Staff Paper

Project	**Leases**
Topic	**Confirmation of the Right-of-Use Model**

Objective

1. The purpose of this paper is to confirm the Boards' tentative decisions to apply a right-of-use (ROU) model to all lease arrangements. That is, a lessee in a lease arrangement should recognize a ROU asset representing its right to use an underlying asset during the lease term and a liability to make lease payments.

2. Although the Boards are considering all issues from both a lessee and a lessor perspective during redeliberations, this paper does not discuss the specifics of lessor accounting under a ROU model. The lessor accounting model will be discussed in a future memo.

3. This paper is organized as follows:
   (a) Summary of proposals in the leases Exposure Draft
   (b) Feedback received (from outreach activities and comment letters)
   (c) Staff analysis.

4. This paper does not discuss the following topics, which the staff will present to the Boards in other memos:
   (a) Scope (IASB Agenda Paper 5B/FASB Memo 138)
   (b) Definition of a lease (preliminary discussions held at the joint Board meeting held in February 2011)
   (c) Initial measurement (future meeting)
   (d) Subsequent measurement (future meeting).

Summary of proposals in the leases Exposure Draft

5. The leases Exposure Draft (ED) proposes that, at the date of commencement of a lease, a lessee should recognize a ROU asset and a liability to make lease payments in the statement of financial position.

Feedback Received

Summary of User Feedback

6. Almost all users noted that they presently make adjustments to capitalize operating leases for lessees. Therefore, users support applying the ROU model in principle to lessees. Some users think that this model would provide better information than the broad assumptions used today (for example, those that apply multiples to disclosed lease payments may use numbers such as six through eight, which are often carried over from past calculations that may not accurately reflect an entity's lease term or discount rate). That is particularly important for users when calculating leverage ratios because operating leases are taken into account when assessing leverage.

> We generally agree with the right-of-use model presented in the Proposed Standard…We have long viewed the accounting distinction between operating and finance leases as substantially artificial because, in both cases, the lessee contracts for the use of an asset, entering into a debt-like obligation to make periodic rental payments. As a result, we historically have adjusted reported amounts to eliminate the operating or financing distinction by capitalizing lease obligations accounted for as operating leases by corporate issuers. We principally adjust by capitalizing the net present value of disclosed future minimum lease payment commitments and by adjusting profitability and cash-flow measures used in our analysis to reflect our view of the financing nature of this activity. (CL #748)

7. However, some users said that they would still adjust the statement of financial position if a ROU model is implemented because they support a whole asset approach where the lessee would recognize the entire underlying asset during the lease term. Other users also suggested an approach that represents the lease as a single contract with both an asset and a liability component, resulting in the liability to make lease payments accounted for using the effective interest method

and the ROU asset accounted for on a basis similar to that of an interest-bearing loan.

8. Other users commented that they would find improved information on entities' long-term contractual commitments useful, regardless of whether they arise from leases or from other contractual arrangements.

Comment Letter Feedback Received

9. There was general support for the Boards' efforts to address (a) criticisms of the 'bright lines' that exist in current lease accounting guidance and (b) the objective of improving information provided to users of the financial statements by providing greater transparency and comparability. In that regard, most respondents supported the recognition of lease obligations and related assets on the lessee's statement of financial position.

10. Many respondents to the ED (which included preparers, users, industry organizations, etc.) expressed support for recognizing a ROU asset and a liability to make lease payments as a result of a contract that meets the definition of a lease.

> We support the proposed right-of-use model for lessees. We acknowledge the criticism that the existing leasing model in IAS 17 and ASC 840 fails to meet the needs of users as it does not provide a faithful representation of leasing transactions in the statement of financial position. We are therefore supportive of the boards' aim to develop a new approach to lease accounting that would ensure all assets and liabilities arising under leases are recognised in the statement of financial position.
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> We agree with the boards' analysis that rights and obligations arising in a simple lease meet the definition of assets and liabilities, respectively. As a result, for lessees we believe the 'right-of-use' model provides a better underpinning for a new standard than the current IAS 17 and ASC 840 accounting model. (CL #63)

11. However, a few respondents did not think that current requirements in Topic 840 and IAS 17 needed such fundamental reform and that, instead, improvements could be made to existing guidance (for example, through improved disclosures) and that the current requirements are well understood by users.

> The Boards have not sufficiently substantiated that IAS 17 requires such fundamental reform as entailed in the transition to right-of-use accounting. The mere assertion that assets and liabilities arising under an operating lease are not accounted for appropriately is no reasonable justification. The right-of-use model – at least as it is specifically defined in the present Exposure Draft – gives rise to new and much more profound breaches of the framework and other IFRSs. (CL #204)

12. Some respondents also noted that they did not think it was appropriate to recognize a ROU asset for all lease arrangements.

> Moreover, the proposed model presumes that all leases consist in the financing of the purchase of an asset. However, in many arrangements, lessees are not acquiring an asset but buying flexibility e.g. to be provided with the asset they need for the period they need while lessors are providing this flexibility. Therefore, considering that these lease contracts result in the recognition of an asset and a liability would deny the economics of these arrangements.
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> Thus, we do not consider that it is appropriate to consider simply that all leases result in a right-of-use asset and a liability that should be recognised in the statement of financial position of the lessee. (CL # 682)

Private Company Consideration

13. The comment letter feedback received from private companies was consistent with that of the overall feedback from other comment letters summarized in paragraphs 12–15 of this memo.

> We agree that a lessee should recognize a right-of-use asset and a liability to make lease payments. We believe such gross accounting for a lease contract allows for more informative financial reporting for the lease contract. The lessees obligation to make lease payments will be recognized in a manner similar to other obligations of the lessee. For example, if the right-of-use asset becomes impaired, that impairment can be measured and recognized without affecting the accounting for the lessee s obligation to make lease payments. (CL #66)

Staff Analysis

14. As stated in the basis for conclusions in the ED, the staff thinks that the principles underlying the proposed ROU model would address many of the problems in

existing U.S. GAAP and IFRSs. In particular, application of the model to lessees would:

(a) Reflect the assets and liabilities arising in all leases in the statement of financial position. In contrast, the existing requirements reflect only the assets and liabilities arising from leases that the entity classifies as capital/finance leases. Many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liability arising from operating leases.

(b) Result in the same accounting for the majority of leases on the statement of financial position. That would increase comparability of the statement of financial position and the income statement for users of financial statements and reduce the opportunity to structure transactions to achieve a desired accounting outcome.

(c) Be possible to apply to a wide range of leasing arrangements. For example, the measurement of a ROU asset arising from a 3-year lease of an asset with an estimated useful life of 20 years would be small relative to the value of the underlying asset. In contrast, the measurement of a ROU asset arising from a 45-year lease of an asset with a life of 50 years would more closely approximate the value of the underlying asset.

(d) Be consistent with the Boards' conceptual frameworks. A ROU asset is a resource controlled by the lessee as a result of entering into the lease (a past event) and from which future economic benefits are expected to flow to the lessee. It therefore meets the definition of an asset. A liability to make lease payments is a present obligation of the lessee arising from entering the lease, the settlement of which is expected to result in an outflow from the lessee of resources embodying economic benefits. It therefore meets the definition of a liability.

15. Some suggest that it is not possible to develop a ROU model until the conceptual framework project has advanced. However, the staff does not think that progress in individual projects should wait until the conceptual framework project is

completed. The objective of the conceptual framework project, particularly the phase on the definition and recognition of elements, is to improve and clarify existing concepts. Furthermore, the proposals under the ROU model are consistent with the existing conceptual framework and it is unlikely that future developments in the conceptual framework project would cause the Boards to revise their fundamental conclusions about the definitions of assets and liabilities arising from leases or their recognition.

16. Additionally, those that do not support a ROU model think that the model leads to the recognition of assets and liabilities for all executory contracts, including purchase orders and long-term sales and supply agreements and would inappropriately gross up the statement of financial position. However, others supported the Boards view that lease arrangements have different characteristics than other executory contracts.

17. As noted in paragraph 14, some think that the existing guidance is well understood by both preparers and users of financial statements and that the existing model is not fundamentally flawed. However, the staff thinks that when a lessee enters into a lease, it obtains a valuable right that meets the Boards' definitions of an asset. Similarly, the lessee incurs an obligation that meets the Boards' definition of a liability. At present, if a lease is classified as an operating lease, the lessee does not recognize in the statement of financial position the right to use the underlying asset or the liability to make lease payments. In addition, the existence of two very different accounting models for leases (the capital lease model and the operating lease model) leads to (a) similar transactions being accounted for very differently on the statement of financial position and (b) significant structuring opportunities.

18. Some argue that the application of the ROU model is costly and does not exceed the benefits of such a model. However, the staff has conducted numerous outreach activities (including workshops with preparers, roundtables, and meetings with users of financial statements) that suggest that many of the concerns about the difficulty of the model proposed in the ED are related to the application of the model in areas such as the definition of a lease, the measurement of options to extend or terminate a lease and the measurement of

variable lease payments, rather than the actual ROU model itself. A number of those issues were discussed in the joint Board meetings held in January 2011 and February 2011 and will be continued to be discussed by the Boards.

Staff Recommendation

19. The staff recommends that the Boards confirm the ROU model for lessees for lease arrangements because it addresses many of the problems in existing standards.

20. In particular, a ROU model:

    (a) Provides comparable information for all leases on the statement of financial position.

    (b) Faithfully reflects the assets and liabilities arising in all lease contracts. Therefore, users may no longer need to adjust many of the amounts presented in the statement of financial position for lessees to reflect the lessee's obligations in a lease contract.

Question
Question – The staff recommends that the Boards confirm the ROU model for lease arrangements for lessees. Do the Boards agree with the staff recommendation? If not, why not?