Project **Leases**

Topic **Lessee accounting - Subsequent measurement of the obligation to pay rentals**

Purpose

1. The objective of this paper is to discuss the subsequent measurement of the lessee's obligation to pay rentals in a simple lease. More complex leases that include options, contingent rental arrangements and residual value guarantees will be discussed at subsequent meetings.

2. In this paper, the staff recommends:

   (a) subsequently measuring the lessee's obligation to pay rentals using an amortised cost-based approach

   (b) not permitting the lessee to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate

   (c) no option to subsequently measure the obligation to pay rentals at fair value

   (d) specifying the required accounting for the obligation rather than cross-referring to existing guidance for similar obligations.

3. This paper does not discuss lessor accounting.

Structure of the paper

4. The structure of the paper is as follows:

(a) Background information

(b) Basic approach – Amortised cost or fair value

(c) Reassessment of the incremental borrowing rate

(d) Option to fair value the obligation to pay rentals

(e) Cross-referring to existing guidance

(f) Staff recommendations and questions.

Background

5. In the March 2009 Discussion Paper *Leases: Preliminary Views*, the boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of the lessee's obligation to pay rentals.

6. In addition, the IASB tentatively decided that the lessee's obligation to pay rentals should be remeasured to reflect changes in its incremental borrowing rate. However, the FASB tentatively decided not to require reassessment of the incremental borrowing rate.

7. The boards also tentatively decided to specify the required accounting for the obligation to pay rentals in the leases standard.

Basic approach – Amortised cost or fair value

8. In the discussion paper the boards considered whether to require the lessee to measure its obligation to pay rentals subsequently at amortised cost or fair value.

9. The boards noted that fair value reflects current market conditions. Therefore, it can be argued that fair value measurement provides users of financial statements with more relevant information.

10. However, the boards identified the following disadvantages to requiring subsequent measurement at fair value:

    (a) It is inconsistent with the subsequent measurement of many other non-derivative financial liabilities, thus decreasing comparability for users.

(b) A fair value approach would be more complex and costly for preparers to apply than a cost-based approach as it requires the use of both current expected cash flows and current market interest rates.

(c) It would be inconsistent with the boards' tentative decision not to require initial measurement at fair value.

11. Because of the reasons described above the boards tentatively decided to subsequently measure the lessee's obligation to pay rentals on an amortised cost basis.

12. The majority of respondents agreed with the boards' tentative decision to adopt an amortised cost-based approach to subsequently measure the lessee's obligation to pay rentals. They noted that an amortised cost-based approach is consistent with current guidance for non-derivative financial liabilities and therefore would increase comparability among reporting entities.

13. However, some respondents noted that the subsequent measurement of the obligation to pay rentals and the right-of-use asset should remain linked (a linked approach). Under a linked approach, leases that are currently classified as finance leases would be accounted for as purchases. Leases currently classified as operating leases would be subject to mortgage-based amortisation for both the obligation to pay rentals and the right-of-use asset.

14. Those who supported a linked approach said that it better reflects the economics of most lease contracts because costs are evenly distributed and the asset and liability arising in a lease contract are linked over the lease term (see Agenda Paper 5C/Memo 48 for more discussion on a linked approach).

Staff recommendation

15. The staff does not recommend subsequent measurement of the lessee's obligation to pay rentals at fair value. Instead the staff recommends that subsequent measurement should be on an amortised cost basis (see Appendix for an example under the amortised cost-based approach) because:

(a) It is consistent with the way many other non-derivative financial liabilities are subsequently measured.

(b) It is simpler and less costly for preparers to apply than fair value measurement of the obligation.

Question 1
The staff recommends that the subsequent measurement of the lessee's obligation to pay rentals should be on an amortised cost basis. Do the boards agree with the staff recommendation?

Reassessment of the incremental borrowing rate

16. In the discussion paper, the boards 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 IASB tentatively decided to require the lessee to remeasure its obligation to pay rentals to reflect changes in the lessee's incremental borrowing rate. The FASB tentatively decided not to require remeasurement for changes in the incremental borrowing rate.

17. At this meeting, the staff recommends initially measuring the lessee's obligation to pay rentals at 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 (see Agenda Paper 5A/Memo 46 on initial measurement). Consequently, the staff thinks that if the implicit rate is used, there would not be a need to revise the discount rate because the interest rate implicit in the lease does not change over the term of the lease.

18. If the boards do not agree with the staff's recommendation on initial measurement using the interest rate implicit in the lease or the lessee is unable to determine the implicit rate, the boards will need to consider whether to require the obligation to pay rentals to be remeasured for changes in the lessee's incremental borrowing rate. This issue is discussed below.

19. Revising the incremental borrowing rate reflects current market conditions and therefore may provide more relevant information. Also, this approach is consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

20. Several respondents supported reassessment of the incremental borrowing rate. Those respondents said that the incremental borrowing rate used to discount the lessee's liability should reflect current economic conditions. However, they added that an adjustment should only be required when there is a change in estimated cash flows in a lease contract.

21. However, requiring a reassessment of the incremental borrowing rate has the following disadvantages:

    (a) It is inconsistent with subsequent measurement at amortised cost of many non-derivative financial liabilities.

    (b) It is more complex and costly for preparers to apply.

22. Almost all respondents including users said that the lessee should not be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate. Those respondents argued that revising the incremental borrowing rate would significantly increase complexity and reduce consistency and comparability.

> Revising the incremental borrowing rate appears to be mixing amortised cost principles and fair value principles. The treatment should be consistent with that for other financial liabilities under IAS 39. (CL #35)

Staff recommendation

23. The staff does not recommend requiring reassessment of the incremental borrowing rate because:

    (a) it is inconsistent with the treatment of other non-derivative financial liabilities.

    (b) it would add complexity and reduce comparability for users to understand the financial statements.

Question 2
The staff recommends that the lessee should not be required to reassess its incremental borrowing rate.

Do the boards agree with the staff recommendation?

Option to fair value the obligation to pay rentals

24. The boards have previously noted that the lessee's obligation to pay rentals meets the definition of a financial liability. Existing guidance permits (in some circumstances) financial liabilities to be subsequently measured at fair value. Consequently, in the discussion paper, the boards asked whether to permit fair value measurement of the obligation to pay rentals (ie an option to measure the liability at fair value rather than a requirement).

25. The majority of respondents did not support an option to fair value the obligation to pay rentals subsequently. They argued that a fair value option would reduce comparability.

> The proposal would implement an unnecessary option limiting the comparability of financial statements. (CL #75)

26. A number of respondents supported a fair value option. They noted that it would provide more relevant information because lease liabilities are similar to other financial liabilities.

Staff recommendation

27. The staff does not recommend permitting subsequent measurement of the obligation to pay rentals at fair value because a fair value option would reduce comparability between entities.

Question 3

The staff recommends that there should not be an option to subsequently measure the obligation to pay rentals at fair value.

Do the boards agree with the staff recommendation?

Cross-referring to existing guidance

28. The lessee's obligation to pay rentals meets the definition of a financial liability in accordance with both IFRSs and US GAAP.

29. In developing their preliminary views, the boards decided to specify the required accounting for the obligation to pay rentals in the proposed leases standard. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.

30. The majority of respondents supported the boards' tentative decision. Those respondents stated that providing guidance in one comprehensive standard would make the standard clearer and easier to apply.

31. Several respondents did not support the proposed approach. Rather, they argued that accounting for the obligation to pay rentals in accordance with existing financial instruments standards would increase comparability and reduce complexity.

32. The staff acknowledges that the obligation to pay rentals is a financial liability. However, it has some features that are unusual in financial liabilities, for example because the obligation is linked to the right-of-use asset and includes specific terms of leases, such as options and contingent rentals. Therefore, the staff thinks that the accounting for the lease obligation should be specified in the leases standard.

Staff recommendation

33. The staff recommends that the boards should specify the required accounting for the obligation to pay rentals because the obligation to pay rentals differs from other financial liabilities measured in accordance with existing financial instruments standards. This approach would ensure consistent application of accounting for leases, increasing comparability.

Question 4
The staff recommends specifying the required accounting for the lessee’s obligation to pay rentals. Do the boards agree with the staff recommendation?