Project **Leases**

Topic **Two types of leases and lessor accounting**

Two types of leases

1. The leases exposure draft (ED) proposed a single lessee accounting approach. This approach requires that for *all* leases a lessee:

    (a) recognise a right-of-use asset and a liability to make lease payments;

    (b) amortises the right-of-use asset over the lease term or useful life of the underlying asset if shorter (typically on a straight-line basis); and

    (c) incurs interest expense on the liability to make lease payments, using the effective interest method.

2. As a consequence of the combination of straight-line amortisation of the right-of-use asset and use of the effective interest method to recognise interest expense, a lessee would typically recognise higher expenses in the earlier years of a lease than in the later years.

3. Respondents to the ED had mixed views on the approach proposed in the ED, with some suggesting that there should be two types of leases for lessees as well as for lessors. [Refer to paragraphs 15-24 of paper 5A attached.] Specifically, some respondents were concerned with the expectation that, when applying the proposals in the ED, lessees would typically recognise higher expenses in the earlier years of a lease than in the later years. These respondents supported a straight-line profit or loss recognition pattern for some, or all leases, with some thinking this recognition pattern would be closer to the pattern of cash payments made by the lessee.

This paper has been prepared for discussion at a public meeting of the Analyst Representative Group of the IASB.

The views expressed in this paper are those of the authors.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

4. The staff are discussing the attached paper (paper 5A) regarding two types of leases with the Board on 17 February 2011. That paper recommends that the boards conduct targeted outreach to obtain further input regarding an accounting approach that identifies two types of leases for both lessees and lessors. This paper forms part of that outreach. Input that we receive from the ARG at this meeting will help the boards make final decisions about the lessee accounting model, and possibly the lessor accounting model, at future board meetings.

Questions –Lessee accounting model
1. Do you prefer that: i) all lessees recognise profit or loss on a consistent basis for **all** leases and that this basis should create a higher lease expense in the early years of a lease (refer to paragraphs 26-30 and 40-44 of paper 5A for arguments in favour of the approach in the ED); or that ii) lessees recognise higher lease expense in the early years of some lease arrangements (eg those with a significant financing element) and a straight-line pattern of lease expense recognition for other lease arrangements (eg those with an insignificant financing element) (refer to paragraphs 31-37 of paper 5A)? 2. If you prefer approach ii) above, what indicators would help distinguish between those leases recognising a straight-line pattern of lease expense and those leases recognising higher lease expense in the early years? (refer to paragraphs 57-68 for a discussion of distinguishing features)? 3. If you prefer approach ii) above, would you prefer that lease expense is presented as two line items in profit or loss (interest expense and amortisation expense) or would you prefer that lease expense is presented in one operating expense line item (eg rent or lease expense)?

Lessor accounting

5. The ED proposed two approaches for lessors—a derecognition approach and a performance obligation approach.

6. According to the performance obligation approach, a lessor would:

   (a) recognise a lease receivable and a lease liability equal to the present value of lease payments; and

   (b) continue to recognise the asset that is the subject of the lease

7. A lessor would apply the performance obligation approach when the lessor's exposure to the risks and benefits associated with the underlying asset is significant (largely consistent with what is currently considered to be operating leases).

8. In all other circumstances, the lessor would apply derecognition approach, which is similar to a lessor's accounting for finance leases in current IFRSs and US GAAP. Under this approach the lessor would:

   (a) recognise a right to receive lease payments in the statement of financial position;

   (b) derecognise from the statement of financial position the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease; and

   (c) reclassify as a residual asset the remaining portion of the carrying amount of the underlying asset that represents the rights in the underlying asset that the lessor retains.

9. There was not much support for the lessor approaches proposed in the ED. During the last ARG meeting, we discussed lessor accounting using several examples of lease transactions—similar examples were used in other outreach meetings. A lot of the feedback received suggests that the current lessor accounting model is not broken, with supports for an approach similar to the current finance and operating lease model for lessors.

Questions –Lessor accounting model
1. Would you support keeping the current lessor accounting model? a) If yes, what adjustments, if any, would you make to that model? b) If not, what would you propose?