Project **Leases**

Topic **Lessee accounting - Subsequent measurement of the right-of-use asset**

Purpose

1. The objective of this paper is to discuss the subsequent measurement of the lessee's right-of-use asset.

2. In this paper the staff recommends:

   (a) subsequently measuring the lessee's right-of-use asset using an amortised cost-based approach.

   (b) describing any decrease in the value of the right-of-use asset as amortisation or depreciation rather than rental expense.

   (c) requiring entities to refer to existing applicable standards for impairment.

   (d) permitting revaluation of the right-of-use asset for IFRS preparers.

   (e) not permitting revaluation of the right-of-use asset for US GAAP preparers.

3. This paper does not discuss lessor accounting.

Structure of the paper

4. The structure of the paper is as follows:

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) Background information

(b) Basic approach - Amortised cost or fair value

(c) Decrease in value of the right-of-use asset

(d) Impairment of the right-of-use asset

(e) Revaluation of the right-of-use asset

(f) Staff recommendations and questions

(g) Appendix – A linked approach to subsequent measurement.

Background

5. In the March 2009 Discussion Paper *Leases: Preliminary Views*, the boards tentatively decided that a lessee should subsequently measure the right-of-use asset on an amortised cost basis.

6. In June 2009, the boards discussed impairment and revaluation of the right-of-use asset. The boards tentatively decided to require lessees to refer to existing applicable standards for impairment. For revaluation, the IASB tentatively decided that revaluation of the right-of-use asset should be allowed. However, the FASB tentatively decided not to permit revaluation of the right-of-use asset.

Basic approach – Amortised cost or fair value

7. In the discussion paper, the boards discussed whether to require the lessee to measure its right-of-use asset subsequently at fair value. Fair value reflects current market conditions and thus it may provide users of financial statements with more relevant information.

8. 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-financial assets, which could reduce comparability for users.

(b) Fair value measurement would be more complex, less reliable, and costly for preparers to apply than a cost-based approach.

(c) It is inconsistent with the boards' tentative decision to require initial measurement at cost.

9. Because of the disadvantages to requiring fair value measurement described above the boards tentatively decided to subsequently measure the lessee's right-of-use asset on an amortised cost basis.

10. Amortised cost-based measurement requires depreciation/amortisation, which is the systematic allocation of the depreciable amount of an asset over its useful life.

11. Consistent with the standard applicable to the underlying leased asset (for example, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*, ASC 360 *Property, Plant, and Equipment* or ASC 350 *Intangibles-Goodwill and Other*) the lessee will depreciate/amortise the right-of-use asset over the shorter of the lease term and the economic life of the leased asset.

12. For leases of items for which it is expected that the lessee will obtain title at the end of the lease term, the amortisation period would be the economic life of the leased item. For leases of land the amortisation period would be the lease term unless the lessee is expected to purchase the land, in which case the land would not be depreciated.[1]

13. The majority of respondents agreed with the boards' tentative decision to adopt an amortised cost-based approach to subsequently measure the lessee's right-of-use asset. They noted that an amortised cost-based approach is consistent with the treatment of other non-financial assets and therefore would increase comparability.

14. However, some respondents supported linking the subsequent measurement of the right-of-use asset and the obligation to pay rentals (a linked approach)

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[1] At a future meeting, the staff will present a paper that discusses whether leases in which the lessee is expected to purchase the leased item should be excluded from the scope of the leases standard.

because they think that it better reflects the economics of most lease contracts. Under a linked approach, costs are evenly distributed and the asset and liability arising in a lease contract are linked over the lease term (See the Appendix for more discussion on a linked approach).

Staff recommendation

15. The staff recommends that the subsequent measurement of the lessee's right-of-use asset should be on an amortised cost basis because:

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

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

    (c) It is consistent with the boards' tentative decision to require initial measurement at cost.

Question 1
The staff recommends that the subsequent measurement of the lessee's right-of-use asset should be on an amortised cost basis. Do the boards agree with the staff recommendation?

Decrease in value of the right-of-use asset

16. In the discussion paper, the boards asked whether to describe any decrease in value of the right-of-use asset as rental expense rather than amortisation or depreciation in the income statement.

17. Some board members think that describing the decrease in value of the right-of-use asset as amortisation or depreciation is potentially misleading for some leases. They think that the decrease in value of the right-of-use asset represents the lessor's charge for the use of the leased item. Consequently, they think the decrease in value of the right-of-use asset should be described as rental expense.

18. Nearly all respondents disagreed with describing the decrease in the right-of-use asset as rental expense. Those respondents stated that reporting a decrease in the value of a right-of-use asset as depreciation or amortisation is consistent with accounting for other non-financial assets. Describing a decrease in the value of some right-of-use assets as rental expense may introduce the need to classify leases similar to what is required in the existing standards.

> Similar to owned assets, and consistent with an amortized cost approach, the decrease in value of the right-of-use asset should be reported as depreciation or amortization expense. (CL #198)

> We do not believe that the decrease in value of the right-of-use asset should be treated as rental expense. Doing so effectively unwinds all that this DP proposes to do — it recreates operating leases. (CL #244)

Staff recommendation

19. The staff does not recommend describing the decrease in value of the right-of-use asset as rental expense but as amortisation or depreciation in the income statement.

Question 2
The staff recommends that the decrease in the value of the right-of-use asset should be described as amortisation or depreciation rather than rental expense in the income statement. Do the boards agree with the staff recommendation?

Impairment of the right-of-use asset

20. At their June 2009 meetings, the boards discussed how to determine impairment of a right-of-use asset. Right-of-use assets are non-financial assets and are subject to amortisation. IAS 36 *Impairment of Assets* provides guidance on how to assess impairment of those assets. Similarly, ASC 360-10-35 *Impairment or Disposal of Long-Lived Assets* addresses impairment accounting for long-term assets subject to amortisation, for example right-of-use assets.

21. The boards considered four possible approaches for impairment of a right-of-use asset: (a) require all entities to use IFRS approach, (b) require all entities to use

US GAAP approach, (c) develop a specific approach for a right-of-use asset and (d) cross refer to existing applicable standards (IAS 36 for IFRS preparers, ASC 360-10-35 for US GAAP preparers). The boards tentatively decided to refer to existing accounting standards.

22. At the joint leases working group meeting in September 2009, some working group members supported the boards' tentative decision as it represents a practical solution because it provides consistency of accounting (that is, impairment guidance for non-financial assets under IFRS would be consistent and impairment guidance for non-financial assets under US GAAP would be consistent).

23. However, a few working group members expressed concern that this approach would not result in a converged standard as IFRS and US GAAP impairment standards are different. They noted that some entities would be required to maintain two sets of impairment accounting records if they have to follow both IFRS and US GAAP requirements.

24. If the leases standard were to require all entities to apply the IFRS approach to impairment, different impairment models for right-of-use assets and other assets would result under US GAAP. Similar problems would arise for IFRS preparers if the boards were to adopt a US GAAP approach for all leases. Also, both approaches may not work for impairments of a group of assets comprised of both leased and owned assets.

25. Although developing a single, specific approach for leases could remove inconsistency resulting from those two approaches, the boards rejected this approach. Having a different impairment accounting model for right-of-use assets and other non-financial assets would be difficult to justify because right-of-use assets are similar to other non-financial assets subject to amortisation and impairment. In addition, this approach would add complexity to the proposed new standard.

Staff recommendation

26. Although referring to existing applicable impairment requirements would not result in convergence between IFRS and US GAAP, the staff recommends this approach because it would be easier for preparers to understand and implement than the alternative approaches and would increase comparability for both IFRS and US GAAP users.

Question 3
The staff recommends that the lessee should refer to existing applicable impairment standards to determine whether its right-of-use asset is impaired and a loss should be recognised. Do the boards agree with the staff recommendation?

Revaluation of the right-of-use asset

27. IFRSs allow non-financial assets subject to depreciation/amortisation initially measured at cost to be subsequently carried at fair value. US GAAP does not. If the boards decide not to require initial or subsequent measurement of a right-of-use asset at fair value, they would need to discuss whether to permit an option (not a requirement) to revalue the right-of-use asset.

28. At their June 2009 meetings, the boards discussed whether a lessee would be permitted to subsequently remeasure its right-of-use asset to fair value. The IASB tentatively decided that the standard applicable to the underlying leased asset (for example, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*) would determine whether and how a lessee may revalue its right-of-use assets. Permitting revaluation ensures consistency with the accounting for other non-financial assets in IFRS.

29. In contrast, under US GAAP permitting revaluation of right-of-use assets would result in inconsistency with accounting for other non-financial assets. Therefore, the FASB tentatively decided that a lessee would not be permitted to subsequently revalue its right-of-use asset.

30. At the joint leases working group meeting in September 2009, some working group members noted that although revaluation is inconsistent with the proposed

cost-based model, it is important to be consistent between leased and purchased assets.

31. If the leases standard were to permit revaluation, right-of-use assets and other non-financial assets would be measured differently under US GAAP. Similar problems would arise for IFRS preparers if the boards were to prohibit revaluation.

32. The staff thinks that consistent accounting between right-of-use assets and other non-financial assets provides more useful information than adopting a converged approach. This would be easier for preparers to understand and implement and would benefit users of financial statements.

Staff recommendation

33. The staff recommends that for a lessee preparing financial statements in accordance with IFRSs the standard applicable to the underlying leased asset would determine whether and how a lessee may revalue right-of-use assets. For example:

    (a) if the underlying asset is property, plant and equipment, the lessee could revalue its right-of-use asset when IAS 16 *Property, Plant and Equipment* so permits, using the revaluation model in IAS 16.

    (b) if the underlying asset is an intangible asset, the lessee could revalue its right-of-use asset when IAS 38 *Intangible Assets* so permits, using the revaluation model in IAS 38.

34. For a lessee applying US GAAP, the staff recommends that the lessee would not be permitted to subsequently remeasure its right-of-use asset to fair value unless required to do so to recognise an impairment loss.

Question 4
The staff recommends that: a) for IFRS preparers a lessee should refer to existing standards applicable to the underlying leased asset to determine whether and how to revalue its right-of-use asset. b) for US GAAP preparers, a lessee should not be permitted to revalue its right-of-use asset.

Do the boards agree with the staff recommendation?

Appendix – A linked approach to subsequent measurement

A1. In a lease there is a link between the obligation to pay rentals and the right-of-use asset. They arise from the same contract and they are interdependent. The boards' tentative decisions on initial measurement reflect this linkage.

A2. Some constituents think that subsequent measurement of the obligation to pay rentals and the right-of-use asset should also be linked for some leases. 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.

A3. The majority of respondents agreed with the boards' tentative decision to adopt an amortised cost-based approach (ie non-linked approach) to subsequent measurement.

A4. However, a number of respondents (mostly preparers and industry organisations) supported a linked approach. Those respondents noted that it reflects the economic reality of most leases as the lessee pays for its right to use the leased item at the same time it receives the right and consumes its benefits. This approach results in the lessee recognising an even rental expense over the lease term and may be simpler for lessees to apply than a non-linked approach.

> The asset and liability of a lease are intrinsically linked. Therefore, we do not agree with the Boards' proposed approach but considers that subsequent measurement should reflect this specific, linked nature of leases. (CL #29)

A5. However, in the discussion paper the boards tentatively decided to reject a linked approach for the following reasons:

(a) The treatment of the obligation to pay rentals is inconsistent with the treatment of other financial liabilities, which could reduce comparability for users. No interest expense is recognised under a linked approach.

(b) This approach requires the lessee to differentiate between finance leases and operating leases.

(c) Although the right-of-use asset and the obligation to pay rentals are clearly linked at the inception of the lease, this is not necessarily the case after inception.

A6. The staff thinks that a linked approach is based on the idea that there is a fundamental difference between a lease that is classified as an operating lease and a lease that is classified as a finance lease in accordance with existing standards. Therefore, adopting this approach would not be an improvement to lessee accounting and would add complexity to a proposed new standard.

A7. For the reasons set out in paragraphs A4 – A5 above, the staff have not recommended a linked approach to the subsequent measurement of the obligation to pay rentals and the right-of-use asset.