IFRS

FASB

IASB/FASB Meeting
Week commencing 16 May, 2011

IASB Agenda reference **2I**

FASB Agenda reference **176**

Staff Paper

Project **Leases**

Topic **Lessee accounting approach**

1. The Boards tentatively decided in the April 2011 joint meeting that there should be two accounting approaches applied by lessees (refer to Agenda paper 1F / FASB memo 160). Additionally, the Boards tentatively decided that the principle and indicators in IAS 17 should be used to distinguish between approaches (refer to Agenda paper 1G / FASB memo 161).

2. The staff continues to think that there are two types of accounting approaches that should be used by lessees to account for lease contracts. Furthermore, the staff supports the tentative decisions reached in the May 2011 joint meeting on May 17, 2011 that the final leases guidance should define an other-than-finance lease as the inverse of a finance lease (a lease where substantially all of the risks and rewards are not transferred), should include a fair value indicator and a variable rent indicator and should not include an embedded or integral service indicator (refer to Agenda paper 2C / FASB memo 170).

3. Based on these tentative decisions, the staff recommends affirming the decision that there are two accounting approaches for lease and that a finance lease is accounted for in accordance with the ED proposals.

4. However, as a result of the concerns raised by the Boards in the joint meeting on May 17, 2011, the staff recommend that an other-than-finance lease uses OCI to achieve a straight-line profit or loss recognition pattern, assuming a constant pattern of consumption.

5. A summary of the accounting approaches and methods previously discussed by the boards (including staff views) are outlined in Appendix A.

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6. Subsequent to the Boards' decisions at this meeting, the staff will provide a presentation and disclosure package for the Boards' consideration.

Question
Do the Boards agree that: 1) There are two different accounting approaches for lessee accounting; 2) The accounting approaches should be distinguished using a principle of the transfer of substantially all risks and rewards of ownership, as amended (refer to paragraph 2 in this paper); 3) A finance lease is accounted for in accordance with the proposals in the ED and an other-than-finance lease is accounted for using OCI to achieve a straight-line profit or loss recognition pattern.

APPENDIX A

Lessee accounting approaches

Approach		SFP – Recognition: ROU asset & liability	SFP – Measurement: Discounted Y/N	P&L – Recognition: Amort/dep & interest expense	P&L – Recognition: Rent expense		P&L – Measurement: Straight-line	P&L – Measurement: Method of S/L
A	Exposure Draft	YES	YES	YES	NO	[a]	NO	n/a
B	OCI	YES	YES	NO	YES		YES	OCI
C	Annuity amortization/ depreciation	YES	YES	NO	YES		YES	Annuity amort/ dep
D	Undiscounted measurement	YES	NO	NO	YES		YES	Non-discounted
E	No asset or liability recognized	NO	n/a	NO	YES		YES	Operating lease acctg

(Shaded cells) Denotes key difference from Exposure Draft

[a] Approach A could be amended (Approach A') to address concerns through presentation (rent expense) and/or disclosure for some or all leases.

A1. The staff thinks that Approach A, B or C could be applied to all lease contracts by a lessee. However, the staff does not think it would be appropriate to apply Approaches D or E to all lease contracts.

Methods to distinguish between accounting approaches

A2. If the Boards decide that there should be two different approaches to accounting for lease contracts, there are a number of methods to determine which approach should be applied.

1	Transfer of risks & rewards incidental to ownership		
	A	Higher threshold – in substance purchase/sale	
	B	Substantially all (current IAS 17 principle)	[a]
	C	Lower threshold – transfer of a majority (50%)	
2	Significance of financing element		
	A	Predominant element drives accounting, either finance or other elements (exclusivity, flexibility, inability to purchase, etc.)	
	B	Default approach (finance/OTF) – all leases use one approach unless threshold met	
3	Timeframe of lease arrangement		
	A	Less than 12 months v. greater than 12 months	[b]
	B	Increase threshold – greater than 12 months (for example, 3-5 years)	
4	Type of underlying asset		
	A	By class of asset (for example real estate v. non-real estate (equipment))	
	B	Core v. non-core asset	

[a] Tentative decision of Boards to use current IAS 17 principle to differentiate between the two approaches for lease accounting.

[b] Tentative decision of Boards to allow short-term leases (those less than 12 mos.) an option to use operating lease accounting by class of asset.

A3. The staff thinks that Approaches 1 and 4A could be applied to distinguish between approaches. Additionally, some staff members think that the tentative decision regarding short-term leases should be retained.

A4. However, the staff thinks that:

(a) Approach 2 may be challenging to apply and may create misleading outcomes (for example, when applied to real estate transactions or when comparing a 1-day rental of a car with a 6-year lease of a car).

(b) Approach 3 may encourage structuring opportunities as it is a bright-line test and not principles-based. Additionally, Approach 3 may not address the concerns relating to real estate transactions.

(c) Approach 4B creates significant challenges in identifying how to define and apply 'core' versus 'non-core'.

Potential paths forward

Option	Finance lease	SPLIT	Other-than-finance lease
I	ONE MODEL: Exposure Draft (Approach A), no changes in recognition, measurement or presentation. Address concerns via presentation ("rental expense") and/or disclosure.		
II	ONE MODEL: SFP & P&L utilize ED approach, S/L impact achieved through OCI (Approach B)		
III	ONE MODEL: Annuity based amortization used for ROU asset resulting in S/L impact on P&L (Approach C)		
IV	Exposure Draft, no changes (Approach A)	Method 1 or 4A	SFP & P&L utilize ED approach, S/L impact achieved through OCI (Approach B)
V	Exposure Draft, no changes (Approach A)	Method 3	All assets & liabilities recognized on SFP and measured on an undiscounted basis (Approach D)
VI	Exposure Draft, no changes (Approach A)	Method 3 or 4A	No assets or liabilities recognized on SFP (Approach E)

A5. The staff's preferred paths forward include either a one model approach (Option I or II) or Option IV, an approach that utilizes OCI for certain lease transactions.

A6. The staff thinks that:

(d) Options V or VI may be challenged as they continue a bright-line test that may encourage structuring opportunities.

(e) Despite some support in outreach, including from working group members, there was little support for an annuity-based amortization method (Option III) due to the amortization/depreciation expense results and resulting impairment implications.