Project **Leases**

Topic **Should lessees use the right-of-use approach?**

Purpose of this paper

1. The purpose of this paper is to ask the boards (you) if lessees shall apply the right-of-use approach to a simple lease contract. An agreed-upon approach will be the building block to develop the accounting by lessees.

What this Paper does not do

2. This paper does not address:
   - (a) the scope of the leases project. For the purpose of this meeting, the scope is based on existing lease requirements. We will discuss the scope at a later meeting. If at that meeting, we think that any decision with regard to scope will affect the boards' tentative decisions on which approach to apply, we will highlight it to you.
   - (b) definition of a lease. Similar to scope, we will apply the existing definitions of a lease and highlight if there are any problems.
   - (c) Leases with options and contingent rentals. For this meeting, we intend to develop principles for the standard for lessees. Therefore, we will use the simple lease example used in the Leases Discussion Paper (DP). Again we will highlight any problems when we discuss those issues, in due course.

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(d) application of the right-of-use approach to lessor accounting. We acknowledge that the boards may need to revisit the right-of-use approach in light of decisions made on lessor accounting

Background (the boards' preliminary views)

3. In the Leases DP, the boards analysed the rights and obligations from a simple contract.

> A machine is leased for a fixed term of five years; the expected life of the machine is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machine at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the machine has been delivered; these are fixed amounts that are specified in the original agreement. No maintenance or other arrangements are entered into.

4. Lease contracts are more complex than the simple example above. But, by analysing this simple lease, the boards wanted to identify the relevant rights and obligations common to *most* lease contracts.

5. In that example above, the boards came to the following preliminary views:

(a) The lessee's rights and obligations are:

Lessee rights	**Lessee obligations**
• Right to use the machine for the lease term	• Obligation to pay rentals • Obligation to return the machine at the end of the lease term

(b) Applying the boards' definitions of assets and liabilities from the conceptual frameworks

Description of right	**Control**	**Past event**	**Future economic benefits?**	**Asset?**
Right to use machine during the lease term	Legally enforceable right established by the lease contract	Delivery following signing of the lease contract	Yes	Yes

Description of obligation	**Present obligation**	**Past event**	**Outflow of economic benefits?**	**Liability?**
Obligation to pay rentals	Legally enforceable obligation established by the lease contract	Delivery following signing of the lease contract	Yes (cash payments)	Yes
Obligation to return the machine at the end of the lease term	Legally enforceable obligation established by the lease contract	Delivery following signing of the lease contract	No, because the lessee has no right to economic benefits from the machine and will not have to make any payments after the end of the lease term	No

6. In summary, the lessee recognises:

(a) an asset representing its right to use the leased item for the lease term

(b) a liability for its obligation to pay for the right to use the leased item.

This is the right-of-use approach. This approach would apply to *all* leases.

7. This approach would address many criticisms[1] of existing leasing requirements. Therefore:

   (a) Assets and liabilities arising in leases that are presently classified as operating leases will be recognised in the statement of financial position. Consequently, users will no longer need to adjust the recognised amounts to attempt to reinstate these missing assets and liabilities.

   (b) There will be the same accounting for all lease contracts. Consequently, similar transactions will no longer be accounted for differently and comparability for users will be increased.

   (c) The opportunity to structure transactions so that they provide a source of unrecognised financing will be reduced. This will make the financial statements more comparable and easier for users to understand.

   (d) The new approach is consistent with the boards' conceptual frameworks and recently issued standards.

8. The boards rejected the following approaches because they fail to solve many of the problems associated with existing standards:

   (a) Whole asset approach

   (b) Executory contract approach (similar to the existing operating lease model)

   (c) Approach in existing lease standards

   The Appendix to this paper is an extract from the DP, which describes the alternate approaches and why they were rejected.

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[1] The criticisms have come from users, preparers, auditors and regulators. For example the US SEC recommended the FASB reconsider the leasing standard in their June 2005 Report *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*.

Analysis of Comments

9. Most respondents, particularly users, supported the right-of-use approach. They agreed with the boards' reasons to have a single approach for lessees, particularly because it increases comparability for users on lease transactions and potentially minimises structuring opportunities. In addition, apart from some respondents who preferred the existing leasing requirements, no one agreed with the other approaches considered and rejected by the boards.

10. Those who did not support the right-of-use approach argued that:

    (a) Lease arrangements are very diverse - leases range from a one day lease of a car to 150-year long lease - and that no one model can capture the economics of such a wide range of transactions. Therefore the right-of-use model is not applicable to all leases. Existing lease accounting requirements better reflect the economic differences by distinguishing between operating and capital (finance) leases. Respondents who preferred retaining the existing guidance argued that the current guidance is well understood by both preparers and users, and the problems with lease accounting are implementation issues.

    (b) The proposed model is not consistent with the definitions of assets and liabilities in the conceptual frameworks, particularly in recognising lease options and contingent rentals.

    (c) Shouldn't the boards wait until they complete the conceptual framework project? This is so that the boards can develop a leases standard that is consistent with the new conceptual framework, rather than develop one now and amend it when the new framework is done.

    (d) The boards have not done enough research on the implications to change the accounting for lessees.

    (e) The right-of-use approach is too complex and its benefits would not outweigh its costs. The majority of those respondents recommended improving and retaining the existing guidance.

(f) There is concern that the proposed model will lead to recognising assets and liabilities for all executory contracts, including purchase orders and long-term sales and supply agreements. This would only gross up the balance sheet, create additional compliance burdens and complexity, while not providing any additional benefit.

Staff Analysis and Recommendation

Lease arrangements are different and the accounting should reflect that

11. We agree with respondents that lease arrangements are diverse. Therefore to capture this diversity the boards should adopt a principles based approach, that is, the future leases standard should be based on the boards' conceptual frameworks. By applying the principles from the conceptual framework to a simple lease, the boards are able to develop a lease accounting model that applies to most leases. We can then apply this simple model to a wide range of leasing arrangements. For example, for a one-day car lease rental, the lessee recognises a small right-of-use asset. Contrast this to a 99-year lease for a building, the value of the recognised right-of-use asset would almost equal the value of the underlying leased asset. (The right-of-use approach reflects the differences in arrangements by measurement.)

Right-of-use is inconsistent with the conceptual frameworks when recognising lease options and contingent rentals

12. The objective of this paper is to discuss if the right-of-use approach is correct for a simple lease. No respondent disagreed with the boards' analysis of the assets and liabilities that arise from a simple lease.

13. We shall redeliberate the application of the right-of-use approach to lease options and contingent rentals at future meetings. Part of that discussion will include whether recognising lease options and contingent rentals is consistent with the boards' conceptual frameworks.

Shouldn't the boards wait for the new conceptual framework?

14. We disagree that the leases standard should be postponed until the conceptual framework project is completed. The intention of the conceptual framework project, particularly on the definition and recognition of elements, is to improve and clarify existing concepts. Even if the boards choose to postpone the leases project, we doubt that any items that are now recognised as an asset or liability would not be recognised under the new definitions or recognition criterion (or vice versa).

By having the right-of-use approach, more assets and liabilities from executory contracts would be recognised

15. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligation to an equal extent.

16. As discussed earlier, the boards rejected the executory contracts approach and adopted the right-of-use approach. In other words, the boards did not view that the lessee was in an executory contract position. Therefore, this argument is not valid.

17. However, we think the discussion on why the executory contract approach was rejected could be enhanced in the future lease standard's basis for conclusions. We suggest explaining that the lessor has already performed his obligation – the lessee is now able to use the machine. Once that performance has occurred, an executory contract no longer exists. (Other types of ancillary services by lessors will be discussed at later meetings.)

18. It is also worth mentioning that the scope of this project is on leasing – it is not addressing whether all assets and liabilities from an executory contract should be recognised and presented (gross).

The boards had not done research on their proposals. Do the boards know how costly it is to change the leases requirements?

19. We disagree that the boards were not aware of the implications for the new approach. In the beginning of the project, the staff presented a summary of the academic research on lease accounting and potential implications of that research[2]. That paper included a discussion on the impact of capitalising leases and that credit-type analysts would benefit from a single lease model because such an approach would provide more refined calculations of off-balance sheet leases rather than crude firm-wide discount rate and average lease life which analysts have to use currently. (Of course, this research does not negate that the boards will continue to seek views on their proposals, including weighing the cost-benefit arguments.)

20. We disagree with the arguments that just because it is costly, disclosures will compensate for wrong accounting.

21. But we acknowledge that the model proposed in the DP may represent a significant burden to entities that have a large number of lease contracts. Therefore, in developing the leases standard (and because the boards are required to do as part of their due process), we will consider whether the costs of the proposals will out-weigh the benefits. In addition, we will consider:

    (a) ways to simplify the right-of-use approach (e.g. scope exclusions for non-essential or smaller value items or changes in the accounting for options and contingent rentals), and

    (b) the need for field testing after publishing the exposure draft

Staff Recommendation

22. We recommend that the boards reconfirm the right-of-use approach because it addresses many of the problems in existing standards. In particular, a single model:

    (a) provides comparable information for all leases.

[2] This paper was presented in March 2007: IASB Agenda Paper 12D/FASB Memorandum #5.

(b) Faithfully reflects the assets and liabilities arising in all lease contracts. Thus, users will no longer need to adjust the recognised amounts to attempt to reinstate these missing assets and liabilities.

(c) Is consistent with the framework, thus increases the boards and constituents requests for principles-based standards.

23. We also acknowledge that the boards may need to revisit the application of the right-of-use approach by lessees in light of decisions made on lessor accounting.

Question
The staff recommends the boards confirm that lessees apply the right-of-use approach for a simple lease contract. Do the boards agree?

Appendix

Appendix C: Other approaches rejected by the boards

C.1 In developing the right-of-use approach described in this discussion paper, the boards discussed other possible accounting models. The boards rejected these approaches because they fail to solve many of the problems associated with the existing standards. This appendix describes the rejected approaches.

The whole asset approach

Description of the approach

C.2 The whole asset approach is based on the premise that during the lease term, the leased item is under the control of the lessee. Accordingly, this approach recognises the leased item as an asset of the lessee—both the right to the economic benefits during the lease term and the possession of the asset at the end of the lease term—in effect, recognising the full economic value of the asset.

C.3 To correspond to these assets, the lessee recognises two liabilities—a liability for the payments to be made over the lease term and a liability representing the lessee's obligation to return the asset at the end of the lease term. If the lease is for substantially all of the leased item's expected useful life, the obligation to return the item at the end of the term is comparatively insignificant. However, for a short-term lease the obligation to return would be more substantial.

C.4 Some users of financial statements argue that this approach increases comparability between companies. For example, an airline that leases aircraft would, under this approach, recognise similar assets to an airline that purchases its aircraft. The airlines would both recognise the aircraft in their statements of financial position. In addition, if the airline that purchases the aircraft funds the purchase with debt, both airlines would recognise comparable amounts in profit or loss.

Reasons for rejection

C.5 The boards rejected the whole asset approach for the following reasons:

(a) An entity that leases its assets is in a very different economic position from an entity that purchases its assets. Entities that lease their assets on short-term leases have more flexibility to reduce their capital base than those that purchase their assets. The whole asset approach fails to reflect this flexibility.

(b) Few who support this approach would argue that it should be applied to very short-term leases. In addition, some would argue it should not be applied to non-core assets. Consequently, defining those leases that should be accounted for under the whole asset approach is likely to be difficult.

(c) It overstates the assets of the lessee. The asset recognised by the lessee (the full value of the physical item) includes the economic benefits deliverable from the use of the item after the end of the lease term—a right not obtained by the lessee.

(d) It overstates the liabilities of the lessee because a liability is recognised for the lessee's obligation to return the physical item. Because the lessee has no right to the leased asset after the end of the lease term, there is no outflow of economic benefits from the lessee when the leased item is returned.

The executory contract approach

Description of the approach

C.6 This approach treats all leases as executory contracts. It is based on the premise that the lessee's right to use the leased item is conditional on making payments under the lease. Similarly, the lessee's obligation to make payments is assumed to be conditional on the lessor permitting the lessee to use the item throughout the lease term.

C.7 Consequently, the lessee recognises no assets or liabilities in respect of the lease. Information about the lessee's lease contracts, including amounts payable, is disclosed in the financial statements. Therefore, the executory contract approach is similar to the operating lease model used in existing accounting standards.

Reasons for rejection

C.8 The boards rejected the executory contract approach because it fails to recognise the identified assets and liabilities of the lessee, ie the lessee's right to use the leased item and its obligation to pay for that right. This is the most commonly cited weakness of the existing accounting model for leases. Users of financial statements routinely adjust the financial statements of lessees in an attempt to recognise assets and liabilities that are not recognised under the existing operating lease accounting model.

The approach adopted in the existing standards

Description of the approach

C.9 Existing leasing standards adopt a hybrid model. Leases are classified as either finance leases or operating leases depending on whether substantially all the risks and rewards of ownership of the physical item are transferred to the lessee. The lessee treats a finance lease as substantially equivalent to the purchase of the physical item. Accordingly, the lessee recognises an asset together with a liability to make the payments over the lease term. Leases classified as operating leases are accounted for as executory contracts.

Reasons for rejection

C.10 The boards rejected this approach for the following reasons:

(a) When a lease is classified as an operating lease, the lessee fails to recognise the identified assets and liabilities. Even short-term leases convey to the lessee a right to use the leased item and a corresponding obligation to pay for that right.

(b) The two-model approach means that economically similar transactions can be accounted for very differently.

(c) The dividing line between finance and operating leases is difficult to define in a principled way.