IASB/FASB Meeting
Week commencing May 16, 2011

IASB Agenda reference **2C**

Staff Paper

FASB/IASB Education Sessions
Week commencing May 9, 2011

FASB Agenda reference **170**

Project	**Leases**
Topic	**Distinguishing between lease accounting approaches**

Background and overview

1. At the April 2011 joint meetings, the Boards tentatively decided that there should be two accounting approaches for both lessees and lessors (referred to in this paper as a finance lease and an other-than-finance (OTF) lease) and that guidance similar to IAS 17, paragraphs 7-12, should be used to make the distinction between the two accounting approaches for both lessees and lessors. However, the Boards voiced concerns over simply reissuing the guidance in IAS 17 “as is” to make that distinction and asked the staff to consider supplementing the indicators from IAS 17 with some of the more favored elements of the ‘targeted outreach approach’ (Approach B in Agenda Paper 1G/FASB Memo 161), which was brought to the Boards as an alternative to the guidance in IAS 17 at the April 2011 meetings.

2. The purpose of this paper is to discuss whether to include or not include certain elements and indicators with the guidance in IAS 17, paragraphs 7-12, to distinguish between a finance and an OTF lease in the new leases guidance. The staff considered the following adjustments:

   (a) Definition of an OTF lease

   (b) Other adjustments:

(i) 'Fair value indicator'

(ii) Variable rent indicator

(iii) Embedded or integral services indicator

3. Additionally, Appendix A provides IAS 17, paragraphs 7-12, for reference purposes. Appendix B provides proposed guidance for distinguishing between accounting approaches for a lease, starting with the guidance in IAS 17 and marked to reflect the staff recommendations in this paper.

4. The staff notes that none of the changes discussed in this memo are meant to alter the Boards' tentative decision from the April joint meeting regarding the principle to use to distinguish between accounting approaches for leases. The underlying principle remains the transfer of 'substantially all of the risks and rewards incidental to ownership', and the guidance in paragraphs 7-12 of IAS 17 will be the backbone to the language governing the distinction between accounting approaches for leases in the final leases standard.

Definition of an OTF lease

5. During the April 2011 meetings, some Board members expressed interest in including language in the final leases standard to enhance the definition of an OTF lease, rather than defining it as just the inverse of a finance lease, as it currently appears in IAS 17.

6. The staff considered some of the language used as part of the 'targeted outreach approach' (Approach B in AP 1G/Memo 161) in the April 2011 joint meetings and proposes the following enhanced definition of an OTF lease, as written or with similar wording:

> A lease is accounted for as an other-than-finance lease if it does *not* transfer substantially all of the risks and rewards incidental to ownership of the underlying asset. A lease contract accounted for as an other-than-finance lease provides the lessee with the ability to (i) avoid the inflexibilities of ownership and/or (ii) mitigate the risks of ownership.

Staff analysis and recommendation

7. The staff recommends that the Boards include the guidance in paragraph 6 of this paper to expand upon the definition of an OTF lease within the new leases guidance. That is because that guidance would:

    (a) Provide an enhanced definition of an OTF lease, which some argue is currently lacking in IAS 17. Currently, paragraph 8 of IAS 17 defines an operating/OTF lease as the inverse of a finance lease (see Appendix A).

    (b) Acknowledge the feedback from preparer and user participants in targeted outreach that there are other reasons for entering into a lease contract besides financing.

    (c) Link the feedback from targeted outreach to the underlying principle in IAS 17; lease contracts entered into predominantly to avoid inflexibility and/or mitigate the risks of ownership are entered into to avoid the transfer of substantially all of the risks and rewards of ownership.

8. However, the staff notes the following disadvantages of including the guidance in paragraph 6 of this paper to define an OTF lease within the new leases guidance:

    (a) It may diminish one of the main advantages of continuing with the principle from IAS 17—operationality. Some Board members expressed concerns over the operationality of the ‘targeted outreach approach’ in the April 2011 joint meetings and may still hold those concerns with the inclusion of some of the wording used to describe an OTF lease from Approach B in AP 1G/Memo 161.

    (b) It may introduce new practice issues for the application of the definition of an OTF lease, while most practice issues for applying the guidance in IAS 17 “as is” have been identified and practice has evolved to ensure consistency under that guidance.

Question 1
The staff recommends including the following, or similar, wording to enhance the definition of an OTF lease besides the inverse of a finance lease. Do the Boards agree? A lease is accounted for as an other-than-finance lease if it does *not* transfer substantially all of the risks and rewards incidental to ownership of the underlying asset. A lease contract accounted for as an other-than-finance lease provides the lessee with the ability to (i) avoid the inflexibilities of ownership and/or (ii) mitigate the risks of ownership.

Other adjustments

'Fair value indicator'

9. Paragraph 10(d) of IAS 17 includes a 'fair value indicator' to indicate a lease that would normally be classified as a finance lease (see Appendix A). The staff notes that this indicator is commonly cited today as one of the most significant problems in current accounting for leases because it is largely perceived to be interpreted, in practice, to be identical to the '90 percent test' in paragraph 840-10-25-1(d), which is included below:

> d. **Minimum lease payments.** The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at **lease inception** over any related investment tax credit retained by the lessor and expected to be realized by the lessor. If the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

10. Because of this and the recent redeliberations in the Leases project, the staff considered whether including 'the fair value indicator' as an indicator in the final leases standard is appropriate.

Staff analysis and recommendation

11. The staff recommends that the Boards do *not* include 'the fair value indicator' as an indicator of a finance lease in the final leases guidance for the following reasons:

    (a) This indicator, if interpreted the same in practice as in Topic 840, is a distinctive bright-line test that has been cited by many constituent groups, including standard setters and preparer participants in targeted outreach, as a major flaw of the literature of Topic 840 and the implementation of IAS 17 in practice.

    (b) The staff received favorable feedback from constituent groups over excluding this indicator from the 'targeted outreach approach' presented to participants in targeted outreach and as Approach B in AP 1G/Memo 161. Thus, the staff thinks it is appropriate to also exclude this indicator from the guidance to distinguish between two lease approaches in the new leases guidance.

    (c) The remaining indicators in paragraphs 10(a)-(c) and (e) and 11 of IAS 17 (see Appendix A) are appropriate to indicate when a lease should be classified as a finance lease and the indicator in paragraph 10(d) is unnecessary.

12. However, the staff notes the following disadvantages of not including the 'fair value indicator' and arguments *for* including it in the final leases guidance:

    (a) The concepts underlying the indicator – the expected level of consumption of the benefits and value (and, thus, the level of transfer of the risks and rewards) of the underlying asset during the lease term – is still relevant as a difference between lease approaches for both lessees and lessors. The extent of return on the original investment in the underlying asset that is priced into the lease contract to be paid by the lessee (and, thus, the extent to which the lessor has transferred risks and rewards in the underlying asset to the lessee) is a relevant indicator of whether a lease should be accounted for as a finance lease or an OTF lease.

(b) The indicator is still relevant to the distinction between lease approaches, but because lease assets and lease liabilities for both approaches will now be recognized on the statement of financial position, the stress on this indicator as a bright line will be significantly reduced and the principle underlying the indicator may be evaluated more appropriately.

Variable rent indicator

13. In the 'targeted outreach approach' (Approach B in AP 1G/Memo 161), the staff proposed an indicator of an OTF lease based on variable rent:

> *Variable rent* – The contract contains significant variable (contingent) rent during the lease term that is based on the use or performance of the underlying asset.

14. Some Board members expressed interest to include this indicator in the final leases guidance during the discussion of the 'targeted outreach approach' and AP 1G/Memo 161 in the April 2011 joint meetings.

Staff analysis and recommendation

15. The staff thinks that the variable rent indicator is representative of an OTF lease and the definition of an OTF lease described in paragraph 6 of this paper. Based on the following, the staff recommends that the Boards include the variable rent indicator in the new leases guidance to indicate an OTF lease:

(a) A lease agreement in which a significant portion of the rent payments are contingent upon the occurrence of a future event represents risk sharing between the lessee and the lessor in the underlying asset and thus represents an OTF lease (or perhaps more appropriately, does *not* represent a finance lease). The lessor has not transferred substantially all of the risks and rewards of the underlying asset to the lessee because a return of the lessor's original investment in the underlying asset is not guaranteed.

(b) The Boards decided that this indicator appropriately indicated when the lessor *retained* significant risks and benefits (rewards) and should account for a lease under the performance obligation approach in the ED (paragraph B22). Thus, the indicator appropriately indicates when substantially all of the risks and rewards of ownership of the underlying asset have *not* been transferred to the lessee.

(c) If the Boards accept the staff recommendation in Question 1, the staff thinks it would be helpful to include indicators of an OTF lease along with indicators of a finance lease because an OTF lease will have a more enhanced definition. The staff thinks that only having indicators of a finance lease inappropriately creates a default approach so that a hurdle must be reached for a lease to be accounted for using an approach other than the default (that is, a finance lease).

(d) IAS 17 paragraph 12 (see Appendix A) currently includes a similar indicator as follows:

> *… If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value,* ***or if there are contingent rents****, as a result of which the lessee does not have substantially all such risks and rewards.*

16. However, the staff notes that an argument against including a new indicator of an OTF lease based on variable rent in the new leases guidance is that the inclusion of such an indicator of an OTF lease may introduce new practice issues. Most practice issues for applying the current indicators in IAS 17 have been identified and practice has evolved to ensure consistency in their application. Operationality is one of the main advantages of continuing with the principle in IAS 17, and a new indicator may reduce that advantage.

Embedded or integral services indicator

17. In the ‘targeted outreach approach’ (Approach B in AP 1G/Memo 161), the staff proposed an indicator of an OTF lease based on the level of embedded services that are integral to the right to use the underlying asset in the lease contract. That was originally proposed to participants in targeted outreach and to the

Boards at the April 2011 joint meetings as the ‘embedded or integral services indicator’:

> *Embedded or integral services* – The lease contract contains significant embedded and integral services.

18. Some Board members expressed interest during the April 2011 joint meeting to include similar wording as an indicator of an OTF lease. Thus, the staff has considered whether to include this indicator in the new leases guidance to indicate an OTF lease.

19. However, the staff rejected this as a viable indicator to include in the final leases guidance because of the following:

    (a) At the March 2011 joint meetings, the Boards tentatively decided to bifurcate services from a right-of-use asset in a contract and to account for the elements separately. The Boards tentatively decided that the lessor is always required to allocate payments among the elements and that the lessee must do so at all times, except when observable purchase prices cannot be found.

    (b) The existence of inseparable services is, in some cases, a matter for considering whether the contract meets the control element – specifically, the lessee’s ability to direct the use of the underlying asset – in the definition of the lease, as tentatively decided upon by the Boards at the April 2011 joint meetings.

    (c) An indicator of an OTF lease based on embedded services contradicts the tentative decisions discussed above in subparagraphs 19(a) and 19(b).

Summary of staff recommendations

20. The staff recommendations include the following:

    (a) Do not include the ‘fair value indicator’ (paragraph 10(d) in IAS 17).

    (b) Include the variable rent indicator.

    (c) Do not include the ‘embedded or integral services indicator’.

Question 2
Do the Boards prefer to include the guidance from paragraphs 7-12 in IAS 17 with any of the changes suggested below to distinguish between lease approaches in the new leases guidance? a. Do not include the ‘fair value indicator’. b. Include the variable rent indicator. c. Do not include the ‘embedded or integral services indicator’

Appendix A – IAS 17, paragraphs 7-12

Classification of leases

7. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

8. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

9. Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

10. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

11. Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

12. The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

Appendix B – Proposed guidance

The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards reach decisions regarding the distinction between the accounting approaches for leases in this guidance. The Boards have not yet made decisions about all of the views reflected in this appendix, and, therefore, the wording is subject to change. This appendix shows draft wording, starting with the guidance in IAS 17 Leases *and marked for the staff recommendations in this paper as well as tentative decisions reached to date.*

~~Classification of~~ <u>Accounting approaches for</u> leases

7. The ~~classification of~~ <u>accounting approach for</u> leases adopted in this ~~Standard~~ <u>guidance</u> is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

8. A lease is ~~classified~~ <u>accounted for</u> as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is ~~classified~~ <u>accounted for</u> as an ~~operating lease~~ <u>other-than-finance lease</u> if it does *not* transfer substantially all the risks and rewards incidental to ownership <u>of the underlying asset. A lease contract accounted for as an other-than-finance lease provides the lessee with the ability to: (i) avoid the inflexibilities of ownership; and/or (ii) mitigate the risks of ownership.</u>

9. Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being ~~classified~~ <u>accounted for</u> differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

10. Whether a lease is a finance lease or an ~~operating~~ <u>other-than-finance</u> lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being ~~classified~~ <u>accounted for</u> as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has <u>a significant economic incentive to exercise</u> the option to purchase the asset<u>. This is because the option to purchase</u>

is at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable ~~for it to be reasonably certain, at the inception of the lease, that the option will be exercised~~;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred; and

~~(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and~~

~~(e)~~ (d) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

11. Indicators of situations that individually or in combination could also lead to a lease being ~~classified~~ accounted for as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) ~~the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.~~ there is a significant economic incentive for the lessee to exercise an option to extend the lease.

12. The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is ~~classified~~ accounted for as an ~~operating~~ other-than-finance lease. ~~For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value., or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.~~ Examples of situations that individually or in combination would normally lead to a lease being accounted for as an other-than-finance lease are:

(a) ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value; and

(b) the contract contains significant variable (contingent) rent during the lease term that is based on the use or performance of the underlying asset.