IASB/FASB Meeting
Week commencing 11 April, 2011

IASB Agenda reference	**1H**
FASB Agenda reference	**162**

Staff Paper

Project	**Leases**
Topic	**Lessee accounting– other-than-finance lease**

Objectives

1. The objective of this paper is to analyze approaches for initial and subsequent measurement and presentation of an other-than-finance lease (OTF lease) in the financial statements of a lessee.

2. This paper should be read with the series of papers on this topic and follows from the discussion in:

   (a) Agenda paper 1F / FASB Memo 160 and the staff recommendation that the final lease standard identify different profit and loss recognition patterns for different types of leases for lessee accounting; and

   (b) Agenda paper 1G / FASB Memo 161 and the staff recommendation that the final lease standard utilize the newly created principles and supporting indicators for distinguishing between a finance lease and an other-than-finance lease (suggested by the staff as a result of the targeted outreach and preliminary discussions with the Boards at the February 2011 joint meeting).

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB 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 U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

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.

Staff recommendation

3. The staff recommends that for accounting by a lessee for an other-than-finance lease:

   (a) The Boards affirm the ED proposals and require the lessee to recognize at the date of commencement of the lease:

      (i) A liability for lease payments measured at the present value of future lease payments; and

      (ii) A right-of-use asset (ROU asset), measured in an amount equal to the liability, plus any initial direct costs.

   (b) Subsequently, the lessee should:

      (i) Accrete the liability to make lease payments using an effective interest method and reduce the liability for cash payments (consistent with the ED proposals);

      (ii) Use an annuity-based amortization method to decrease the ROU asset based on the usage pattern of benefits over the lease term, a calculation that is independent of the subsequent measurement of the liability. This approach is recommended by the majority of the staff. Other staff recommends using an OCI approach to achieve an income statement result on a straight-line basis over the lease term unless another systematic method of recognition is more representative.

      (iii) As a consequence, the total lease expense would be recognized over the lease term consistent with the pattern of benefits, typically on a straight-line basis.

   (c) The expense recognized by a lessee should be presented as a single line item within operating expenses (for example, rent expense).

4. This paper is organized as follows:

   (a) Summary of proposals in the leases Exposure Draft (ED)

   (b) Summary of feedback including both the targeted outreach and prior feedback during the comment letter period

(c) Staff analysis and recommendations

(d) Appendix A – Approaches rejected by the staff

(e) Appendix B – March 2009 Discussion Paper linked approach

(f) Appendix C – Excel spreadsheet including the detailed calculations of the approaches presented for a variety of payment patterns

Summary of proposals in the ED

5. The ED proposes that for *all* lease contracts at the date of commencement of a lease, a lessee shall recognize in the statement of financial position a right-of-use asset and a liability to make lease payments.

6. A lessee shall recognize the following items in the statement of comprehensive income, except to the extent that another Topic/IFRS requires or permits its inclusion in the cost of an asset:

   (a) Interest expense on the liability to make lease payments.

   (b) Amortization of the right-of-use asset.

7. At the date of inception of the lease, a lessee should measure:

   (a) The liability to make lease payments at the present value of the lease payments.

   (b) The right-of-use asset at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee.

8. After the date of commencement of the lease, a lessee should measure:

   (a) The liability to make lease payments at amortized cost using the effective interest method.

   (b) The right-of-use asset at amortized cost.

Summary of feedback

Targeted outreach during March and April 2011

9. The staff performed targeted outreach during March and April 2011 as outlined in paragraphs 10 – 12 of Agenda paper 1F / FASB Memo 160. The overall feedback on whether or not there should be two approaches for pattern of profit or loss recognition for leases is provided in paragraphs 13 – 21 of Agenda paper 1F / FASB Memo 160.

10. During the targeted outreach the staff gathered the following feedback pertaining to the subject of this paper:

    (a) The majority of preparers proposed that a lessee should recognize profit or loss on a straight-line basis and present a single line item within operating expenses for other-than-finance leases because it better reflects the operating nature of the underlying transactions.

    (b) The majority of users supported recognizing profit or loss on a basis that best reflects the cash flows of lease contracts. For this reason, they supported a straight-line profit and loss recognition and presentation within operating expenses for either *all*, or some leases. A minority of users expressed concerns about the lack of comparability if a lessee presents expenses within operating expenses for some types of leases, but presents interest and amortization expense for other types of leases.

    (c) Auditing firms, industry associations, standard setters and other participants in the targeted outreach were less supportive of the Boards' tentative February 2011 decisions due to concerns for complexity, structuring opportunities and the potential lack of conceptual support. Although they understood why a number of respondents had expressed concerns with identifying a single accounting approach to be applied to all leases, they were concerned with the proposals to identify, and account for other-than-finance leases differently from finance leases.

(d) Some working group members expressed a preference for a straight-line expense recognition pattern for all leases consistent with users. The majority of joint working group members also agreed that there is more than one type of lease and was supportive of the Boards providing for different profit or loss recognition patterns in the final standard.

(e) Many participants of all types questioned how the proposed straight-line profit or loss recognition pattern would be achieved and some suggested:

   (i) The linked approach;

   (ii) An annuity-based or mortgaged-based amortization schedule;

   (iii) The use of other comprehensive income (OCI) to achieve the intended result of straight-line expense.

   (iv) Not discounting the recognized asset and liability.

Feedback received during the comment letter period

11. Overall comment letter feedback was previously provided to the Boards in Agenda paper 5A / FASB memo 123 at the January 2011 joint meeting. Additionally, the staff provided feedback relevant to the subject of this paper in Agenda paper 5F / FASB memo 134 discussed at the February 2011 joint meeting.

User feedback

12. The staff understands that some users currently separate rental expense on operating leases into an interest and depreciation component and therefore support the proposals included in the ED. However, these users do not calculate the interest expense from an effective interest method; instead, they split the straight-line rent expense presently recorded. Therefore, this does not result in the same profit or loss expense recognition pattern that the ED proposed. Other users prefer all expense to be recognized on a straight-line

basis and presented within operating expense, with many users commenting that they see lease cash flows as operating, not financing, in nature.

13. Some users do not make adjustments to the amounts recognized in the profit or loss for operating leases and are therefore concerned about the proposed approach which results in higher lease expense in earlier periods compared to later periods.

Overall feedback

14. While many respondents to the leases ED expressed support for recognizing a right-of-use asset and a liability to make lease payments as a result of entering into a contract that meets the definition of a lease; there was less support for the pattern of profit or loss recognition for lessees with:
    (a) some respondents, specifically those from accounting firms and standard-setters supporting the proposals in the ED; and
    (b) other respondents, specifically those from the leasing industry, some users and prepares, supporting an annuity-based or mortgage-based amortization of the right-of-use asset to create a straight-line profit or loss pattern similar to current operating lease accounting.

15. Almost all respondents supported the proposal to discount the liability to make lease payments using the effective interest method noting that it would be consistent with the measurement of financial liabilities.

16. However, respondents had mixed views on the Boards' rationale that the combined pattern of profit or loss recognition for the right-of-use asset and the liability to make lease payments should be consistent with the pattern that would arise from financing an acquisition of the underlying asset.

17. The respondents that disagreed with the profit or loss recognition pattern proposed in the ED noted that the proposals create:
    (a) Higher lease expense in earlier periods of the lease compared to later periods for all current operating leases;
    (b) Significant deferred tax assets for lessees;

(c) Inconsistency with the accounting for purchasing the underlying asset with finance, because a purchase is unlikely be to 100 percent debt financed; and

(d) Further divergence from the cash payments made for the lease contract (for example, the expense recognized by a lessee in the final year of a lease is very different to the expense recognized by the same lessee in the first year of a replacement lease).

18. Concerns were also raised relating to the nature of the items recognized in profit or loss. A minority of respondents, including many users, think that the expense recognized represents rental expense, rather than a combination of amortization and interest expense or that the allocation of expense between amortization and interest should vary, depending on the nature of the underlying leased asset.

19. Regulated industries and governmental contractors (particularly US based) raised concerns with the effect that the proposed profit or loss pattern and line item classifications might have on their ability to recover costs (for example, interest expense may have different cost recovery attributes than rental expense).

20. Many respondents noted that the Boards acknowledge that a lessee's asset and liability are linked upon initial measurement and think that this linkage should continue to be reflected in subsequent measurement. This is because the right-of-use asset and the liability to make future lease payments are components of the same contract. Unlike a transaction to finance the acquisition of an asset, the right-of-use asset cannot exist in isolation without the lease liability.

21. Users also expressed support for a profit or loss pattern that is closer to the current straight-line approach applied in the present operating lease model. This is because they view it as a closer approximation to cash flows relating to the lease contract.

Staff analysis and recommendations

22. Throughout the leases project many have suggested a variety of methods to achieve a straight-line profit or loss recognition pattern. For example, some have suggested:

    (a) A non-discounted approach;

    (b) A linked approach;

    (c) An annuity-based amortization approach; or

    (d) The use of other comprehensive income.

23. The staff has reviewed and evaluated the suggestions. Additionally, the staff compared the suggested approaches to the proposals in the ED.

Approaches rejected by the staff

Non-discounted approach

24. First, the staff considered a non-discounted approach. This approach would initially measure the liability to make lease payments on an undiscounted basis. As a result, the ROU asset would also be recorded on an undiscounted basis.

25. Despite the simplicity of a non-discounted approach, the staff has rejected the non-discounted approaches for the following reasons:

    (a) The liability recognized by the lessee in a non-discounted approach would always be higher than the liability that would be recognized in accordance with the ED. As a result ratios using liabilities (for example, debt-to-equity) would be unfavorably impacted and comparability concerns may exist.

    (b) A non-discounted approach does not recognize the time-value of money element present in all lease contracts.

    (c) A non-discounted approach is inconsistent with other current guidance regarding discounting of liabilities including the measurement of financial liabilities, pensions and other long-term liabilities such as asset retirement obligations and decommissioning.

26. This non-discounted approach is illustrated in Appendix A with another rejected approach discussed further below.

User short-cut approach – interest expense adjusted rather than amortization expense

27. Next the staff reviewed a 'user short-cut approach' which effectively straight-lines both amortization expense and interest expense. This approach modifies the interest expense recognized rather than approaches which modify the amortization expense recognized. The staff agrees with most respondents and participants in the targeted outreach that the initial recognition of the liability to make lease payments should be on a discounted basis. As a result, the staff thinks that the appropriate subsequent accounting should include the accretion of the liability at a consistent rate throughout the lease term consistent with the proposals in the ED.

28. Therefore, the staff rejects this approach as most feedback focused on adjusting the expense recognition arising from the asset and little to no feedback suggested adjusting the expense generated from the recognized liability. While the method is suggested to replicate what users may be performing today, the staff thinks that any approach performed by users today is a short-hand method performed due to a lack of better information. Additionally, the staff cannot find conceptual basis in a method that adjusts the liability expense recognition when that liability is discounted.

29. This approach is also illustrated in Appendix A.

Approaches to be considered

30. The following three approaches are evaluated further by the staff and are presented to the Boards for their consideration on how a lessee initially and subsequently measures and presents an other-than-finance lease.

    (a) **Approach A** – ***Linked approach*** – ROU asset is linked to the liability to make lease payments both initially and throughout each subsequent period of the lease.

    (b) **Approach B** – ***Annuity-based amortization approach*** – While the ROU asset and liability to make lease payments are linked at

inception of the lease, the ROU asset is amortized *independently* of the measurement of the liability for lease payments. The method of amortization reflects both the consumption of benefits over the lease term and the time value of money.

(c) **Approach C** – ***OCI approach*** – The ROU asset is amortized consistently with the proposals in the ED. Straight-line method of profit or loss recognition pattern is achieved through use of other comprehensive income (OCI).

31. All approaches presented directly above would require the same initial recognition and measurement of the right of use asset and lease liability, consistent with the proposals in the ED. Specifically, on the date of commencement of the lease a lessee recognizes a liability to make lease payments measured as the present value of future lease payments and a corresponding right-to-use asset measured at the amount of the liability (plus any initial direct costs). The approaches differ in subsequent measurement and potentially presentation as further explored below.

32. Below the staff will use a simple lease to illustrate each of these accounting approaches.

> A lessee enters into a 10 year lease that requires payments of 100 currency units (CU) at the end of each year. The rate the lessee is charged in the lease is 7 percent.
>
> There are no initial direct costs.

33. For comparative purposes, an illustration of how the ED method would apply in this example is outlined in Appendix A to Agenda Paper 1J / FASB Memo 164 – Lessee – finance lease accounting.

Approach A – Linked approach

34. Under the linked approach there is a connection between the ROU asset and the liability to make lease payments as they arise from the same contract and do not normally exist independently of each other. The linked approach is viewed by many to be consistent with the initial measurement and recognition

of the lease assets and liabilities as the ROU asset and liability are linked at commencement of the lease. This approach results in a modification to the amortization expense that would be recognized in the ED proposals to create a straight-line profit or loss recognition pattern.

35. Many comment letters expressed a preference for a similar model although admittedly many called for a 'linked approach' that was described and supported in various ways. The staff thinks that those that support the 'linked approach' are referring to two basic concepts:

    (a) The fact that the asset and liability are linked or equal both at commencement of the lease and throughout the remaining subsequent accounting (absent impairment, capitalized initial direct costs, or revaluation).

    (b) The profit and loss recognition pattern is straight-line over the lease term.

36. The staff note the following with respect to Approach A:

    (a) The initial recognition and measurement of the asset and liability is consistent with the ED method. However, unlike the ED method, this linkage between the asset and liability would be maintained throughout the lease term.

    (b) The ROU asset is dependent on the liability to make lease payments.

    (c) Interest expense recognized throughout the lease term is consistent with the ED method.

37. Additionally, the joint leases Discussion Paper (DP), which was issued in March 2009, outlined the "linked approach," potential benefits and the Boards' preliminary views. The section from the DP discussing the linked approach is provided in Appendix B.

38. Using the example outlined above, the lessee at commencement of the lease would recognize a liability to make lease payments of CU 702 and a ROU asset of CU 702, then in the first year subsequent to initial recognition the following would occur:

(a) First, the liability to make lease payments is decreased by a net CU 51 (increased by CU 49 for interest accretion and decreased by CU 100 for the cash payment) so the ending liability balance at the end of Year 1 is CU 652.

(b) Next, the ROU asset is adjusted to equal the liability (CU 652) so amortization expense of CU 51 is recognized to reduce the ROU asset to the new 'linked' balance of the liability to make lease payments. The ROU asset balance is dependent and a secondary calculation to the liability to make lease payments.

39. The following are illustrative journal entries to reflect the linked approach in the example:

Day 1 – commencement of the lease			
	DR: Right-of-use asset		702
		Cr: Liability to make lease payments	702
Year 1			
	STEP 1		
	DR: Interest expense		49
	DR: Liability to make lease payments		51
		CR: Cash	(100)
	STEP 2		
	DR: Amortization/depreciation expense		51
		CR: Right-of-use asset	(51)
Year 10			
	STEP 1		
	DR: Interest expense		7
	DR: Liability to make lease payments		93
		CR: Cash	(100)
	STEP 2		
	DR: Amortization/depreciation expense		93
		CR: Right-of-use asset	(93)

40. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss.

	FINANCIAL POSITION			PROFIT OR LOSS				
Period	**Cash Payment**	**ROU Asset**	**Liability to make lease pmts**	**Amort/ Depr Expense**	**Interest Expense**	**Rent Expense**	**Net P&L**	**Cost of Funds**
Inception		702	(702)					
1	100	652	(652)	51	49	-	100	-7.0%
2	100	597	(597)	54	46	-	100	-7.0%
3	100	539	(539)	58	42	-	100	-7.0%
4	100	477	(477)	62	38	-	100	-7.0%
5	100	410	(410)	67	33	-	100	-7.0%
6	100	339	(339)	71	29	-	100	-7.0%
7	100	262	(262)	76	24	-	100	-7.0%
8	100	181	(181)	82	18	-	100	-7.0%
9	100	93	(93)	87	13	-	100	-7.0%
10	100	-	-	93	7	-	100	-7.0%

41. The linked approach provides a straight-line recognition pattern when the pattern of cash payments is even throughout the lease term and there are no rent holidays, down payments, payments made at the beginning of the period or other payment variations. The linked approach works in these fact patterns as the consumption pattern of benefits is consistent with the pattern of cash payments.

42. However, the linked approach does not adequately provide expense recognition when there are uneven cash payments. As the right-of-use asset is 'linked' to the liability by definition it must follow the cash payment stream which may not follow the consumption of benefits under the lease.

43. For example, if there is rent holiday in the first period of a lease, the liability to make lease payments will increase due to the interest accretion which is not offset by any cash payments. The resulting ROU asset which is by definition linked to the liability would also need to increase to 'offset' the increase in the liability and no expense would be recognized in the first period principally because there is no cash payment made in the first period even though a portion of the benefits under the lease is likely consumed by the lessee.

44. Additionally, since the carrying amount of the ROU asset is dependent on the liability, when the pattern of usage/benefits is uneven the linked approach does not result in an appropriate profit or loss recognition pattern. Also, additional

impairment considerations may result due to the fact that the ROU asset is 'locked into' the carrying amount of the liability.

45. Appendix C illustrates the linked approach and outlines the impacts of this approach when there are:

    (a) Even payments made at the end of the year (the base case presented above);

    (b) Uneven payments made at the end of the year;

    (c) Payments made at the beginning of the year;

    (d) Rent holidays; or

    (e) Upfront payment is made in the lease arrangement.

Presentation considerations in a linked approach

46. The staff has reviewed two alternative methods of presentation for a linked approach:

    (a) **Approach 1** – Recognition of both interest expense and amortization expense (consistent with the ED proposals and the staff recommendation for lessee finance leases); or

    (b) **Approach 2** – Recognition of a single line item within operating expense (for example, rent expense)

47. Approach 1 was outlined above in the discussion of the linked approach which would require the presentation of *both* interest expense arising from the lease liability and amortization expense arising from the ROU asset. The example above illustrated that both interest expense and amortization expense could be recognized in profit or loss. This presentation alternative would be consistent with the proposals in the ED.

48. Approach 2 would result in the presentation of a single line within operating expense (for example, rent expense). Conceptually this can be justified by viewing the (net) decrease in the right of use asset each period as arising from:

    (a) consumption in the period of the economic benefits in the ROU asset; and

(b) the accretion of the ROU asset.

49. The accretion of the ROU asset would result in interest income. However, that interest income would offset the interest expense on the lease liability, thereby negating the need to present interest expense in profit or loss.

50. The journal entries that would be used in this presentation method are as follows:

Day 1 – commencement of the lease		
DR: Right-of-use asset	702	
Cr: Liability to make lease payments	702	
Year 1		
DR: Interest expense	49	
DR: Liability to make lease payments	51	-
CR: Cash	(100)	Nets to zero
DR: Rent expense	100	
CR: Interest income	(49)	
CR: Right-of-use asset	(51)	
Year 10		
DR: Interest expense	7	
DR: Liability to make lease payments	93	-
CR: Cash	(100)	
DR: Rent expense	100	
CR: Interest income	(7)	
CR: Right-of-use asset	(93)	

51. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss.

	FINANCIAL POSITION			PROFIT OR LOSS					
Period	**Cash Payment**	**ROU Asset**	**Liability to make lease pmts**	**Rent Expense**	**Interest Income**	**Interest Expense**	**Net Interest**	**Net P&L**	**Cost of Funds**
Inception		702	(702)						
1	100	652	(652)	100	(49)	49	-	100	-7.0%
2	100	597	(597)	100	(46)	46	-	100	-7.0%
3	100	539	(539)	100	(42)	42	-	100	-7.0%
4	100	477	(477)	100	(38)	38	-	100	-7.0%
5	100	410	(410)	100	(33)	33	-	100	-7.0%
6	100	339	(339)	100	(29)	29	-	100	-7.0%
7	100	262	(262)	100	(24)	24	-	100	-7.0%
8	100	181	(181)	100	(18)	18	-	100	-7.0%
9	100	93	(93)	100	(13)	13	-	100	-7.0%
10	100	(0)	0	100	(7)	7	-	100	-7.0%

Approach B – Annuity based amortization method

52. The annuity based amortization method is similar to the linked approach when applied in even payment pattern situations. However, Approach B differs from the linked approach in that the carrying amount of the ROU asset is determined independently of the liability to make lease payments subsequent to initial recognition and measurement.

53. Approach B should effectively address all payment situations as the ROU asset is amortized based on the pattern in which the benefit of the ROU asset is consumed rather than on the pattern of cash payments. In this approach, after initial recognition the ROU asset is evaluated to identify the amortization of the asset in a manner that reflects the consumption pattern of benefits.

54. For example, using our simple example, after recognizing the ROU asset of CU 702, the pattern of benefits is calculated as CU 100 per year. CU100 is determined using a method to calculate what annuity payment would be required to equate to a present value equal to the recorded ROU asset, assuming a discount rate of 7%, a lease period of 10 years (typically using the Excel PMT function). In this example because the amount and timing of benefit is equal to the amount and timing of cash payments the calculated annuity payment is equal to the annual lease payment.

55. If the pattern of benefit is not even throughout the lease term, then at lease commencement the lessee must estimate the pattern of benefit, both amount and timing, such that the present value of benefits is equal to the ROU asset at commencement. In each subsequent period the ROU asset is re-measured as the present value of remaining benefits.

56. The staff notes the following with respect to Approach B:

    (a) Reflects the expenses associated with both the liability and asset within profit or loss in a consistent manner regardless of whether the payments are made in an even or uneven pattern.

    (b) Achieves a proxy to straight-line expense when benefits are consumed evenly over the lease term. Straight-line expense is not achieved due to time-value of money differences when the pattern of benefits does not match the pattern of cash payments. This consequence will occur even when the pattern of benefits is constant throughout the lease term.

    (c) The carrying amount of the right-of-use asset is independent of the liability to make lease payments therefore any subsequent analysis for impairment, revaluation or other adjustments may be easier.

    (d) Utilizing the pattern of benefits to measure the ROU asset in subsequent periods would assist in the assessment of any future impairment.

    (e) Creates complexity in the accounting and requires subsequent measurement of both the ROU asset and liability to make lease payments.

    (f) The staff notes that an annuity-based depreciation method is not permitted in existing standards; however, some staff thinks that an annuity-based method appropriately allocates the cost of the asset over its useful life in a way that reflects both the pattern of consumption of economic benefits and also the time value of money.

57. The following journal entries illustrate Approach B, including the two presentation approaches outlined in Approach A:

    (a) Approach 1: Interest and amortization expense consistent with the ED

(b) Approach 2: Operating (rent) expense

	Approach 1	Approach 2	
Day 1 – commencement of the lease			
DR: Right-of-use asset	702	702	
Cr: Liability to make lease payments	702	702	
Year 1			
DR: Interest expense	49	49	
DR: Liability to make lease payments	51	51	-
CR: Cash	(100)	(100)	
DR: Amortization/depreciation expense	51	-	Nets to zero
DR: Rent expense (consumption of asset)	-	100	
CR: Interest income	-	(49)	
CR: Right-of-use asset	(51)	(51)	
Year 10			
DR: Interest expense	7	7	
DR: Liability to make lease payments	93	93	-
CR: Cash	(100)	(100)	
DR: Amortization/depreciation expense	93	-	
DR: Rent expense	-	100	
CR: Interest income	-	(7)	
CR: Right-of-use asset	(93)	(93)	

58. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss under Approach B with presentation under Approach 1.

	STMT OF FINANCIAL POSITION				PROFIT OR LOSS			
Period	**Cash Payment**	**Pattern of Benefits**	**ROU Asset**	**Lease Obligation**	**Amort/ Depr Expense**	**Interest Expense**	**Lease Expense**	**Cost of Funds**
Inception			702	(702)				
1	100	100	652	(652)	51	49	100	7.0%
2	100	100	597	(597)	54	46	100	7.0%
3	100	100	539	(539)	58	42	100	7.0%
4	100	100	477	(477)	62	38	100	7.0%
5	100	100	410	(410)	67	33	100	7.0%
6	100	100	339	(339)	71	29	100	7.0%
7	100	100	262	(262)	76	24	100	7.0%
8	100	100	181	(181)	82	18	100	7.0%
9	100	100	93	(93)	87	13	100	7.0%
10	100	100	-	0	93	7	100	7.0%
TOTAL	**1,000**	**-**			**702**	**298**	**1,000**	

59. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss under Approach B with presentation under Approach 2.

	STMT OF FINANCIAL POSITION				PROFIT OR LOSS				
Period	**Cash Pmt**	**Pattern of Benefits**	**ROU Asset**	**Lease Liability**	**Rent Expense**	**Interest Income**	**Interest Expense**	**Lease Expense**	**Cost of Funds**
Inception			702	(702)					
1	100	100	652	(652)	100	(49)	49	100	7.0%
2	100	100	597	(597)	100	(46)	46	100	7.0%
3	100	100	539	(539)	100	(42)	42	100	7.0%
4	100	100	477	(477)	100	(38)	38	100	7.0%
5	100	100	410	(410)	100	(33)	33	100	7.0%
6	100	100	339	(339)	100	(29)	29	100	7.0%
7	100	100	262	(262)	100	(24)	24	100	7.0%
8	100	100	181	(181)	100	(18)	18	100	7.0%
9	100	100	93	(93)	100	(13)	13	100	7.0%
10	100	100	-	0	100	(7)	7	100	7.0%
TOTAI	**1,000**	**-**			**1,000**	**(298)**	**298**	**1,000**	

60. Appendix C illustrates Approach B (annuity based amortization approach) and outlines the impacts of this approach when there are:

(a) Even payments made at the end of the year (the base case presented above);

(b) Uneven payments made at the end of the year;

(c) Payments made at the beginning of the year;

(d) Rent holidays; or

(e) Upfront payment is made in the lease arrangement.

Approach C – OCI method – straight-line method achieved through use of OCI

61. This approach mirrors the ED proposals in both the statement of financial position and the statement of profit or loss. The liability to make lease payments and ROU asset are equal at commencement of the lease and disconnect subsequently. The liability is accreted using the effective interest method and the ROU asset is amortized on a straight-line basis (assuming another pattern of usage is not present). The straight-line profit or loss recognition pattern is achieved through the use of other comprehensive income. As a result the statement of financial position and profit or loss (prior to the impact of AOCI and OCI) are comparable to the proposals in the ED.

62. The staff notes the following with respect to this approach:

    (a) Provides comparability for all lease transactions within the statement of financial position and profit or loss as the impacts of any straight-line impacts are contained within OCI.

    (b) The purpose of other comprehensive income has not been defined and its use is often criticized as being a placeholder to reflect items that would otherwise cause unwanted volatility in earnings.

63. The following journal entries illustrate Approach C, including the two presentation approaches outlined in Approach A:

	Approach 1	Approach 2	
Day 1 – commencement of the lease			
DR: Right-of-use asset	702	702	
Cr: Liability to make lease payments	702	702	
Year 1			
DR: Interest expense	49	49	
DR: Liability to make lease payments	51	51	-
DR: Amortization/depreciation expense	51	-	Nets to
DR: Rent expense (consumption of asset)	-	100	zero
DR: Other comprehensive income	19	19	
CR: Cash	(100)	(100)	
CR: Interest income	-	(49)	
CR: Right-of-use asset	(70)	(70)	
Year 10			
DR: Interest expense	7	7	
DR: Liability to make lease payments	93	93	-
DR: Amortization/depreciation expense	93	-	
DR: Rent expense	-	100	
CR: Cash	(100)	(100)	
CR: Other comprehensive income	(23)	(23)	
CR: Interest income	-	(7)	
CR: Right-of-use asset	(70)	(70)	

64. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss under Approach C and Approach 1 for presentation.

	FINANCIAL POSITION				PROFIT OR LOSS					
Period	**Cash Payment**	**ROU Asset**	**Liability to make lease pmts**	**AOCI**	**Amort/ Depr Expense**	**Interest Expense**	**Net P&L**	**OCI**	**Net OCI**	**Cost of Funds**
Inception		702	(702)	-						
1	100	632	(652)	19	51	49	100	19	119	-7.0%
2	100	562	(597)	35	54	46	100	16	116	-7.0%
3	100	492	(539)	47	58	42	100	12	112	-7.0%
4	100	421	(477)	55	62	38	100	8	108	-7.0%
5	100	351	(410)	59	67	33	100	4	104	-7.0%
6	100	281	(339)	58	71	29	100	(1)	99	-7.0%
7	100	211	(262)	52	76	24	100	(6)	94	-7.0%
8	100	140	(181)	41	82	18	100	(11)	89	-7.0%
9	100	70	(93)	24	87	13	100	(17)	83	-7.0%
10	100	-	0	1	93	7	100	(23)	77	-7.0%
Total Pmts	1,000					CHECK		(0)		
S/L Pmts	100									

65. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss under Approach C and Approach 2 for presentation.

	FINANCIAL POSITION				PROFIT OR LOSS						
Period	**Cash Payment**	**ROU Asset**	**Liability to make lease pmts**	**AOCI**	**Amort/ Depr Expense**	**Interest Income**	**Interest Expense**	**Net P&L**	**OCI**	**Net OCI**	**Cost of Funds**
Inception		702	(702)	0							
1	100	632	(652)	19	100	(49)	49	100	19	119	-7.0%
2	100	562	(597)	35	100	(44)	46	101	16	117	-7.0%
3	100	492	(539)	47	100	(39)	42	102	12	115	-7.0%
4	100	421	(477)	55	100	(34)	38	103	8	111	-7.0%
5	100	351	(410)	59	100	(29)	33	104	4	107	-7.0%
6	100	281	(339)	58	100	(25)	29	104	(1)	103	-7.0%
7	100	211	(262)	52	100	(20)	24	104	(6)	98	-7.0%
8	100	140	(181)	40	100	(15)	18	104	(11)	92	-7.0%
9	100	70	(93)	23	100	(10)	13	103	(17)	86	-7.0%
10	100	-	0	(0)	100	(5)	7	102	(23)	78	-7.0%
Total Pmts	1,000								(0)		
S/L Pmts	100										

Staff recommendation

Cost benefit considerations

66. In performing the evaluation of approaches to achieve a straight-line profit or loss pattern, the staff recognizes that any approach recommended may result in additional costs to apply. First, an entity would need to perform an assessment on a lease contract to determine whether or not the lease is a finance or other-than-finance lease. Next, after initially recognizing and measuring the lease assets and liabilities, the entity may need to perform additional calculations to determine the pattern of benefits. While the staff thinks that in most cases the pattern of benefits will be consumed in a 'straight-line' pattern, additional complexity is added whenever the cash payment stream or the pattern of benefits is uneven.

67. The staff has illustrated these complexities within Appendix C for all three approaches outlined above.

68. Despite these cost concerns, the staff thinks that there is still support to pursue an other-than-finance lease accounting approach.

Overall approach

69. First, the staff rejected Approach A, the linked approach. This Approach was previously rejected by the Boards in both the ED and the Discussion Paper. The principle reason the staff rejected the linked approach is the short-coming identified with uneven cash payments. As identified above, due to the dependence of the ROU asset on the liability to make lease payments, the expense recognition pattern with uneven payments will match the cash payments rather than the pattern of benefits.

70. Next, the majority of the staff rejected the use of other comprehensive income, or Approach C. While the use of OCI has some benefits, namely the comparability to the ED method (the staff's recommendation for lessee finance leases), it is criticized as a placeholder or plug figure to achieve a result. Finally, the staff thinks that adding OCI into the leases project will add complexity to the model.

71. Therefore, the majority of the staff recommends Approach B, an annuity-based approach. Approach B achieves reasonable results, which approximate a straight-line pattern, in many lease transactions with varying payment and benefit patterns. While some may argue against Approach B due to the potential added complexity, the majority of the staff thinks that it is generally consistent with the proposals in the ED in that the ROU asset is independent of the liability to make lease payments and the pattern of recognition in the profit or loss is consistent with a systematic and rational basis (straight-line).

72. Other staff members recommend Approach C, the OCI approach. Those staff members think that the pattern of income statement recognition was the main concern of constituents, including users, and Approach C addresses that concern while maintaining an appropriate balance sheet measure of the right of use asset and obligation to make lease payments.

Presentation considerations

73. In each of the three approaches presented above there were two potential profit or loss presentation options:

    (a) Recognition of amortization/depreciation expense AND interest expense; or

    (b) Recognition of a single line item within operating expense (rent expense)

74. The staff notes that a presentation requirement to present both amortization expense and interest expense may be more comparable to the presentation requirements of a finance lease.

75. In contrast, the presentation of a single line as operating expense is more consistent with the principle and indicators of an other-than-finance lease. Additionally, the ROU asset in all approaches is also initially measured on a discounted basis therefore it would be appropriate to accrete the asset over the lease term consistent with the accretion of the liability to make lease payments.

76. The staff weighted the comments by all participants in the targeted outreach and the majority preferred the expense recognized under an other-than-finance

lease to be presented as an operating expense (rent expense or comparable term) within the profit or loss as a single line item.

77. Therefore, the staff recommends the recognition of operating expense by all lessees in an other-than-finance lease transaction.

Questions
Q1. *Initial and subsequent measurement* Which approach should be used for initial and subsequent measurement of an other-than-finance lease (OTF lease) in the financial statements of a lessee? Q2. *Presentation* Should the recorded expense be presented in a single-line item by lessees as operating (rent) expense within the profit or loss for all other-than-finance leases?

APPENDIX A – Other approaches rejected by the staff

Approach 1 – No discounting of liability or ROU asset

A1. Approach 1 would not require the liability to make lease payments to be discounted at commencement of the lease. Rather the liability to make lease payments would be the non-discounted aggregate amount of lease payments over the term of the lease. The right-of-use asset would be recognized at commencement of the lease at the same amount as the liability to make lease payments. Using our example the recorded liability in Approach 1 would be CU 1,000 and a corresponding asset would be recorded at CU 1,000.

A2. Consequently, the liability to make lease payments would only be reduced by the cash amount of lease payments. The right-of-use asset would be amortized on a systematic basis, consistent with the ED.

A3. The amortization of the right-of-use asset would be presented as an operating expense (rent expense).

A4. The following illustrative journal entries would be used for this example.

Day 1 – commencement of the lease			
	DR: Right-of-use asset		1,000
		Cr: Liability to make lease payments	1,000
Year 1			
	DR: Interest expense		-
	DR: Amortization/depreciation expense		100
	DR: Liability to make lease payments		100
		CR: Cash	(100)
		CR: Right-of-use asset	(100)
Year 10			
	DR: Interest expense		-
	DR: Amortization/depreciation expense		100
	DR: Liability to make lease payments		100
		CR: Cash	(100)
		CR: Right-of-use asset	(100)

A5. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss.

	FINANCIAL POSITION			PROFIT OR LOSS			
Period	**Cash Payment**	**ROU Asset**	**Liability to make lease pmts**	**Amort/Depr Expense**	**Interest Expense**	**Rent Expense**	**Net P&L**
Inception		1,000	(1,000)				
1	100	900	(900)	*Expense presented as rent expense*	-	100	100
2	100	800	(800)		-	100	100
3	100	700	(700)		-	100	100
4	100	600	(600)		-	100	100
5	100	500	(500)		-	100	100
6	100	400	(400)		-	100	100
7	100	300	(300)		-	100	100
8	100	200	(200)		-	100	100
9	100	100	(100)		-	100	100
10	100	-	-		-	100	100

Approach 2 – Straight-line interest & amortization, increasing cost of funds ('user short-cut approach')

A6. This approach attempts to create an approach similar to that performed today by some users to adjust operating leases. This approach splits the recorded expense between depreciation expense and interest expense (2/3 to 1/3 – or another comparable manner). This recognition pattern would create a straight-line amortization/depreciation expense (70 CU) and a straight-line interest expense (30 CU) throughout the lease term.

A7. The following illustrative journal entries would be used for this example.

Day 1 – commencement of the lease			
	DR: Right-of-use asset		702
		CR: Liability to make lease payments	(702)
Year 1			
	DR: Interest expense		30
	DR: Amortization/depreciation expense		70
	DR: Liability to make lease payments		70
		CR: Cash	(100)
		CR: Right-of-use asset	(70)
Year 10			
	DR: Interest expense		30
	DR: Amortization/depreciation expense		70
	DR: Liability to make lease payments		70
		CR: Cash	(100)
		CR: Right-of-use asset	(70)

A8. The table below illustrates the example through all periods of the lease in the statement of financial position and profit or loss.

	FINANCIAL POSITION			PROFIT OR LOSS				
Period	**Cash Payment**	**ROU Asset**	**Liability to make lease pmts**	**Amort/ Depr Expense**	**Interest Expense**	**Rent Expense**	**Net P&L**	**Cost of Funds**
Inception		702	(702)					
1	100	632	(632)	70	30	100	100	-4.2%
2	100	562	(562)	70	30	100	100	-4.7%
3	100	492	(492)	70	30	100	100	-5.3%
4	100	421	(421)	70	30	100	100	-6.1%
5	100	351	(351)	70	30	100	100	-7.1%
6	100	281	(281)	70	30	100	100	-8.5%
7	100	211	(211)	70	30	100	100	-10.6%
8	100	140	(140)	70	30	100	100	-14.1%
9	100	70	(70)	70	30	100	100	-21.2%
10	100	-	-	70	30	100	100	-42.4%

Appendix B – Excerpt from March 2009 Leases Discussion Paper

A linked approach to subsequent measurement

5.5 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 do not normally exist independently of each other. The boards' decisions on initial measurement reflect this linkage.

5.6 Some think that subsequent measurement of the obligation to pay rentals and the right-of-use asset should also be linked for some leases. Consequently, they suggest a linked approach to subsequent measurement. This 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.

5.8 A different method would apply to leases currently classified as operating leases. The lessee would:

(a) amortise the obligation to pay rentals using mortgage-based amortisation. No interest would be accrued on the obligation. Mortgage-based amortization results in the obligation decreasing more in the later years of the lease than in the early years.

(b) amortise the right-of-use asset using mortgage-based amortisation. This would result in a periodic amortisation charge that increases over the lease term.

(c) base the amortisation of both the asset and the liability on the lessee's incremental borrowing rate. The amortisation of the asset and liability would net to zero in the income statement.

(d) include rental payments as an expense in the income statement on a straightline basis over the lease term.

5.9 This method of accounting for leases currently classified as operating leases results in:

(a) the right-of-use asset and the obligation to pay rentals remaining equal over the lease term (assuming even rental payments and no asset impairment)

(b) the same income statement effect for leases currently classified as operating leases under existing lease accounting standards.

5.10 Supporters of this approach think that it has the following advantages:

(a) It reflects the pattern in which the economic benefits from the lease are consumed by the lessee. In a straightforward lease, the lessee pays for its right

to use the leased item at the same time it receives the right and consumes its benefits.

(b) It reflects the way in which some lease contracts are priced. Operating leases are priced to achieve an even rent expense over the lease term. This approach results in the lessee recognising these even rentals in the income statement over the lease term. Alternative approaches that require the lessee to recognize interest expense on the obligation to pay rentals and amortise the right-of-use asset, possibly on a straight-line basis, result in higher expenses in the early years of the lease.

(c) This approach may be simpler for lessees to apply than an approach that does not link the lessee's right-of-use asset and obligation to pay rentals and, in some jurisdictions, would align the income statement and the tax treatment of leases.

Preliminary views

5.11 Some board members support the linked approach to subsequent measurement for some leases because they think that the costs associated with requiring recognition of interest and amortisation on some leases outweigh the benefits. However, these board members did not define to which leases this approach should apply.

5.12 However, the boards tentatively decided to reject this 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. Nonderivative financial liabilities (other than those measured at fair value) give rise to interest expense. The obligation to pay rentals in a lease contract clearly contains an interest component. If the lessee chose to prepay the lease, the amount prepaid would equal the present value of the future rentals discounted at a market rate of interest. Not recognising this interest component would fail to reflect the economics of the transaction. No interest expense is recognized under this approach.

(b) This approach requires the lessee to differentiate between finance leases and operating leases. This would add complexity to the proposed new standard and could result in similar lease contracts being accounted for differently.

(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. For example, the right-of-use asset could be impaired but the lessee would still be required to make the same rental payments. Conversely, increases in the value of the right-of-use asset do not necessarily result in a change to the rental payments.