Staff Paper

Project	**Leases**
Topic	**Lessee Accounting—finance leases**

Objective

1. The objective of this paper is to discuss the accounting by a lessee for a finance lease.

2. This paper should be read with the series of papers discussing accounting for finance and other-than-finance leases 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 utilise the newly created principles and supporting indicators (suggested by the staff as a result of the targeted outreach and preliminary discussions with the boards at the February 2011 joint meeting).

3. This paper will discuss:

   (a) The initial and subsequent measurement of a lessee's right-of-use asset and its liability to make lease payments under a finance lease.

   (b) The need for unique guidance for the measurement of a lessee's right-of-use asset and its liability to make lease payments under a finance lease in the final *Leases* standard rather than referencing existing IFRS/US GAAP guidance in other standards.

4. At future meetings, staff will bring analyses of:

   (a) impairment, revaluation, and effects of foreign exchange differences on the lessee's right-of-use asset, and

   (b) subsequent measurement of variable lease payments and changes in lease term and the effects of those changes on the right-of-use asset and the liability to make lease payments.

Staff recommendation

5. The staff recommend that the boards confirm the proposals in the *Leases* exposure draft ('the ED') for the initial and subsequent measurement of the assets and liabilities arising for a lessee in a finance lease. Specifically, the staff recommend that:

   (a) Both the liability to make lease payments and the right-of-use asset should be initially measured at the present value of lease payments.

   (b) The liability to make lease payments should be subsequently measured using the (effective) interest method.

   (c) The right-of-use asset should be subsequently measured using a systematic and rational amortisation method.

   (d) There should be specific guidance in the final standard for the initial and subsequent measurement of the liability to make lease payments and of the right-of-use assets for the finance leases of lessees.

6. This paper is structured as follows:

   (a) Background

   (b) Summary of feedback

   (c) Staff analysis and recommendation for:

(i) Initial measurement of the right-of-use asset and liability to make lease payments

(ii) Subsequent measurement of the right-of-use asset and liability to make lease payments

(iii) unique guidance for the measurement of a lessee's right-of-use asset and liability to receive lease payments under a finance lease in the final *Leases* standard rather than just referencing to existing IFRS/US GAAP guidance in other standards.

(d) Appendix A: illustration of amortisation method proposed in the ED

(e) Appendix B: preliminary draft wording

Background

Finance leases

7. At the February 2011 joint meeting, the boards tentatively acknowledged that there were two types of leases ('finance' and 'other-than-finance') and directed the staff to conduct further targeted outreach in this area. At the March 2011 joint meeting, the boards tentatively confirmed the right-of-use model, agreeing that all lessees would recognise an asset representing the right to use an asset during the lease term and a liability representing the obligation to make lease payments during the lease term.

8. Agenda paper 1G/FASB Memo 161 provides the staff's proposed revised indicators of a finance lease and states that 'the purpose of a finance lease is for the lessor to finance the lessee's right to use an underlying asset in a contract and the financing element is significant.' This notion is similar to the statement in the ED that '[l]easing is an important source of finance.' The ED's proposed accounting for lessees is based on the premise that the lessee has purchased a right-of-use asset and financed that acquisition with debt.

Initial and subsequent measurement

9. Regarding initial measurement, the ED proposed:

> At the date of inception of the lease, a lessee shall 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…

10. Regarding subsequent measurement, the ED proposed:

> After the date of commencement of the lease, a lessee shall measure:
>
> (a) The liability to make lease payments at amortised cost using the (effective) interest method…
>
> (b) The right-of-use asset at amortised cost…
>
> If a lessee measures the right-of-use asset at amortised cost, it shall amortise the asset on a systematic basis from the date of commencement of the lease to the end of the lease term or over the useful life of the underlying asset if shorter. The lessee shall select the amortisation method and review the amortisation period and amortisation method in accordance with IAS 38/Topic 350.

Summary of feedback

Feedback received during the comment letter period

11. Many respondents did support the initial measurement of the right-of-use asset and liability to make lease payments by a lessee at the present value of lease payments. A few respondents did suggest that this asset and liability should be initially measured at fair value or at the undiscounted sum of lease payments.

12. FASB agenda paper 134/IASB agenda reference 5F, discussed at the February 2011 joint meeting, provided a summary of the feedback that was received from respondents to the ED regarding subsequent measurement of the right-of-use asset and liability to make lease payments.

13. Most respondents also supported the use of the (effective) interest rate method to subsequently measure the liability to make lease payments. However, some respondents suggested that the liability should not be discounted (eg some private entities for cost/benefit reasons). A few respondents suggested that the liability should be measured at fair value, or that the final standard should at least include a fair value option. These respondents argued that including a fair value option would be consistent with existing guidance on financial instruments and would provide more relevant information.

14. As discussed in Agenda paper 134/FASB memo 5F, there were mixed views on the subsequent measurement of the right-of-use asset. While some respondents agreed with the ED's proposals, many respondents disagreed with the profit or loss recognition pattern that would result from these proposals. These respondents supported an annuity-based amortisation of the right-of-use asset that, combined with interest expense on the liability to make lease payments, would result in a straight-line profit or loss recognition pattern. These respondents pointed out that such an amortisation method would also appropriately 'link' the right-of-use asset and liability to make lease payments. Among these respondents, views were mixed on whether this amortisation should be used for all leases or only a subset of leases that would be considered more operational in nature (which the boards have currently termed 'other-than-finance' leases). Again, a few other respondents suggested that the right-of-use asset be subsequently measured at fair value.

15. Accounting firms and standard-setters were most likely to support the ED's proposals in this area, while preparers were most likely to disagree with them. Reactions among users were mixed.

Initial measurement of right-of-use asset and lease liability

16. At the joint meeting in March 2011, the boards made a tentative decision to re-confirm the application of a right-of-use model to all lease arrangements, but they

did not make any tentative decisions relating to the initial measurement of the right-of-use asset and liability to make lease payments arising for a lessee in a finance lease.

17. The ED proposed that both the liability to make lease payments and the right-of-use asset should be initially measured at the present value of the lease payments.

18. The boards have previously considered and rejected initial measurement at fair value. They had proposed in the ED to measure the liability to make lease payments and right-of-use asset at the present value of lease payments because that measurement is:

    (a) consistent with the treatment of nearly all nonfinancial assets and some financial liabilities;

    (b) simpler and less costly for preparers to apply than fair value measurement; and

    (c) a reasonable approximation to fair value.

19. Most respondents did agree with the boards' proposals in the ED on initial measurement of the right-of-use asset and liability to make lease payments. The staff recommend that the boards confirm the decision for a lessee in a finance lease to initially measure the liability to make lease payments and right-of-use asset arising under a finance lease at the present value of lease payments.

Subsequent measurement of the liability to make lease payments

20. The ED proposed that a lessee measure the liability to make lease payments using the (effective) interest method.

21. The staff think that there are two approaches to subsequent measurement of the liability to make lease payments for a finance lease that the boards need to consider:

    (a) Approach A: the (effective) interest method; or

(b) Approach B: fair value.

Approach A: (effective) interest method

22. Approach A is the approach proposed in the ED to measure the liability to make lease payments using the (effective) interest method.

23. The boards proposed requiring a lessee's liability to make lease payments to be subsequently measured using the (effective) interest method because:

    (a) It is consistent with the subsequent measurement of many other non-derivative financial liabilities.

    (b) It is consistent with the initial measurement of the liability to make lease payments at cost (subject to the boards' confirmation of the proposal in the ED).

    (c) It provides useful information to users of financial statement.

24. Approach A is also consistent with the principle of a finance lease in that it faithfully depicts the financing element of the lease contract; it is conceptually consistent with other borrowing or financing activities that a lessee would enter into. It results in interest expense that would represent useful information about the financing component of the finance lease.

Approach B: fair value

25. Another approach the boards have previously considered for the subsequent measurement of the liability to make lease payments is fair value. A few respondents argued that fair value would result in more relevant and useful information because it would reflect current market conditions, and a few other respondents requested that a fair value option be allowed for subsequent measurement to maintain consistency with other financial assets.

26. The boards rejected this approach because it was complex, costly and inconsistent with the initial measurement of the liability to make lease payments and the subsequent measurement of many other non-derivative financial liabilities.

Staff recommendation

27. The majority of respondents commenting on this issue support the use of the (effective) interest method to subsequently measure the liability to make lease payments.

28. The staff think that the (effective) interest method is particularly appropriate for a lessee entering into a finance lease because the financing component of the lease arrangement is faithfully depicted. The staff think that the boards' previous reasons for requiring the effective interest rate method described in paragraph 23 of this paper continue to remain appropriate. The staff would also like to note that the (effective) interest method is consistent with the staff recommendation for the initial measurement of the liability to make lease payments.

29. Therefore, the staff recommend that the final standard require lessees in a finance lease to subsequently measure their liability to make lease payments using the (effective) interest method.

Subsequent measurement of the right-of-use asset

30. The ED proposes that a lessee amortise the right-of-use asset on a systematic basis over the shorter of the lease term or useful life of the underlying asset in accordance with IAS 38 *Intangible Assets*/Topic 350 *Intangibles—Goodwill and Other* in the *FASB Accounting Standards Codification*®.

31. The staff think there are two approaches to subsequent measurement of the right-of-use asset the boards need to consider:

    (a) Approach A: amortisation of the right-of-use asset on a systematic basis in accordance with IAS 38/Topic 350

(b) Approach B: amortisation of the right-of-use asset that would achieve the recognition of straight-line expense for the lessee

32. The staff do not think that the boards should consider subsequent measurement of the right-of-use asset at fair value because it would be inconsistent with the staff recommendation for the initial measurement of the right-of-use asset at amortised cost, inconsistent with the subsequent measurement of most other non-financial assets, and a more complex and costly approach to subsequent measurement. However, revaluation of the right-of-use asset will be discussed at a future date by the IASB.

Approach A: systematic basis in accordance with IAS 38/Topic 350

33. Approach A is the approach proposed in the ED: amortising the right-of-use asset on a systematic basis over the shorter of the lease term or useful life of the underlying asset in accordance with IAS 38/Topic 350.

34. The boards proposed this approach because:

(a) It is consistent with the amortisation of a lessee's owned assets and other non-financial assets.

(b) It is consistent with the initial measurement of the right-of-use asset at cost (subject to the boards' confirmation of this decision).

(c) It is simple for preparers to follow and would not represent a major cost.

35. Amortising the right-of-use asset on a systematic basis is a flexible method that allows lessees to best depict how they expect to consume the economic benefits of the right-of-use asset. The systematic basis would normally result in straight-line amortisation of the right-of-use asset, although it would not prohibit other amortisation methods such as the diminishing balance method or unit of production method.

36. A disadvantage of Approach A for many preparers and users is that, combined with the effective interest method, total lease expense (interest plus amortisation)

would be higher in the earlier years of a lease than in the later years. This may not match the cash flows present in the lease arrangement.

37. Appendix A provides an illustration of this method using a simple example also used in Agenda paper 1H/FASB Memo 162.

Approach B: amortisation that results in straight-line expense

38. Approach B would require that the right-of-use asset be amortised in a way that results in the recognition of straight-line total lease expense by the lessee over the course of the lease contract.

39. Agenda paper 1H/FASB Memo 162 describes in detail the advantages and disadvantages of this approach and the different amortisation methods that could result in straight-line expense. Another advantage of the boards choosing this approach for finance leases would be consistency with the profit or loss recognition of other-than-finance leases (dependent on the boards' decisions resulting from Agenda paper 1F/FASB Memo 160 and Agenda paper 1H/FASB Memo 162).

40. A disadvantage of Approach B is that amortisation expense for the right-of-use asset would be lower in the earlier years of a lease. Some argue that this would likely not reflect how the economic benefits of the underlying asset in a finance lease would be consumed by the lessee and could be inconsistent with the profit or loss recognition profile that would be presented if the underlying asset was owned by the lessee, rather than leased.

Staff recommendation

41. The staff recommend the boards confirm their proposal in the ED to require that the right-of-use asset arising from a finance lease be amortised on a systematic basis over the shorter of the lease term or useful life of the underlying asset.

42. Regardless of the decision that the boards make for the subsequent measurement of the right-of-use asset resulting from an other-than-finance lease, the staff think

that amortising the right-of-use asset on a systematic basis is the appropriate subsequent measurement method for finance leases.

43. In a finance lease, a lessee is financing the acquisition of the right-of-use asset. It is important to depict both how the acquisition is being financed through interest expense and how the economic benefits of that asset are being consumed through amortisation. A lessee needs to faithfully depict subsequent measurement on both the asset and liability side; it would be inappropriate to look at the amortisation of the asset as only being a component of the net lease contract expense, as suggested under Approach B.

44. Since finance leases can be very similar to instalment purchases of property, plant and equipment, the staff think that it is important to ensure that subsequent measurement of the right-of-use asset is generally consistent with the subsequent measurement of a lessee's owned assets and other nonfinancial assets. Approach A achieves this consistency, while Approach B would introduce major inconsistency between leases and purchases.

45. For these reasons, and the other advantages listed in paragraph 34, the staff recommend Approach A.

46. The staff's suggested wording for the final standard can be found in Appendix A. The staff note that the ED's reference to IAS 38/Topic 350 has been retained in Appendix A. The issue of whether a right-of-use asset is a tangible or intangible asset will be addressed by the boards at a future date. Therefore, the staff will ask the boards to clarify in a future meeting whether this amortisation should be in accordance with IAS 38/Topic 350 or with IAS 36/Topic 360.

47. Regardless, amortising the right-of-use asset on a systematic basis would be consistent with the amortisation of both tangible and intangible assets.

Need for specific lease guidance for finance leases

48. An issue that has been brought up throughout the project is the need to include specific guidance in the final standard on leases for finance leases, especially for the liability to make lease payments, rather than just referring to existing IFRSs or US GAAP.

49. Some argue that, because finance leases could be viewed as similar to a purchase, the final leases standard should simply refer lessees to IAS 16/Topic 360 for accounting for the right-of-use asset and IFRS 9/Topic 835 for the liability to make lease payments. The proposals in the ED (and the staff's recommendation to retain these proposals in the final standard) are generally consistent with the requirements in those standards, especially for subsequent measurement.

50. However, the staff do not think that simply referring lessees in finance leases to existing guidance would be appropriate.

51. Regarding the right-of-use asset, the staff acknowledge that one could argue that referring to either IAS 16/Topic 360 or IAS 38/Topic 350 would be a simpler way of addressing initial and subsequent measurement of this asset. However, the measurement of the right-of-use asset depends on many factors that are unusual for straightforward purchase contracts and somewhat unique to leases, such as variable lease payments and renewal and purchase options. The staff think there needs to be special guidance for these areas, especially for initial measurement, in the final *Leases* standard.

52. Similarly, the staff think that special guidance for the liability to make lease payments in the final leases standard is warranted to address features such as options and variable lease payments rather than referring to guidance on financial liabilities.

53. The final *Leases* standard will provide a definition of a lease and a way to distinguish between finance and other-than-finance leases (subject to the boards' decisions in these areas). Providing further initial and subsequent measurement

requirements for lessees in finance leases will make the standard clearer and easier to apply consistently.

54. Moreover, although finance leases are similar to purchases, not all finance leases will meet the definition of a sale and purchase under revenue recognition guidance. Special guidance in the final *Leases* standard is needed for these cases.

55. For these reasons, the staff recommend including specific guidance (namely the proposals in the ED) on initial and subsequent measurement for lessees in finance leases in the final standard.

Question
The staff recommend that a lessee apply the lessee model proposed in the ED to its finance leases. Specifically: a) Both the liability to make lease payments and the right-of-use asset should be initially measured at the present value of lease payments. b) The liability to make lease payments should be subsequently measured using the (effective) interest method. c) The right-of-use asset should be subsequently measured using a systematic and rational amortisation method. d) There should be specific guidance for the initial and subsequent measurement of the liability to make lease payments and the right-of-use assets for finance leases of lessees in the final standard. Do the boards agree?

Appendix A –illustrative example of ED amortisation method

A1. Agenda paper 1H / FASB Memo 162 discusses the accounting for an other-than-finance lease and illustrates the application of various amortisation methods using one illustrative example. The illustrative example used in that paper is included here to illustrate the method proposed in the ED for comparative purposes. The staff recommend that the method proposed in the ED be used for lessees in *finance* leases.

A2. The illustrative example is as follows:

> 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.

ED Approach

A3. In the ED approach the lessee would use the rate charged in the lease (7 percent) to discount the lease payments and would recognise a liability to make lease payments of CU 702 at the date of commencement. A corresponding right-of-use asset of CU 702 would also be recognised at lease commencement. The staff note the following with respect to the ED approach:

(a) The cost of funds (calculated as interest expense divided by the beginning-of-year liability) is consistent throughout the lease period and is the interest rate charged in the lease.

(b) Interest expense is recognised each year in accordance with an effective interest method and the ROU asset is amortised on a systematic basis (assumed to be straight-line).

(c) The ED approach recognises higher total lease expense in earlier periods of the lease (year 1 total expense of CU 119) as compared to the later years of a lease where a lower total lease expense is recognised (year 10 total expense of CU 77).

A4. 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	49
	DR: Amortization/depreciation expense	70
	DR: Liability to make lease payments	51
	CR: Cash	(100)
	CR: Right-of-use asset	(70)
Year 10		
	DR: Interest expense	7
	DR: Amortization/depreciation expense	70
	DR: Liability to make lease payments	93
	CR: Cash	(100)
	CR: Right-of-use asset	(70)

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**	**Net P&L**		**Cost of Funds**
Inception		702	(702)						
1	100	632	(652)		70	49	119		7.0%
2	100	562	(597)		70	46	116		7.0%
3	100	492	(539)		70	42	112		7.0%
4	100	421	(477)		70	38	108		7.0%
5	100	351	(410)		70	33	104		7.0%
6	100	281	(339)		70	29	99		7.0%
7	100	211	(262)		70	24	94		7.0%
8	100	140	(181)		70	18	89		7.0%
9	100	70	(93)		70	13	83		7.0%
10	100	-	0		70	7	77		7.0%
Total	1,000				702	298	1,000		

56.

Appendix B: preliminary draft wording

The preliminary draft wording included in this appendix has been prepared by the staff to help the boards reach decisions regarding the scope of the leases standard. The boards have not yet made decisions about the views reflected in this appendix, and, therefore, the wording is subject to change. This appendix shows marked changes from what was originally proposed in the exposure draft on leases.

B1. At the date of ~~inception~~commencement of the lease, a lessee shall 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…

B2. After the date of commencement of the lease, a lessee shall measure:

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

(b) The right-of-use asset at amortised cost…

B3. If a lessee measures the right-of-use asset at amortised cost, it shall amortise the asset on a systematic basis from the date of commencement of the lease to the end of the lease term or over the useful life of the underlying asset if shorter. The lessee shall select the amortisation method and review the amortisation period and amortisation method in accordance with IAS 38/Topic 350.