IASB/FASB Meeting
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IASB Agenda reference **1F**

Staff Paper

IASB Education Session April 6, 2011
FASB Education Session April 7, 2011

FASB Agenda reference **160**

Project	**Leases**
Topic	**Types of Leases – Is more than one accounting approach necessary?**

Objective

1. The purpose of this paper is to discuss the application of the Boards' right-of-use model and to consider whether two approaches are required to best represent the wide variety of different lease transactions.

2. This paper is organized as follows:

   (a) Summary of staff recommendations

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

   (c) Summary of feedback from:

      (i) Comment letters and other outreach activities during the comment letter period

      (ii) Targeted outreach in March – April 2011

   (d) Staff analysis and discussion of approaches

   (e) Appendix A – Summary of feedback from comment letters and other outreach activities during the comment letter period

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.

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Staff Recommendation

Lessor accounting

3. The staff recommends that the final leases standard affirm the proposal in the ED and distinguish two different types approaches for applying the right-of use model to lessors.

   (a) A ***lessor finance lease*** acknowledges that at commencement of the lease the lessor has completed its obligations in connection with the transaction and, as a result, income is recognized at lease commencement.

   (b) A ***lessor other-than-finance lease*** acknowledges that the lessor has key elements in the arrangement to perform throughout the lease term despite the lessor providing the lessee with the right to use the underlying asset at lease commencement, and therefore, income is recognized over the lease term.

Lessee accounting

4. The staff recommends that the final lease standard also distinguish two different approaches under the Boards' right-of-use model for profit or loss recognition patterns by lessees. This recommendation to have two different approaches is consistent with: the ED approach for lessor accounting, the above staff recommendation for lessor accounting, current lease accounting and the views of many respondents, including those engaged in the targeted outreach performed by the staff.

5. Specifically, the staff recommend the final standard distinguishes the following two types of leases, both of which result in a lessee recognizing a right-to-use asset and a liability to make lease payments at the commencement date of the lease contract:

   (a) A ***lessee finance lease*** which is characterized by a profit and loss pattern that is consistent with the proposals in the ED and includes the recognition of interest expense and amortization expense; and

(b) A ***lessee other-than-finance*** lease which is characterized by a straight-line profit or loss recognition pattern, unless another systematic and rational basis is more representative.

Summary of proposals in the ED

6. The exposure draft proposes a new accounting model for leases in which:

    (a) A lessee would recognize an asset (a right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5-BC12). The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

    (b) A lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23-BC27).

7. As outlined above, the ED requires a single lessee right-of-use model and approach while the lessor model proposes application of the right-of-use model through a dual approach whereby lessors must make a determination between one of two lessor accounting approaches at the date of inception of the lease.

8. Additionally the ED provides application guidance for lessors to make the determination between the two approaches (B22 – B27) as follows:

> A lessor shall consider the following factors in assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the current lease:
>
> (a) significant contingent rentals during the lease term that are based on the use or performance of the underlying asset.
>
> (b) options to extend or terminate the lease.
>
> (c) material non-distinct services provided under the current lease.

> [**IASB only**] The existence of material non-distinct services may expose the lessor to a significant risk that the lessee will terminate the lease early because of the non-provision of those services. When the risk that the lessee will terminate the lease is significant, the lessor is likely to be exposed to significant risks or benefits associated with the underlying asset during the term of the lease.
>
> A lessor shall consider the following factors when determining whether it retains exposure to significant risks or benefits associated with the underlying asset after the expected term of the current lease:
>
> (a) whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset.
>
> (b) whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making that assessment, the lessor shall consider:
>
> (i) the present value of the underlying asset at the end of the lease term, and
>
> (ii) the effect that any residual value guarantees (including those provided by an unrelated third party) may have on the lessor's exposure to risks or benefits.
>
> In general, a residual value guarantee will reduce a lessor's exposure to downside risk but may give the lessor the potential to benefit from increases in the expected value of the underlying asset at the end of the lease.
>
> The existence of one or more indicators is not conclusive in determining whether the lessor retains exposure to significant risks or benefits associated with the underlying asset.
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> A lessor shall not consider the risks associated with the counterparty credit risk of the lessee when determining whether it retains exposure to significant risks or benefits associated with the underlying leased asset during the expected term of the current lease.

Summary of feedback

Feedback received in comment letters and other outreach activities

9. The staff previously provided a summary of comment letter feedback at the January 2011 joint meeting (Agenda paper 5A / FASB Memo 123). In light of the feedback provided through comment letter and other outreach activities, as outlined in Appendix A, the staff initially addressed types of leases in the February 2011 joint meeting. The staff presented Agenda paper 5F / FASB

Memo 134 and the Boards made a tentative decision to distinguish two types of leases for accounting purposes. Additionally, the Boards directed the staff to undertake targeted outreach on that tentative decision.

Targeted outreach feedback

10. As directed by the Boards in the February 2011 joint meeting, the staff engaged in targeted outreach during March and April 2011. The staff held over 20 meetings with over 70 representative organizations. All constituent groups were represented, including users, preparers, standard-setting organizations, accounting firms and representatives of the leases joint working group.

11. The preparer organizations were identified from roundtable participation, comment letter submission and other outreach activities. The staff also ensured that a diverse group of preparer industries were represented including: retail and trade, power and utilities, oil and gas, life sciences, financial services, real estate, airlines, outsourcing, shipping, telecommunications and construction. Additional organizations and representatives contacted the leases team and requested to participate and those individuals/organizations either attended the meetings or provided written feedback to the staff.

12. Additionally, the FASB staff incorporated non-public entities within the targeted outreach by including representative private company organizations within the preparer meetings. Additionally, the FASB staff held separate meetings for private and not-for-profit organizations to solicit feedback.

13. Generally, a majority of preparers, many of which were lessees, supported the view that there are different types of leases and expressed appreciation to the Boards and staff for listening to the arguments identified in comment letters and roundtable discussions.

14. These preparers stated that they think that some lease transactions are operating, rather than financing in nature, therefore identifying two types of leases for accounting purposes in accordance with the Boards' tentative decision in February 2011:

    (a) is more consistent with their business model;

(b) leads to presentation of operating items as operating expenses and operating cash flows, therefore providing greater transparency to the underlying economics of some lease transactions; and

(c) addresses some of the concerns with the ED raised by specific industries (for example, real estate leases do not usually include a significant financing element, power purchase contracts are economically similar to arrangements to purchase commodities, and some contracts include significant service components).

> We support the Board's decision to have both a performance obligation approach and a derecognition approach to Lessor accounting. We strongly agree with the conclusions of the Boards that a single approach to Lessor accounting would not be appropriate for all leases because of differences in the economics of the business models for Lessors.
>
> Based on our business model … in most instances, the Company would be required to apply the Performance Obligation method. The Performance Obligation method more closely matches the underlying economics (i.e. cash flows) of our bundled lease arrangements which is designated to generate the maximum amount of revenue from the active management and usage of the underlying equipment being leased. In addition, revenue recognition under the Performance Obligation method comports well when there are significant elements of operational control, continuing involvement, on-going costs and risks, and residual interest in the assets being leased. (CL # 244)

15. However, preparers did acknowledge that there are disadvantages in a decision to identify two types of leases for accounting purposes. This is because it:

(a) Adds complexity back into the model that the project was intending to eliminate;

(b) Creates new bright-lines that may allow structuring between types of leases;

(c) Provides difficulty in identifying appropriate conceptual arguments to support different types of leases; and

(d) Affects the calculation of ratios (for example net debt calculations) when a lease liability (debt) is recognized without the corresponding interest expense.

16. The accounting firms identified many of the same advantages and disadvantages of the preparers noted above. In addition, the firms stressed in their feedback the following challenges:
    (a) Additional complexity added to the model;
    (b) Creation of new bright lines in lease accounting and potential structuring opportunities; and
    (c) Difficulty in identifying a conceptual rationale to support the two types of leases.

17. Despite the concerns expressed by the firms, most agreed that identifying two types of leases for accounting purposes is a practical solution and was responsive to much of the feedback received by the Boards during the comment letter timeframe.

18. Most users we met with during our targeted outreach, including equity analysts and credit rating agencies, re-emphasized their support for recognizing lease assets and liabilities, explaining that their concerns with current lease accounting were more with the statement of financial position than the income statement (profit or loss).

19. However, most of these users, consistent with the feedback received on the ED, stated that they would prefer the profit or loss to represent or be a proxy for cash payments/receipts. Those that supported a straight-line profit or loss recognition pattern principally cite the economics of the transaction and believe that a straight-line (or cash) expense pattern is a better representation.

20. Some users expressed a preference that *all* leases should result in a straight-line expense pattern in profit or loss. Those users explained that they thought a straight-line expense pattern is more consistent with the economics, makes more practical sense and would be more in line with the cash flows. Other users agreed with the initial discussion in the February 2011 joint meeting whereby the Boards discussed whether there are different types of leases for accounting purposes where for some leases an entity would report straight-line expense, while for other leases that are more financing in nature recognize an entity would report an expense pattern consistent with the ED proposals. During the targeted outreach, many users did not support the proposals in the

ED which required the same profit or loss pattern for all leases and in which expense/income would be higher in earlier periods of the lease due to the interest expense recognized.

21. Finally, some working group members expressed a preference, similar to some users, for a straight-line recognition pattern for *all* leases. As a result, most working group members could support identifying two types of leases for accounting purposes for both lessees and lessors.

Staff analysis and discussion of approaches

Lessors

22. The accounting for lessors today under both IFRSs and U.S. GAAP identifies more than one type of lease for accounting purposes. Specifically a lease classification determination is made at the inception of a lease and the lease is classified as either an operating or a capital/finance lease in accordance with Topic 840 and IAS 17. The classification decision under Topic 840 and IAS 17 is based on whether or not a lease transfers substantially all the risks and rewards incidental to ownership. As noted above, many respondents do not view lessor accounting as currently broken and as a result think that there is more than one type of lease for the purposes of applying lessor accounting.

23. Additionally, during the deliberations leading to the issuance of the ED, the Boards debated lessor accounting extensively and resolved to issue the document with a dual approach model that acknowledges two types of leases when applying lessor accounting.

24. Many respondents challenged the Boards proposals for lessor accounting in the ED. While some encouraged the Boards to continue deliberations with the objective of identifying one lessor accounting approach, others acknowledged the need for more than one approach to lessor accounting even if they did not support the ED proposals for a dual approach. As a result, some suggested retaining current lessor accounting.

25. During the roundtables and other outreach meetings many lessors provided significant feedback about certain business models and appreciated the Boards'

acknowledgement that there are different lease transactions and that these should be reflected in the accounting for lease transactions. Many suggested that while it may be conceptually superior to achieve one lessor approach, in practice it would be unlikely to faithfully represent all lease transactions.

26. Specifically, there are clear fact patterns where the lease transaction is more akin to a sale of the underlying asset and the lessor retains limited risk relating to the underlying asset. In these situations, the lessor takes on significant credit, rather than asset, risk and views the lease as a similar transaction to a sale (for example, manufacturer/dealers).

27. In contrast, there are fact patterns, typically shorter-term arrangements or real estate leases, when the lessor is engaging in an operating manner and typically provides the right to use the asset in connection with other service elements that may or may not be distinguishable in the transaction. This lessor typically views the underlying asset as an investment, retains asset risk throughout the term of the lease.

28. The staff views these two transactions differently and thinks that the accounting should follow the economics in these transactions rather than a single lease accounting model. The ED proposed that not all lease transactions should be accounted for uniformly by the lessor while, in contrast, all lease transactions should be consistently accounted for by the lessee. There are advantages and disadvantages of both a single approach and a dual approach model.

29. The staff have identified the following advantages of a single lessor accounting approach:

    (a) Increases the comparability for lease accounting

    (b) Simplicity in application;

    (c) Elimination of bright-line tests;

    (d) Reduction in structuring to achieve a certain accounting result;

    (e) Support to the Boards' tentative conclusions in the ED that there is one lessee model and approach; and

(f) May provide a greater linkage with the Revenue Recognition ED by clearly identifying when a lessor is determined to have met performance obligations relating to lease contracts.

30. However, the staff have also identified the following disadvantages of proceeding with a single lessor accounting approach:

    (a) Inconsistent with current accounting, which many describe as not currently broken in that it acknowledges that there are a different types of leases and faithfully depicts the different nature of those lease contracts;

    (b) Fails to acknowledge the different lessor business models which contribute significantly to the economics of the transaction; and

    (c) Potentially forces consistent accounting to transactions that are not alike and may require all transactions to be accounted for under one approach either as:

        (i) Similar to the sale of an asset; or

        (ii) Similar to the delivery of a service over the term of the lease.

31. The majority of the staff is conceptually attracted to a single lessor accounting approach that would apply one profit or loss recognition pattern to all leases. Those staff thinks that, if the Boards determine that the present lessor accounting approach requires significant change, the best approach would be to pursue an alignment with the proposals in the revenue recognition ED. However, they acknowledge the uniqueness of lease contracts and the challenges that may arise in aligning lessor accounting with the revenue recognition project.

32. Additionally, the staff recognizes the differing lessor business models which drive the economics and business purpose of lease transactions. As a result of these different business models and the lessee's differing objectives, leases are used for a variety of business reasons rather than a single business purpose.

33. Therefore, on balance, the staff finds the arguments to support the principle that there are different types of lease transactions for lessors compelling and

thinks that the disadvantages of a single lessor accounting approach outweigh the advantages. Therefore, the staff recommends that the Board proceed to confirm the decision in the ED that there are two different types of leases that are identified when applying lessor accounting.

34. Both IAS 17 and Topic 840 derive from the view that if a lease transfers substantially all of the risks and rewards incidental to ownership that a lease should be accounted for like the acquisition of an asset and incurrence of an obligation by the lessee and as a sale or financing by the lessor (a finance lease). While if substantially all the risks and rewards are not transferred in a lease than that lease is classified as an operating lease.

35. As a result, the staff recommends that the final leases standard affirm the proposal in the ED and identify two different approaches for lessor accounting:

    (a) A finance lease; and

    (b) An other-than-finance lease.

36. As outlined above, the staff thinks that two approaches are warranted for lessors to differentiate the profit or loss recognition patters to:

    (a) Different business models which drive different economic results;

    (b) Varying levels of continuing involvement by the lessor (services and other elements in a contract);

    (c) Different levels of asset risk; and

    (d) Risks and rewards transferred at different times in the arrangement.

Question 1
Do the Boards agree with the staff recommendation to affirm the decision in the ED that there are two different approaches for lessor accounting, specifically a finance lease and an other-than-finance lease? If not, why not?

Lessees

37. As outlined above, the ED proposes a single accounting model and approach for lessees, the right-of-use model, which requires all leases to be accounted for on a uniform basis by lessees.

38. Current accounting under IAS 17 and Topic 840 requires a lessee to make a lease classification determination at inception of the lease contract and either classify a lease as operating or capital/finance. As a result, current accounting differentiates between different types of leases.

39. Many respondents to the ED and participants in the targeted outreach expressed concerns with how the lessee accounting proposals aligned with the lessor accounting proposals and whether a lessee should account for all lease transactions similarly to financing the acquisition of an asset.

40. The staff have identified the following advantages of retaining a single lessee model and approach as proposed in the ED:

    (a) Increases the comparability for lease transactions;

    (b) Simple application;

    (c) Elimination of bright-lines which are consistently cited as the shortfall of current lease accounting;

    (d) Reduced structuring opportunities, as all leases would be accounted for uniformly; and

    (e) Conceptually sound and more consistent with the initial recognition of a right-to-use asset (measured at amortized cost) and a liability to make lease payments (measured on a discounted basis).

41. Additionally, the staff have identified the following disadvantages of retaining the single lessee model and approach as proposed in the ED:

    (a) Requires expense recognized to be more divergent than a straight-line method from cash payments in the lease;

    (b) Forces all lease transactions, despite differing economic drivers, to be accounted for uniformly;

(c) Requires higher expense in earlier periods of the lease and lower expense in later periods which does not reflect the underlying economics of the transaction when an asset is 'used' consistently over the term of the lease;

(d) Inconsistent with current accounting and the staff recommendation for lessors in Question 1 above; and

(e) Requires recognition of interest expense in all lease transactions which is presented as a non-operating expense and is not reimbursable under certain government contracts;

42. In principle, there are certain leases for which the financing element is significant because the transaction is similar to the lessee financing the acquisition of an asset. However, in other lease transactions the financing element is not significant because the lessee enters into a rental transaction to use the asset.

43. As a result, there are some leases for which the economics and business purpose align with the Boards' proposals, and an entity is financing an otherwise purchase transaction. However, in some cases the purpose of a lease is to avoid the inflexibilities of ownership, mitigate the risk of ownership (for example, technological obsolesce) and/or outsource significant activities principally related to maintenance and administration of an asset. The staff acknowledges that there is a financing element present in all lease transactions; however, the staff thinks that the predominance of the finance element varies, which indicates that there are different types of leases.

44. The staff reviewed feedback from all constituents and heavily weighed remarks by many users in the recommendation that there are two different types of leases for lessees. The staff found the reasons presented above compelling and exceeding the reservations to add significant complexity into the lessee model proposed in the ED.

45. As outlined above, the staff thinks that two approaches are warranted to differentiate the profit or loss recognition patterns for lessees to:

(a) Different business purposes for entering into the transaction which drive different economic results;

(b) Varying levels of consideration of the finance element by a lessee; and

(c) Different levels of continuing involvement by the lessor (services and other elements in a contract);

(d) Risks and rewards transferred at different times in the arrangement.

Question 2
Do the Boards agree with the staff recommendation, consistent with the above lessor staff recommendation, that there are two approaches for lessee accounting? If not, why not?

Appendix A

Feedback received in comment letters and other outreach activities

A1. The staff previously provided a summary of comment letter feedback at the January 2011 joint meeting (Agenda paper 5A / FASB Memo 123). Additionally, the staff initially addressed types of leases in the February 2011 joint meeting with Agenda paper 5F / FASB Memo 134.

A2. The feedback received on the ED generally supported the right-of-use model and the recognition by lessees of lease assets and lease liabilities. However there were mixed views on the pattern of profit or loss recognition for lessees with:

(a) Some respondents, specifically accounting firms and standard-setters, supporting the proposals in the ED; and

(b) Other respondents, specifically those from the leasing industry, some users and many preparers, 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.

A3. Additionally, many respondents expressed some level of concern with the proposals relating to whether:

(a) One lessee accounting model can be applied to all lease contracts (for example, retailers and the hotel industry in particular do not think the proposed model reflects their business activities);

(b) All leases should be considered as being similar to financing the acquisition of an asset, rather than being operational in nature; and

(c) The proposed change from recognition of rental expense to amortization and interest expense would provide more useful information or be appropriate for some entities, particularly government contractors where interest expense is not reimbursable.

A4. Feedback on the lessor accounting model included concerns that the model was less developed than lessee accounting, with many questioning whether the proposals in the ED were an improvement on current lessor accounting. Many interested parties observed that lessor accounting in present IFRSs and U.S. GAAP may not 'be broken' and instead of changing the lessor accounting model, recommended that the Boards should focus on enhancing existing disclosure requirements.

A5. Consequently, respondents offered a variety of proposals for the path forward with significant support expressed for developing a:

(a) Single lessor accounting model, consistent with the lessee accounting model proposed in the ED; or

(b) Lessor accounting model that would be consistent with the *Revenue from Contracts with Customers* exposure draft (the Revenue Recognition ED), specifically relating to the accounting for licenses of intangible assets; or

(c) A business model approach to lessor accounting that would more closely reflect the economics of lease transactions (which may lead to retaining, or substantially retaining, the guidance in current IFRS/U.S. GAAP).

A6. When commenting on the specific proposals in the ED for two approaches to lessor accounting, respondents:

(a) requested additional application guidance on how to apply the criteria for determining whether the lessor retains exposure to significant risks and benefits associated with the underlying asset;

(b) questioned why an assessment of risks or benefits would be the best indicators for determining whether to apply a derecognition or the performance obligation approach, noting that the right-of-use model is based on control concepts; and

(c) proposed that the guidance in BC27 of the ED relating to the use of a lessor's business model and an assessment of a lessors' asset and credit

risk as an indicator of which lessor accounting approach to be applied should be included in the final standard as a key indicator.

A7. When comparing the proposals in the ED to include one approach to lessee accounting, but two approaches to lessor accounting many respondents commented that:

(a) proposing two approaches to lessor accounting is inconsistent with the single approach to lessee accounting included in the ED. They noted that the proposal creates conceptual concerns relating to why the lessee is always determined to have a lease obligation when the lease commences but the lessor may be determined to continue to perform over the entire lease term, rather than just performing at the date of commencement;

(b) a single approach to lessee and lessor accounting would be less costly to apply, would be consistent with the Boards' objective of simplifying the accounting for leases and would avoid the opportunity for accounting arbitrage; and

(c) a single approach to lessee and lessor accounting would assume that all leases are economically similar transactions. This does not reflect that:

(i) some leases are entered into by lessees as an alternative to acquiring the underlying asset with finance, whereas other lessees are transactions that the lessee enters into for other reasons such as operational flexibility.

(ii) different lessors have very different business models and different approaches to managing the asset and credit risk relating to lease contracts.