Project **Leases**

Topic **Lessee accounting: subsequent measurement**

Objective

1. Some constituents disagree with the Boards' proposal on subsequent measurement for lessees, particularly on the effect on the statement of comprehensive income. The objective of this meeting is to discuss that proposal and an alternative approach proposed by some constituents.

Approaches available on subsequent measurement

2. In the Discussion Paper (DP, paragraphs 5.5 – 5.13) and Exposure Draft (ED, paragraphs 16 and 20), the Boards proposed that a lessee would measure the following:

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

   (b) The right-of-use (ROU) asset at amortized cost, amortized on a systematic basis (which will typically be straight line) over the lease term, or over the useful life of the underlying asset if shorter.

3. Consequently, the Boards' proposals would result in the recognition of lease expenses (amortization of the right-of-use asset + interest on the liability to make

lease payments) greater than lease payments in the early years of a lease and lower than the lease payments in the later years (ED, paragraph BC9).

4. Some constituents feel that a lease contract creates assets and liabilities for which the measurement should be linked, both on initial measurement and subsequently. Consequently, unless there is an impairment of the right-of-use asset, the asset and liability should be measured on the same basis—at an amount equal to the present value of the remaining lease payments. This approach (approach 2 in the table below) results in lease expenses (amortization + interest) that are recognized on a straight-line basis throughout the life of the lease (unless there is a change in estimates, e.g., a change in lease term or in contingent rentals during the lease term). Under this approach, the right-of-use asset is amortized using an 'interest' method of amortization (also called the annuity method of amortization), which takes account the time value of money in addition to the consumption of the asset.

5. Appendix A illustrates the effects of both approaches in the financial statements using a simple example.

6. The following section compares subsequent measurement under the two approaches.

Analysis to compare each approach

Views expressed	Boards' proposal Approach 1	Proposed by constituents Approach 2
The lease expense (amortization of the right-of-use asset + interest expense) recognized should match the cash outflows because lease expenses constitute a good proxy to mirror the lease cash outflows. Note: 1) Currently finance/capital and operating lease	Lease expense will not mirror lease cash outflows.	For most leases, the lease expense recognized will reflect the cash outflows of the entity. For leases that contain rent-free access or, for IFRS applicants, if the ROU asset is revalued, the lease expense will not reflect cash outflows. Some users, particularly those who focus on particular

Views expressed	Boards' proposal Approach 1	Proposed by constituents Approach 2
accounting do not provide users with cash outflow information. Current operating lease accounting requires an entity to recognize an expense on a straight-line basis and does not reflect contingent rental payments. 2) The ED proposed requiring separate cash flow information in the statement of cash flows 3) Matching cash outflows to expenses is not consistent with the premise that financial reports are prepared on an accrual accounting basis and is inconsistent with the definition of expenses.		industries that are more cash-based (e.g., retail or hotels) support this approach because lease expense will normally match cash outflows. For some not-for-profit entities, reimbursement of services is often driven by cash paid. Lack of 'predictable expenses' (i.e., expenses that are equal throughout the life of the lease term) that match the cash outflows will not allow such entities to match their revenue (from governments) to their expenses.
Unit to account for the assets and liabilities arising from the lease contract.	Reflects the fact that the value of the right-of-use asset and liability arising from the lease are not necessarily linked after initial measurement. Subsequently, the assets and liabilities should be measured independently.	Consistent with the initial measurement approach in which the ROU asset equals the liability. For leases that are currently accounted as a finance/capital lease, this will be a change in practice.
Comparison with the subsequent measurement of other types of assets and liabilities. For example, consistent with the P&L	Consistent, thus increasing comparability for users (e.g., credit rating agencies).	Not consistent, reduces comparability. However, proponents of this approach consider that lease financing is a different transaction than

Views expressed	Boards' proposal Approach 1	Proposed by constituents Approach 2
pattern if an entity borrows to purchase the asset.		a debt financing of the ROU asset.
Consistency with the definition of amortization in existing requirements.	Amortization of the ROU asset is consistent with the amortization of other tangible and intangible assets.	Amortization under this approach would reflect the linked nature of the ROU asset and the liability for the lease. Amortization expense reflects the time value of money in addition to the consumption of the asset. For IFRSs, this method of amortization is not appropriate for intangible assets in accordance with IFRIC 12, *Service Concession Arrangements* (paragraphs BC64 – BC65).
Impairment	Less risk of impairment of the ROU asset compared to Approach 2.	If amortization is back loaded, there is an increased risk of the impairment of the ROU asset.
Profit/loss and EBIT or EBITDA effect (assuming that there is no change in assumptions; e.g., lease terms or effects on contingent rentals and income is constant). See Appendix A for a demonstration of the effect.	Profit increases as the lease matures because lease expenses decrease. EBIT and EBITDA effect is equal throughout the life of the lease. If the lessee has a growing (or expanding) business and has many newer leases, the effect of the increasing profit will be more pronounced.	Lease expenses and, therefore, profit are recognized evenly throughout the life of the lease. This reflects a view that a lease provides equal (and even) benefits throughout the life of the lease. EBIT decreases as the lease matures and EBITDA does not change.

Views expressed	Boards' proposal Approach 1	Proposed by constituents Approach 2
Deferred tax implications	Creates new temporary tax differences for entities in jurisdictions that provide tax relief only for lease rentals as paid.	Simpler (less complex) in these jurisdictions because this method is consistent with the treatment of leases for tax purposes.
Transitional provisions (if the Boards retain proposed transitional provisions): On the day of transition: ROU asset = present value of remaining lease payments.	Treatment of all leases using the simplified retrospective transition approach in the ED creates a higher profit or loss expense for lessees in the immediate years following transition.	The lease expense is measured on a constant (equal) basis.
Other issues		For IFRSs, if the ROU asset was revalued during the lease term or if the ROU asset is componentized (because some portions of the ROU asset have a shorter useful life compared to the lease contract), calculating the amortization is more complicated.

Question 1

Which approach do you prefer? Why?

Question 2

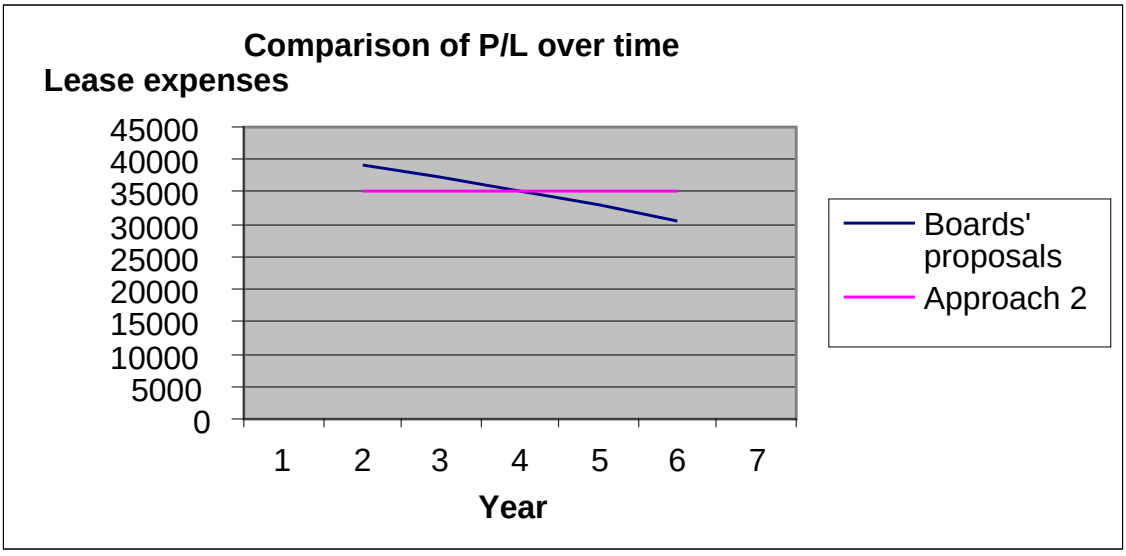
Are there other approaches that the Boards should consider for the subsequent measurement of the lessee's right-of-use asset and liability to make lease payments?

Appendix A
Illustration of both approaches for subsequent measurement

A1. This appendix illustrates the effects in the financial statements of both approaches to subsequent measurement.

> A machine is leased for a fixed term of five years. The expected life of the machine is 10 years. The lease is non-cancellable, and there are no rights to purchase the machine at the end of the contract and no guarantees of its value at that point. Lease payments of CU35,000 are due at the end of each year. The entity amortizes the machine on a straight-line basis. No maintenance or other arrangements are entered into.
>
> At the start of the lease the present value of the lease payments, discounted at the lessee's incremental borrowing rate of 8 percent, is CU139,745.
>
> Assume that the entity has a fixed revenue of CU50,000 per annum.

A2. The effects can be seen in this graph below.



Boards' proposals (Approach 1)

Amortization schedule:

Year	Liability to make lease payments beginning of the year	Lease payments	Interest	Liability to make lease payments at year end
0	139,745			139,745
1	139,745	35,000	11,180	115,924
2	115,924	35,000	9,274	90,198
3	90,198	35,000	7,216	62,414
4	62,414	35,000	4,993	32,407
5	32,407	35,000	2,593	
		175,000	35,255	

Year	**0**	**1**	**2**	**3**	**4**	**5**
Statement of financial position						
Right-of-use asset	139,745	139,745	111,796	83,847	55,898	27,949
less amortization	0	(27,949)	(27,949)	(27,949)	(27,949)	(27,949)
	139,745	111,796	83,847	55,898	27,949	0
Liability to make lease payments	139,745	115,924	90,198	62,414	32,407	0
Net asset/ (liability)	0	(4,129)	(6,351)	(6,516)	(4,458)	0
Profit or loss						
Revenue		40,000	40,000	40,000	40,000	40,000
Amortization expense	-	27,949	27,949	27,949	27,949	27,949
Interest expense on liability to make lease payments	-	11,180	9,274	7,216	4,993	2,593
Lease expense		(39,129)	(37,223)	(35,165)	(32,942)	(30,542)
Profit		871	2,777	4,835	7,058	9,458
EBIT		12,051	12,051	12,051	12,051	12,051
EBITDA		40,000	40,000	40,000	40,000	40,000

Constituents' proposals (Approach 2)

Year	**0**	**1**	**2**	**3**	**4**	**5**
Statement of financial position						
Right-of-use asset	139,745	115,924	90,198	62,414	32,407	0
Liability to make lease payments	139,745	115,924	90,198	62,414	32,407	0
Net asset	0	0	0	0	0	0
Profit or loss						
Revenue	-	40,000	40,000	40,000	40,000	40,000
Interest expense on liability to make lease payments	-	11,180	9,274	7,216	4,993	2,593
Amortization of right-of-use asset	-	23,820	25,726	27,784	30,007	32,407
Lease expense		(35,000)*	(35,000)	(35,000)	(35,000)	(35,000)
Profit		15,000	15,000	15,000	15,000	15,000
EBIT		16,180	14,274	12,216	9,993	7,593
EBITDA		40,000	40,000	40,000	40,000	40,000

* Lease expense = $\frac{[\text{Cost of machine x } (1 + \text{rate})^{\wedge}5 \text{ years}] \text{ X } [(1 - 1 + \text{interest rate})]}{[1 - (1+ \text{rate})^{\wedge}5 \text{ years}]}$

= CU35,000

Amortization for year 1 = CU35,000 – CU11,180 = CU23,820