Project **Leases**

Topic **Lessee accounting – Transition**

Purpose

1. At their June 2009 joint meeting, the boards tentatively decided that on the date of initial application of the proposed new leases requirements a lessee should recognise and measure all existing lease contracts as follows[1]:
   (a) the obligation to pay rentals should be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate
   (b) the right-of-use asset should be measured on the same basis as the liability, subject to any adjustments required to reflect impairment.
2. This paper provides additional analysis on the following identified transition issues for lessees:
   (a) whether to apply the proposed transition requirements to leases currently accounted for as finance/capital leases;
   (b) whether additional adjustments to the carrying amount of the right-of-use asset should be required when lease payments are uneven over the lease term (for example, if the lease includes large upfront payments);
   (c) transition requirements for arrangements that contain both lease and non-lease (service) elements;

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[1] Please see the June 2009 IASB Agenda Paper 11E/FASB Memo 34 for background information on transition.

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.

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(d) transition requirements when a reporting entity has revalued assets held under a lease (IFRS preparers only).

3. Transition requirements for lessors are discussed in IASB Agenda Paper 10E/FASB Memo 70.

Transition requirements for finance/capital leases

4. At the joint leases working group meeting in September 2009, some working group members expressed the view that the proposed transition requirements should not be applied to leases currently classified as finance/capital leases. They argued that the assets and liabilities arising in finance leases are already presented in the financial statements, and therefore the costs of restating would exceed the benefits.

5. The staff identified four possible approaches:

   (a) assets and liabilities under a finance lease remain the same on the transition date with no change to the accounting for those assets and liabilities subsequently;

   (b) assets and liabilities under a finance lease remain the same on the transition date, but those assets and liabilities are subsequently accounted for in accordance with the proposed new accounting requirements;

   (c) apply the proposed transition requirements to both assets and liabilities under finance leases;

   (d) apply the proposed transition requirements to liabilities only.

Approach (a): assets and liabilities under a finance lease remain the same with no change to accounting

6. Under this approach, the lessee would not apply the proposed transition requirements to leases currently classified as finance leases on the transition date. In addition, these assets and liabilities would continue to follow the requirements under IAS 17 and ASC Topic 840 *Leases*. Consequently, the new requirements

would not be applied to leases currently classified in their entirety as finance leases.

7. Many preparers favour approach (a) because they think that most finance leases are already capitalised and valued correctly. Also, they note that the focus of the leases project is to recognise assets and liabilities arising in leases currently classified as operating leases, in order to provide better information to users. Consequently, the burden and cost of also applying the new requirements to finance leases would outweigh the potential benefit to users.

8. The staff think that if the accounting under the existing requirements and the new requirements is not materially different, this approach is unlikely to impair the quality of financial reporting.

9. The Appendix to this paper summarises the main differences between the existing requirements and the proposed new requirements.

10. Although there are differences in accounting for options and contingent rentals, the staff think that these differences may not be significant in many leases when a lease is classified as a finance lease, ie (a) amounts payable in optional periods are either not significant or have been included in recognised liabilities, and (b) contingent rentals are generally not significant.

11. However, the staff think that the difference in accounting for residual value guarantees could result in material differences in the recognised amounts. Under the existing requirements, the maximum amount payable under a residual value guarantee is included in the minimum lease payments, whereas the amounts expected to be paid are included in the obligation under the proposed new requirements.

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12. Consequently, the staff think that although this approach would reduce the complexity and costs of applying the new accounting requirements to finance leases for preparers, it may not provide comparable information to users.

13. The following table summarises the advantages and disadvantages of approach (a):

Advantages	Disadvantages

Advantages	Disadvantages
• Least complex and costly for preparers to apply.	• Inconsistent accounting between leases currently classified as finance leases and other leases, thereby reducing comparability • Does not reflect the economics of lease transactions (eg different accounting for options, contingent rentals and/or RVGs).

Approach (b): assets and liabilities under a finance lease remain the same but are subsequently accounted for in accordance with the proposed new requirements

14. Under this approach, the lessee would not follow the transition requirements for leases currently classified as finance leases on the initial application of the proposed new leases requirements. However, the lessee would subsequently account for assets and liabilities under those finance leases following the proposed new requirements.

15. By not requiring the transition requirements on the transition date, this approach might reduce the burden and cost of transition application to finance leases. In addition, after the transition date, accounting for leases currently classified as finance leases would be the same as accounting for other leases, thereby increasing comparability.

16. However, the differences in accounting for options, contingent rentals and/or residual value guarantees still exist. The staff think that the previously recognised amounts under the existing requirements could have been valued incorrectly. Also, this approach would result in inconsistent accounting applied for a finance lease (ie following the existing requirements before the transition date and following the new requirements after the date). This could result in misleading information.

17. Therefore, the staff think that although this approach would reduce complexity and cost of applying the transition requirements to finance leases for preparers, it would not provide comparable information to users.

18. The following table summarises the advantages and disadvantages of approach (b):

Advantages	**Disadvantages**
• Less complex and costly for preparers to apply than approach (c) and (d).	• More complex and costly for preparers to apply than approach (a) • Does not reflect the economics of lease transactions (eg different accounting for options, contingent rentals and/or RVGs).

Approach (c): apply the proposed transition requirements to both assets and liabilities under finance leases during the reporting periods presented (modified retrospective application)

19. Under approach (c), the lessee is required to apply the proposed transition requirements to finance leases, and the lessee would subsequently account for assets and liabilities under those finance leases following the proposed new requirements. On the date of initial application, the lessee would derecognise the assets and liabilities under all outstanding finance leases, and recognise the obligation to pay rentals and the right-of-use assets arising in those finance leases measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate.

20. This approach would be the most complex and costly for preparers to apply. However, it would provide the most comparable information. The lessee would account for leases currently classified as finance leases in the same way as for any other leases. This approach also eliminates having similar leases accounted for differently, based on when an entity entered into a lease. The benefit of accounting for all lease contracts consistently may outweigh the costs.

21. In addition, the recognised amounts would reflect amounts payable in optional periods, under contingent rental arrangements and/or residual value guarantees consistent with the proposed new requirements.

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22. Respondents to the Leases discussion paper commented that comparability among reporting entities is important. They noted:

> …to aid comparability, we believe that comparatives should be restated, although a pragmatic approach to this should be adopted. (CL #167)

23. The staff think that the lessee would be likely to have the information needed to apply the proposed new requirements to leases currently classified as finance leases. An entity will have systems in place to track their assets and liabilities, and will have developed expectations about options, contingent rentals, etc., based on past experience and history.

24. Consequently, although this approach would increase the cost of applying the transition requirements to finance leases for preparers, the benefit of accounting for all lease contracts consistently may outweigh the costs.

25. The following table summarises the advantages and disadvantages of approach (c):

Advantages	**Disadvantages**
• Consistent accounting between leases currently classified as finance leases and other leases, thereby increasing comparability • Reflects amounts payable in optional periods, under contingent rental arrangements and/or residual value guarantees.	• Most complex and costly for preparers to apply.

Approach (d): apply the proposed transition requirements to liabilities only, and measurement of assets remain the same on the transition date

26. Under approach (d), the lessee is required to apply the transition requirements to the obligation to pay rentals. Measurement of the lessee's asset would not be changed on transition, but the asset held under a finance lease would be reclassified as a right-of-use asset. The lessee would subsequently account for these assets and liabilities following the proposed new requirements.

27. This approach would be less complex and costly for preparers to apply than approach (c). In addition, as liabilities are remeasured following the new requirements, it would provide useful and comparable information. This is because the recognised amounts of liabilities would reflect amounts payable in optional periods, under contingent rental arrangements and/or residual value guarantees.

28. Although the measurement of assets previously held under finance leases would be different from the measurement of assets under other lease contracts, such an exemption is unlikely to impair the quality of financial reporting. Instead, some staff think that it might improve the information quality, because the recognised right-of-use asset will be measured at depreciated/amortised cost, rather than being valued at the same as the liability on the transition date.

29. In addition, for leases currently classified as finance leases, if previously recognised carrying amounts of assets were carried forward as right-of-use assets, problems with uneven payments would not exist. This is because the carrying amount of the right-of-use asset would reflect the depreciated/amortised cost, thus not resulting in an understatement. Also, any impairment review will address overstatement (uneven lease payments are discussed further in the next section).

30. The following table summarises the advantages and disadvantages of approach (d):

Advantages	Disadvantages
• Less complex and costly for preparers to apply than approach (c) • Consistent accounting for liabilities between leases currently classified as finance leases and other leases, thereby increasing comparability • Reflects amounts payable in optional periods, under contingent rental arrangements and/or residual value guarantees • Reflects depreciated/amortised costs for assets, thereby improving information quality • Solves asset overstatement and understatement problems associated with uneven lease payments.	• More complex and costly for preparers to apply than approaches (a) and (b) • Inconsistent measurement with other right-of-use assets on transition.

Staff recommendation

31. Some staff recommend approach (d). That is, lessees will be required to apply the transition requirements to liabilities under leases currently classified as finance/capital leases in the same way as for any other leases. Measurement of the lessee's asset would not be changed on transition. Assets held under finance leases would be reclassified as right-of-use assets. The staff think that this approach provides comparable information for liabilities and useful information for assets previously held under finance leases.

32. Other staff recommend approach (c). That is, lessees will be required to apply a modified retrospective approach to all finance leases. On the date of initial application, the obligation to pay rentals and the right-of-use assets under all outstanding finance leases will be recognised and measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate.

They think that although this approach would be complex and costly to apply, it provides the most comparable and useful information to users.

Question 1
Do the boards prefer: A: liabilities under leases currently classified as finance/capital leases to follow the proposed transition requirements in the same way as any other leases. Measurement of assets under finance leases would not be changed, and would be reclassified as right-of-use assets on the transition date, or B: a modified retrospective approach applied to all outstanding finance leases, ie both assets and liabilities under those leases should be accounted for following the proposed leases requirements after the effective date. Why?

Uneven lease payments

33. The proposed transition requirements would require the lessee to recognise and measure an obligation to pay rentals and a right-of-use asset in respect of all outstanding leases as of the date of initial application of the proposed new leases requirements. That asset and liability would be measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate on the transition date.

34. This requirement may result in an overstatement or understatement of the right-of-use asset when lease payments are uneven over the lease term (for example, if a lease includes large upfront payment or large payments are payable at the end of the lease term, ie balloon payments).

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35. If a lease includes large upfront payments, the right-of-use asset would be understated. In this case, structuring opportunities may exist on the transition date to minimise the recognised amounts. Conversely, if a lease includes large balloon payments, the right-of-use asset would be overstated.

36. Consequently, the question is whether additional adjustments to the carrying amount of the right-of-use asset should be required.

37. At the September 2009 joint leases working group meeting, some working group members commented that uneven payments are not a significant issue. They argued that uneven payments in leases often reflect increases or decreases in leased asset capacity (for example, if a lease includes large upfront payments, an entity derives the benefits of the right of use sooner rather than later).

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38. The staff note that the proposed transition requirement for the right-of-use asset requires the lessee to review the right-of-use asset for impairment on the initial application date. An overstatement would therefore already be addressed with the transition requirements. However, under that requirement, an understatement of the right-of-use asset resulting from large upfront payments will not be addressed.

39. The staff considered two possible approaches to address this issue:

(a) measure the right-of-use asset at fair value on the date of transition

(b) require further adjustments for prepaid or accrued rentals in addition to following the transition requirements.

Approach (a): measure the right-of-use asset at fair value on the date of transition

40. This approach would require an entity to measure the right-of-use asset at fair value if lease payments are uneven. However, this approach has the following disadvantages:

(a) Measuring the asset at fair value is inconsistent with the measurement of other non-financial assets, thereby decreasing comparability for users.

(b) It is inconsistent with the proposed amortised cost-based approach to subsequent measurement of the right-of-use asset.

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(c) Determining fair value of the right-of-use asset after the inception of the lease may be difficult and costly for preparers.

41. In addition, many working group members did not support the use of fair value for the right-of-use asset.

Approach (b): require further adjustments for prepaid or accrued rentals in addition to following the transition requirements

42. Under approach (b), the right-of-use asset will be recognised and measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application, subject to any impairment review and to any further adjustments for rentals prepaid or accrued.

43. Under this approach, for large upfront payments, previously recognised, prepaid rentals would be recharacterised to the right-of-use asset on the transition date. To illustrate this approach, the staff use the following example:

> Example 1
>
> A machine is leased for a fixed term of five years. The lessee prepaid upfront a lump sum of CU139,745[2], instead of annual payments of CU35,000.
>
> The lessee's incremental borrowing rate is 8%. Assume that the right-of-use asset is amortised straight-line over five years.
>
> The lease was classified as an operating lease. At the start of the lease the present value of the lease payments, discounted using the lessee's incremental borrowing rate of 8%, is CU139,745.
>
> Assume that the transition date is at the beginning of Year 2.

44. The following table compares and summarises the accounting for large upfront payments and even annual payments before and after the transition date.

Existing requirements – operating leases	
Upfront payment	Annual payment
Journals at Year 0: DR Prepaid rentals 139,745 CR Cash 139,745	No journals at Year 0
Journals at Year 1: DR Rental expense 27,949 CR Prepaid rentals 27,949	Journals at Year 1: DR Rental expense 35,000 CR Cash 35,000

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[2] CU = currency units

New requirements – right-of-use model	
Journals at Year 2, the transition date (PV of lease payments, discounted using the IBR): DR Right-of-use asset 0 CR Obligation to pay rentals 0	Journals at Year 2, the transition date (PV of lease payments, discounted using the IBR): DR Right-of-use asset 115,925 CR Obligation to pay rentals 115,925
Adjusting entries: Recharacterise prepaid rentals to right-of-use asset DR Right-of-use asset 111,796 CR Prepaid rentals 111,796	

45. For large balloon payments, overstated right-of-use assets will be reviewed for impairment as the normal transition requirement requires for any impairment review. Any accrued rentals will be reversed on transition.

46. For leases currently classified as finance leases, if previously-recognised carrying amounts of assets are carried forward as right-of-use assets (approach (d) in the previous section), problems with uneven payments would not exist. The carrying amount of the right-of-use asset would reflect the depreciated/amortised cost, thus not resulting in an understatement. Also, any impairment review will address overstatement.

47. This approach is easier and less costly for preparers to apply than approach (a). In addition, unlike the normal transition requirements, it would address an understatement of the asset as well as an overstatement. Consequently, in both cases, the carrying amount of the right-of-use asset will be faithfully represented and would provide useful information to users.

Staff recommendation

48. Because of the advantages noted above in paragraph 47, the staff recommend approach (b).

Question 2
The staff recommend that the right-of-use asset be recognised and measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date, subject to any impairment review and to any further adjustments for rentals prepaid or accrued. Do the boards agree? If not, what approach do the boards prefer, and why?

Arrangements that contain both lease and non-lease (service) elements

49. The February 2010 IASB Agenda Paper 10C/FASB Memo 68 addresses accounting treatment for arrangements that include both lease and non-lease (service) elements. This paper recommends that an entity should account for the service elements and the lease elements separately.

50. Subsequently, the staff questioned whether there should be the same requirement for all leases on transition. The existing leases requirements require bifurcation of service and lease elements within an arrangement. For leases currently classified as finance leases, the bifurcation has been already done. For leases currently classified as operating leases, the requirement might be more difficult, but bifurcation is required for disclosure purposes.

51. The staff considered applying the proposed transition requirements for all such arrangements assuming that these arrangements are wholly lease contracts (ie there is no service element).

52. The staff think that accounting for services as leases would not reflect the economics of services that would be treated differently when they are arranged on a stand alone basis. Many working group members supported the bifurcation of the service and lease elements within an arrangement, because they are accounted for very differently. Not requiring bifurcation would reduce comparability.

53. Consequently, the staff recommend that an entity should be required to allocate the value of all existing arrangements between service and lease elements, and the lease elements would be accounted for in accordance with the proposed transition requirements.

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54. This approach might be burdensome and costly for preparers to apply, because it requires bifurcation of such arrangements that contain leases that are currently classified as operating leases.

55. However, this approach would not change existing guidance. It can be argued that the costs of changing would outweigh the benefits. It would therefore increase comparability with similar arrangements entered into after the effective date of the new leases requirements.

Question 3
The staff recommend that lessees and lessors should be required to bifurcate all arrangements that contain both service and lease elements, and apply the transition requirements to the lease elements on the transition date (ie there would be no special transitional provisions for existing arrangements). Do the boards agree?

Revaluation (IFRS preparers only)

56. This section would be applicable only if the boards decide to adopt approach (a), (b) or (d) in the first section of this paper for the transition requirements for finance/capital leases. Under these approaches, the carrying amount of assets held under finance leases is used as the carrying amount of the right-of-use asset on transition.

57. At their October 2009 joint meeting, the boards tentatively decided that a lease contract has created a new right (a right of use), which is an intangible asset.

58. Consistent with that decision, the IASB tentatively decided at the November 2009 joint meeting that IFRS preparers would be permitted to revalue their right-of-use assets using the revaluation model in IAS 38 *Intangible Assets*.

59. Under the revaluation model in IAS 16 *Property, Plant and Equipment*, property, plant and equipment are revalued if their fair values can be measured reliably. Under IAS 38 *Intangible Assets*, revaluations of these assets are determined by reference to an active market. Both Standards state that revaluations shall be

made with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value.

60. Because of the different thresholds, some property, plant and equipment held under a lease could have been revalued using the revaluation model in IAS 16 *Property, Plant and Equipment.* However, they may not qualify for revaluation under the IAS 38 *Intangible Assets* revaluation model because an active market for the right-of-use asset would be very rare.

61. The question is therefore whether to revert to cost, or to use the revalued amount as the carrying amount of the right-of-use asset on transition.

62. Requiring the reversal of any previous revaluation might prove to be burdensome and costly to apply. However, this approach would result in more comparable information between IFRS preparers and US GAAP preparers, because under US GAAP revaluation of right-of-use assets would not be permitted.

63. However, the staff think that the revalued amount would provide more relevant information than the cost of the asset. Also, using the revalued amount of property, plant and equipment as the carrying amount of the right-of-use asset would be less complex and costly to apply for preparers than requiring adjustments to revert to the cost.

64. Consequently, the staff recommend that a reporting entity should carry forward the revalued amount of property, plant and equipment to the carrying amount of the right-of-use asset. Under this approach, no adjustments would be necessary other than to reclassify the revalued amount of property, plant and equipment as a right-of-use asset.

Question 4
The staff recommend that the revalued amount of property, plant and equipment should be carried forward as the carrying amount of a right-of-use asset if the boards decide that the measurement of the lessee's asset held under a finance lease would not be changed on transition, but that the asset would be reclassified as a right-of-use asset. Do the boards agree?

Appendix – Summary of main differences

65. This Appendix summarises the main differences between the existing requirements and the proposed new requirements.

	Existing requirements	Proposed requirements
Initial recognition	• At the fair value of the leased property or, if lower, the present value of the **minimum** lease payments • The discount rate to be used is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used.	• At the present value of the lease payments • The discount rate to be used is the lessee's incremental borrowing rate. If the interest rate implicit in the lease is a reasonable approximation to the incremental borrowing rate and can be determined reliably, it can be used.
Options	• The lease term may include optional periods if it is reasonably certain (assured) that the lessee will exercise the option • No reassessment of the lease term at each reporting date.	• The lessee will determine the longest possible lease term that is more likely than not to occur • Reassessment of the lease term at each reporting date if there is a change in facts or circumstances.
Contingent rentals	• Minimum lease payments exclude contingent rentals (under US GAAP, only contingent rentals based on index or rate are included) • No reassessment at each reporting date.	• Lease payments include all contingent rentals • Reassessment at each reporting date if any new facts or circumstances indicate that there is a material change.

	Existing requirements	Proposed requirements
Residual value guarantees	• Minimum lease payments include the maximum amount payable under a residual value guarantee.	• Account for in the same way as for contingent rentals.