Project **Leases**

Topic **Lessee accounting - Initial measurement**

Purpose

1. The purpose of this paper is to discuss the initial measurement of the lessee's obligation to pay rentals and of its right-of-use asset.
2. At this meeting, the staff recommends initially measuring the lessee's obligation to pay rentals at the present value of the lease payments. A lessee shall discount the present value of the lease payments using the interest rate implicit in the lease, if this can be determined. If not, the the lessee's incremental borrowing rate shall be used.
3. In addition, the staff recommends initially measuring the lessee's right-of-use asset at cost. Cost equals the present value of the lease payments discounted using the interest rate implicit in the lease, if this can be determined. If not, the lessee's incremental borrowing rate is used. The cost would include any initial direct costs incurred by the lessee.
4. This paper does not discuss lessor accounting.

Structure of the paper

5. The structure of the paper is as follows:
   (a) Background information
   (b) Initial measurement of lessee's obligation to pay rentals
      (i) Discount rate

(c) Initial measurement of lessee's right-of-use asset

  (i) Initial direct costs

(d) Staff recommendations and questions.

Background

6. In the March 2009 Discussion Paper *Leases: Preliminary Views*, the boards identified and analysed the rights and obligations arising in a simple lease contract. They tentatively decided that these rights and obligations meet the boards' definitions of assets and liabilities in accordance with the frameworks. They should therefore be presented in the statement of financial position. (The boards reconfirmed that decision at their October meeting.)
7. In the discussion paper, the boards also tentatively decided to initially measure the lessee's obligation to pay rentals at the present value of the lease payments, discounted using the lessee's incremental borrowing rate. The boards tentatively decided not to require using the interest rate implicit in the lease for discounting.
8. The boards tentatively decided that the lessee should initially measure its right-of-use asset at cost. Cost equals the present value of the lease payments discounted using the lessee's incremental borrowing rate.
9. In June 2009, the boards discussed initial direct costs under the right-of-use model. The boards tentatively decided that a lessee would recognise any initial direct costs as an expense when they are incurred.

Initial Measurement of Lessee's Obligation to Pay Rentals

10. The boards have previously discussed whether to require the lessee to measure the obligation to pay rentals initially at fair value. Measuring the obligation to pay rentals at fair value has the following advantages:
    (a) it reflects current market conditions, thus providing users of financial statements with more relevant information than other measures.
    (b) it produces more comparable information for users because it ignores entity-specific factors.
    (c) it is consistent with the treatment of some other financial liabilities.

11. However, the boards noted that:
    (a) discounting the lease payments at an appropriate discount rate would be a reasonable approximation to fair value.
    (b) calculating the present value of the lease payments is simpler for the lessee than measuring the obligation at fair value.
12. Consequently the boards tentatively decided to initially measure the lessee’s obligation to pay rentals at the present value of the lease payments.
13. Nearly all respondents agreed with the boards’ tentative decision to measure the lessee’s obligation to pay rentals at the present value of the lease payments.
14. However, respondents were divided on whether the lease payments should be discounted using the lessee’s incremental borrowing rate or at the interest rate implicit in the lease. This issue is discussed further below.

Discount rate

15. In the discussion paper, the boards considered two alternatives for determining the present value of the lease payments:
    (a) using the interest rate implicit in the lease, or
    (b) using the lessee’s incremental borrowing rate.
16. In IAS 17 the definition of the interest rate implicit in the lease 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.’
17. 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. FASB ASC 840 contains similar definitions of both the interest rate implicit in the lease and the incremental borrowing rate.
18. In theory, the interest rate implicit in the lease should equal the lessee’s incremental borrowing rate. However, the implicit rate is affected by differences between the lessee’s and lessor’s estimates of the residual value, and

it may also be affected by other factors only known to the lessor. This means that it may be difficult to determine the implicit rate for some leases (particularly those leases that have significant residual values at the end of the lease such as leases currently classified as operating leases). Consequently, the boards tentatively decided not to require using the interest rate implicit in the lease for discounting.

19. Those who agreed with the boards' approach stated that the implicit rate in a lease arrangement is difficult to determine. In many cases, the incremental borrowing rate would be a reasonable approximation to the implicit rate.

> The use of the lessee's incremental borrowing rate to discount the lease payments when measuring the lessee's obligation is a pragmatic method that adequately reflects its obligation to pay the future lease payments. (CL #117)

20. Those respondents who did not support the boards' approach argued that the implicit rate should be used when it can be determined. These respondents noted that discounting the lease payments using the implicit rate is the conceptually correct approach, because it reflects the return that the lessor expects to receive from the transaction. In their view, the incremental borrowing rate should only be used when the implicit rate is not available.

> The boards appear to have chosen the approach on the basis of ease of measurement rather than conceptual superiority. The interest rate implicit in the lease is the conceptually superior approach to discounting as it is specific to the transaction in question. (CL #12)
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> The interest rate implicit in the lease is conceptually preferable and would be easily determinable in many cases. We wondered why this should not be required to be used when this is practicable to determine, with the incremental borrowing rate being the default position. (CL #33)

21. Additionally, some respondents argued that using the lessee's incremental borrowing rate for the lease obligation would not necessarily reduce complexity, because the incremental borrowing rate must reflect the credit standing of the lessee as well as the level of security provided by the leased item. The degree of security could be different from lease to lease and from period to period, depending on the fair value of the leased item. Also, the incremental borrowing rate may not be readily obtainable in cases where the lease term is long (eg a 99-year lease).

> Requiring the lessee to use the incremental borrowing rate under all circumstances may not necessarily be a simplification for preparers. Indeed, determining this rate may be a costly exercise for lessees as they would potentially need to estimate or obtain quotes from a number of sources for a rate that appropriately reflects the level of security provided by the leased item. (CL #72)

22. Several respondents also noted that, in practice, determining the implicit interest rate is often relatively easy to determine.

> Lessors will know the interest rate they are charging to lessees. Indeed, many agreements will surely explicitly state the interest rate implicit in the lease on the face of the agreement. It is in an entity's interest to know the rates being charged, how else could logical conclusions be reached in the decision between alternative sources of finance? (CL #20)

23. At their July meetings, the boards tentatively decided that the initial measurement of the lessor's right to receive rental payments would be discounted using the interest rate implicit in the lease. Consequently, different rates used by the lessor (ie the implicit rate) and the lessee (ie the lessee's incremental borrowing rate) could result in the measurement of the lessee's obligation to pay rentals not being equal to the lessor's lease receivable.

Staff recommendation

24. The staff recommends that the initial measurement of the lessee's obligation to pay rentals should be the present value of the lease payments, because:
    (a) it would be a reasonable approximation to fair value.
    (b) it is simpler to determine than the fair value of the obligation.
25. The staff recommends that the interest rate used to discount the lease payments should be the interest rate implicit in the lease, because:
    (a) it is, as pointed out by many respondents, the conceptually better answer.
    (b) it may be difficult to determine the incremental borrowing rate in some situations.
    (c) it is more consistent with the boards' tentative decisions on lessor accounting.
26. The staff acknowledges that it may sometimes be difficult to determine the interest rate implicit in the lease. Consequently, the staff also recommends that

if the lessee is unable to determine the interest rate implicit in the lease, the lessee's incremental borrowing rate shall be used.

Question 1
The staff recommends that the initial measurement of the lessee's obligation to pay rentals should be the present value of the lease payments discounted using the interest rate implicit in the lease. If the lessee is unable to determine the interest rate implicit in the lease, the lessee's incremental borrowing rate should be used to discount the lease payments. Do the boards agree with the staff recommendation?

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

27. In the discussion paper, the boards tentatively decided that the lessee should initially measure its right-of-use asset at cost rather than at fair value. Cost equals the present value of the lease payments discounted using the lessee's incremental borrowing rate.

28. A lessee's right-of-use asset is a non-financial asset. Most non-financial assets are initially measured at cost. For example, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* require initial measurement at cost rather than at fair value. The requirements of US GAAP are similar.

29. The boards previously identified the following advantages to requiring initial measurement at cost:
    (a) it is consistent with the initial measurement of other non-financial assets, thus increasing comparability for users.
    (b) a cost-based approach is easier and less costly for preparers to apply than requiring fair value measurement.
    (c) the cost of the right-of-use asset will be a reasonable approximation to its fair value at the inception of the lease.

30. Nearly all respondents supported initially measuring the lessee's right-of-use asset at cost because it is consistent with the measurement of other non-financial assets.

31. A number of respondents said that the right-of-use asset should initially be measured at fair value. These respondents stated that measuring the right-of-use

asset at fair value would provide a more relevant assessment of the economic benefit derived from the use of the asset.

Staff recommendation

32. The staff recommends (for the reasons set out in paragraph 25 above) that the initial measurement of the lessee's right-of-use asset should be at cost, which is equal to the present value of the lease payments discounted using the interest rate implicit in the lease, if this can be determined.

Question 2
The staff recommends that the initial measurement of the lessee's right-of-use asset should be at cost, which is equal to the present value of the lease payments discounted using the interest rate implicit in the lease, if this can be determined. Do the boards agree with the staff recommendation?

Initial direct costs

33. At their June meetings, the boards considered three possible approaches to address how initial direct costs should be accounted for:
    (a) capitalising initial direct costs to the carrying amount of the right-of-use asset;
    (b) allocating initial direct costs between debt issuance costs and asset acquisition costs; and
    (c) recognising such costs as an expense as incurred.
34. The boards tentatively decided that a lessee would recognise any initial direct costs as an expense when they are incurred.
35. The boards' preliminary view on initial direct costs was not included in the discussion paper, because their view was reached after publication of the discussion paper. However, a number of respondents to the discussion paper commented on this issue. Almost all of these respondents expressed views that are not in agreement with the boards' tentative decision.
36. Such respondents stated that initial direct costs should be included in the carrying amount of the right-of-use asset, and accounted for on an amortised

cost basis consistent with other standards. These respondents argued that recognising initial direct costs as expenses will result in dissimilar accounting for similar transactions, and thus will not provide useful information to users.

37. They also noted that it is inconsistent with the boards' proposed approach to lessee accounting. The boards tentatively decided that in all lease contracts, the lessee has bought a right-of-use asset and is funding that acquisition with an obligation to pay rentals. Consequently, recognising such costs as expenses is inconsistent with existing accounting for asset purchases (ie asset acquisition costs) and for borrowing arrangements (ie debt issuance costs).

38. At the joint leases working group meeting in September 2009, some working group members expressed the view that recognising initial direct costs as expenses is inconsistent with the requirements of existing standards and with the proposed cost model. Several working group members expressed concern that the inconsistency could result in structuring opportunities (if it is a lease, recognise it as an expense; if it is an acquisition with a loan, capitalise it).

Staff recommendation

39. The staff does not recommend allocating initial direct costs between costs associated with issuing the obligation to pay rentals, and costs associated with acquiring the right-of-use asset. Such an approach would be costly for preparers to apply, with little benefit for users of financial statements, and would add complexity to any proposed standard.

40. The staff recommends capitalising initial direct costs in the carrying amount of the right-of-use asset, and amortising those costs with that asset, because:
    (a) it is consistent with the treatment of the costs associated with acquiring other non-financial assets (eg property, plant and equipment or intangible assets), thus increasing comparability between non-financial assets.
    (b) it is consistent with the proposed amortised-cost-based approach to measurement of the right-of-use asset. The boards tentatively decided to initially measure the right-of-use asset at cost. In general, cost includes incremental costs directly attributable to the acquisition of the asset.

(c) different treatment between leased assets and owned assets may provide structuring opportunities.

Question 3
The staff recommends that any initial direct costs should be added to the amount recognised as an asset. Do the boards agree with the staff recommendation?