for all leases is preferable.
    - The requirement to classify leases is a source of significant complexity in the current standards. The staff believes that removing the requirement to classify leases would result in a significantly simpler lease accounting standard.
    - It is often difficult to determine lease classification. Consequently, economically similar leases can be classified differently. Removing the requirement to classify leases would result in similar transactions being accounted for similarly, leading to increased comparability for users.
    - Retaining the classification requirement could lead to inconsistencies between how the minimum lease payments are determined for the purpose of lease classification and how assets and liabilities arising under operating leases are measured. For example, contingent rentals are excluded from the minimum lease payments for the purposes of lease classification. However, the Boards could decide to include contingent rentals in the measurement of the lessee's right of use asset arising under an operating lease (although the staff does not recommend this). If this were to happen, the Boards would need to decide whether:

        (a) To include contingent rentals in the definition of minimum lease payments for lease classification purposes (resulting in a significant change to existing practice); or

        (b) To use different definitions of minimum lease payments for lease classification purposes and the measurement of assets and liabilities arising under operating leases.

- The staff believes that any differences between current accounting requirements for finance leases and any new model that will be developed for operating leases are unlikely to justify the additional complexity of a classification requirement.

Staff Recommendation

8. A decision to remove the classification requirement will have the following implications:
    - Any decisions that the Boards make in a new lease accounting model to move away from the accounting requirements of IAS 17 may result in a change to the required accounting for leases currently classified as finance leases; and
    - The staff will need to develop new guidance for a number of areas that currently rely on the lease classification requirements (for example, scope exclusions and accounting for sale and leaseback transactions).
9. Despite this, the staff believes that the advantages of removing the classification are significant. Consequently, the staff recommends that the Boards remove the requirement for lessees to classify leases as operating or finance and develop a single model of accounting for all lease contracts.

Question for the Boards

The staff recommends that the Boards remove the requirement for lessees to classify leases as operating or finance and develop a single model of accounting for all lease contracts.

Do the Boards agree?