STAFF PAPER

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FASB | IASB Meeting

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Project	**Leases**		
Paper topic	Lessee accounting—introduction and overview		

CONTACT(S)	Patrina Buchanan	pbuchanan@ifrs.org	+44 207 246 6468
	Danielle Zeyher	dtzeyher@fasb.org	+1 203 956 5265

Purpose of the meeting

1. The purpose of this meeting is to decide whether to reaffirm the Boards' tentative decisions with respect to the lessee's subsequent measurement of the right-of-use (ROU) asset, or to modify them and, if so, how.
2. This paper sets out:
   (a) the reasons for re-discussing the subsequent measurement of the ROU asset,
   (b) additional feedback received on the Boards' tentative decisions,
   (c) a discussion of the rights and obligations that arise from a lease contract,
   (d) a summary of the questions for the Boards, and
   (e) a summary of the staff recommendations regarding lessee accounting.

Background

Main objectives of the project

3. The Boards' primary objective in adding a leases project to their respective agendas was to address the criticisms of the existing lease accounting model that has failed to meet the needs of users of financial statements. More specifically, many users consider leases to be financing transactions and they routinely adjust the amounts in

the financial statements in an attempt to recognise the assets and liabilities that arise from lease contracts. The Boards also concluded that lease contracts give rise to rights and obligations that meet the definition of assets and liabilities according to their respective frameworks.

4. In addition, the Boards hoped to remove the dividing line between operating and finance leases, which is often applied as a 'bright-line' in practice. The difference in the accounting on either side of that line and, in particular, the off-balance sheet treatment that lessees achieve when a contract is an operating lease, has led to some contracts being written with the sole objective of achieving a particular accounting outcome.

Reasons for re-discussing the subsequent measurement of the ROU asset

5. The Boards discussed and reached tentative decisions regarding lessee accounting at their April and May 2011 joint board meetings. Those decisions were that a lessee would recognise:

   (a) a liability to make lease payments (hereafter, referred to as 'lease liability'), initially measured at the present value of lease payments, and subsequently measured at amortised cost using the effective interest method.

   (b) a right-of-use (ROU) asset, initially measured at an amount equal to the lease liability and subsequently measured at amortised cost.

6. Those initial and subsequent measurement decisions are the same as the proposals in the 2010 *Leases* exposure draft (ED). Many respondents to the ED supported the recognition of an asset and liability by the lessee, and the initial measurement of the asset and liability at an amount equal to the discounted lease payments. However, some expressed concern about the reducing lease expense recognition profile that would arise from the Boards' proposals.

7. In response to those concerns raised, the Boards discussed some alternative ways to subsequently measure the ROU asset early in 2011 that would address the reducing lease expense recognition profile. However, after some considerable discussion, the Boards tentatively decided to retain the initial and subsequent measurement

proposals for the ROU asset and lease liability in the 2010 ED but re-expose those proposals together with other changes proposed (eg the changes proposed relating to renewal options and variable lease payments).

8. Since reaching those tentative decisions, comments and objections continue to be raised by some constituents (in particular, preparers) about the lessee accounting decisions made by the Boards early in 2011. Interestingly, there seems to be general agreement (or, at least, acceptance) that leases should be recognised on-balance sheet. However, some constituents remain concerned about the lease expense recognition profile that, in their view, does not reflect the economics of all lease transactions.

9. In light of the comments received and because of the significance of the changes being proposed to the existing lessee accounting model, both in terms of the accounting outcome (eg effect on the balance sheet, income statement and equity) and in terms of the costs involved (eg systems changes), the Boards decided that it would be appropriate to re-discuss the lessee accounting proposals *before* publishing the re-exposure document.

A summary of the feedback received regarding lessee accounting

10. There are mixed views among constituents, including within the user community, as to the best way to account for lease contracts[1]:
    (a) Some support the Boards' tentative decisions, agreeing with the Boards that a lease contract gives rise to an asset and liability for the lessee. Having reached that conclusion, they think that the most logical way to account for a lease contract is to treat it as the purchase of a non-financial asset that is financed separately. Those in support of the Boards' tentative decisions include regulators, the accounting firms, many standard setters, some preparers and some users (particularly credit analysts but also some equity analysts). Those constituents also note the benefit of having one accounting model for all lease contracts.

[1] This summary is based on feedback received in response to the 2009 Discussion Paper, in response to the 2010 ED, from targeted outreach performed early in 2011, from the working group and from other outreach performed with those within the user community.

(b) Others agree that a lease contract gives rise to an asset and liability for the lessee, but believe that the nature of a lease contract (and of the ROU asset arising from that contract) is different from purchasing a non-financial asset and financing it separately. The ROU asset and lease liability arise from the same contract and, as such, are inextricably linked. Support for this view comes mainly from the leasing industry, some other preparers and some users (mainly equity analysts).

(c) Others think that it is impossible to develop one accounting model that results in accounting outcomes that make sense for all lease contracts, given the spectrum of lease contracts that exist. They would suggest that the Boards retain different accounting models for different populations of lease contracts. Some of those constituents think that at least some lease contracts are executory contracts but would propose accounting for such contracts gross on a lessee's balance sheet.

(d) And yet others would prefer to retain the existing lessee accounting guidance, with a requirement for possibly some additional disclosures.

11. That mix of views also exists within the user community. The feedback received from the working group in January 2012 also emphasised that there is no one approach to lessee accounting that is preferred by all constituents, in part because constituents do not have a united view as to the economics of lease transactions.

12. A more complete analysis of the comments received from respondents to the 2010 ED, and from targeted outreach conducted in March 2011, is included in agenda paper 5F/memo 134 discussed at the February 2011 joint meeting, and agenda paper 1H/memo 162 discussed at the April 2011 joint meeting.

13. A summary of feedback received from working group members at the meeting held on 24 January 2012 is included in agenda paper 2A/225.

Questions for the Boards

14. In light of the diversity of views held, it is not possible to develop lessee accounting proposals that would reflect the views of all constituents. For this

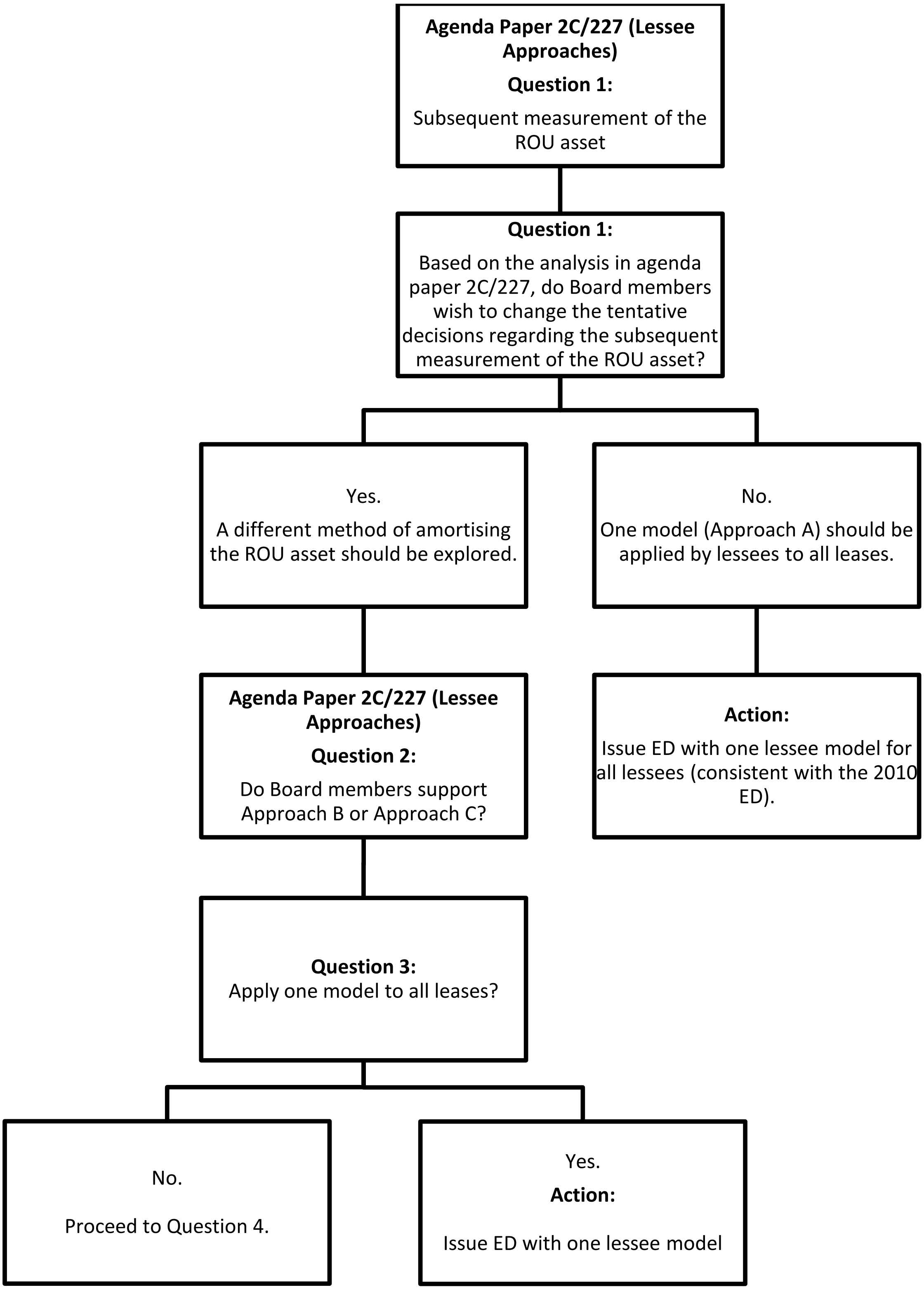
reason, we think our goal should be to develop lessee accounting proposals that, in the Boards' view:

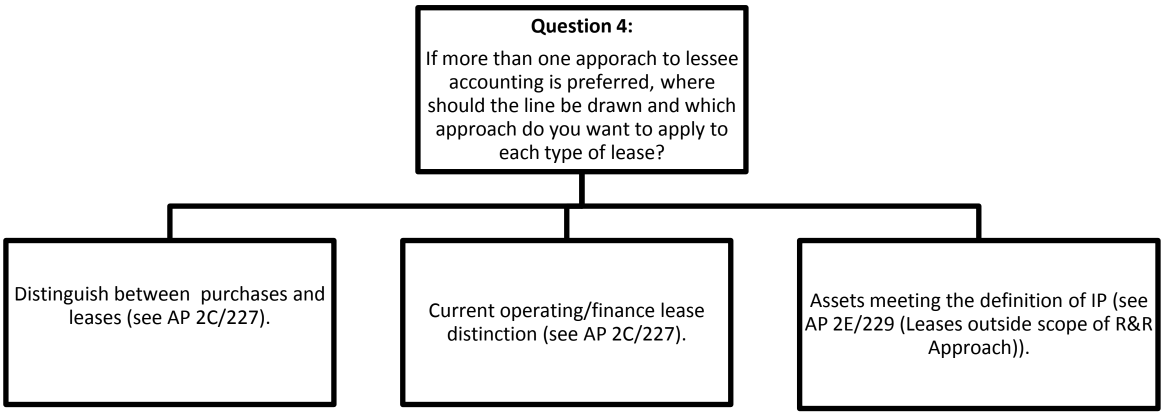
(a) provide decision-useful and relevant information that faithfully depicts the economics of lease transactions and, thereby, improves the quality and transparency of information provided by lessees;

(b) have a sound rationale that can be explained to constituents; and consequently

(c) will be generally accepted by constituents.

15. The following flowchart shows the questions for the Boards that will be asked relating to agenda papers 2C/227 and 2E/229.


Agenda Paper 2C/227 (Lessee Approaches)
Question 1:
Subsequent measurement of the ROU asset
Question 1:
Based on the analysis in agenda paper 2C/227, do Board members wish to change the tentative decisions regarding the subsequent measurement of the ROU asset?
Yes.
A different method of amortising the ROU asset should be explored.
No.
One model (Approach A) should be applied by lessees to all leases.
Agenda Paper 2C/227 (Lessee Approaches)
Question 2:
Do Board members support Approach B or Approach C?
Action:
Issue ED with one lessee model for all lessees (consistent with the 2010 ED).
Question 3:
Apply one model to all leases?
No.
Proceed to Question 4.
Yes.
Action:
Issue ED with one lessee model



The nature of a lease contract and the rights and obligations that arise from such a contract

16. The Boards have concluded that a lease contract gives rise to the following rights and obligations that meet the definition of assets and liabilities for the lessee at lease commencement:

    (a) A right to use the underlying asset throughout the lease term (recognised as a ROU asset).

    (b) An obligation to pay rentals (recognised as a lease liability).

17. Thus, the Boards have decided to treat lease contracts differently from executory contracts.[2] A lease contract is defined as one in which the right to use an asset (hereafter referred to as the 'underlying asset') is conveyed for a period of time, in exchange for consideration. Accordingly, a lease contract transfers control of the right to use the underlying asset to the lessee at lease commencement. The lessor has fully performed when the underlying asset is made available for use by the lessee and, as such, the lease contract is not an executory contract. The financing element of the transaction is the time between lease commencement when the lessor has fulfilled its obligation under the lease contract (ie the underlying asset is made available for the lessee's use) and the time all of the lease payments are collected.

[2] In this paper, we refer to an 'executory contract' as one in which neither party to the contract has performed, or both have performed to the same extent.

The lease liability

18. The lease liability recognised by the lessee (being an obligation to pay rentals) is a financial liability and, as such, is treated similarly to other financial liabilities. The Boards have tentatively decided that the lessee should initially measure the lease liability at the present value of lease payments and subsequently measure it at amortised cost, using the effective interest method. This typically results in a higher interest expense relating to the lease liability in the early years of a lease than in the later years, which is the same as other liabilities recognised on a discounted basis.

19. The staff papers do not discuss or propose any change to the Boards' tentative decisions regarding the recognition and measurement of the lease liability.

The ROU asset

20. The Boards have also tentatively decided that the lessee should initially and subsequently measure the ROU asset at cost—the lessee initially measures the ROU asset at an amount equal to the lease liability (plus any initial direct costs and prepaid lease payments) and subsequently measures it at amortised cost using a systematic basis that reflects the expected pattern of consumption of benefits from using the underlying asset.

21. Again, the staff papers do not discuss or propose any change to those tentative decisions. However, agenda paper 2C/227 does discuss different ways to amortise the ROU asset, depending on how the Boards view the nature of the ROU asset. Thus, having determined that a lessee controls the right to use the underlying asset, and recognises a ROU asset in this respect, the question arises as to the nature of this ROU asset. The answer to this question could, in our view, lead to different conclusions regarding the subsequent measurement of the ROU asset.

22. We think there are three possible ways to view the ROU asset:

    (c) As similar in nature to an intangible asset (refer to Approach A in agenda paper 2C/227)

(d) As a non-financial asset that is different from other non-financial assets because it arises from the same contract that also gives rise to the lease liability (refer to Approach B in agenda paper 2C/227)

(e) As similar in nature to the underlying asset itself (refer to Approach C in agenda paper 2C/227).

Structure of the lessee accounting papers

23. Agenda paper 2C/227 sets out three different approaches to subsequently measuring the ROU asset:

    (a) Approach A: the Boards' current tentative decisions

    (b) Approach B: the 'interest-based amortisation' approach

    (c) Approach C: the 'underlying asset' approach

24. As noted above, these approaches do *not* propose to change the Boards' tentative decisions regarding (a) the initial measurement of the right-of-use (ROU) asset and (b) the initial and subsequent measurement of the lessee's obligation to make lease payments (hereafter referred to as a 'lease liability'). Instead, Approaches B and C propose alternative ways to amortise the ROU asset.

25. In addition, it is important to note that none of these approaches would achieve a straight-line lease expense profile for all lease contracts. Some respondents to the 2010 ED suggested developing such an approach. However, having discussed ways to achieve such an outcome, we have rejected any approach that would have an objective of achieving a straight-line lease expense recognition profile, regardless of the terms of the lease contract.

26. In summary:

    (a) Approach A treats a lease contract as being equivalent to the purchase of an intangible asset, which is financed separately.

    (b) Approach B treats a lease contract differently from the purchase of a non-financial asset, which is financed separately. Lease contracts give rise to ROU assets, which are a distinct class of non-financial asset that are amortised differently from other non-financial assets.

(c) Approach C treats a lease contract as being equivalent to the purchase of the underlying asset being leased (typically, an item of property, plant and equipment (PPE)), which is financed separately.

27. Agenda paper 2D/228 provides illustrations of the application of each of the above approaches to different lease contracts.

Staff recommendations

28. Having considered the merits of each of the approaches discussed in agenda paper 2C/227 (including comments received from constituents over recent months), the staff are divided in their views.

29. Some staff recommend **Approach A**—that the Boards reaffirm their tentative decisions regarding the subsequent measurement of the ROU asset. The staff who support Approach A think that the Boards' tentative decisions have a sound rationale that is straight forward to explain and understand. Upon entering into lease contract, a lessee obtains a ROU asset and that asset is financed by the lease liability (if not prepaid). As the ROU asset is a non-financial asset, it is accounted for consistently with other non-financial assets. As the lease liability is a financial liability, it is accounted for consistently with other financial liabilities. Those staff also see benefits for all constituents, including users, in applying one lessee accounting model by removing the current operating and finance/capital lease distinction and not replacing it with a new distinction. This makes accounting simpler, more comparable and reduces structuring opportunities.

30. Other staff recommend modifying the Boards' tentative decisions.

31. Some of those who recommend modifying the tentative decisions see merits in **Approach C**. This is because it results in lessee accounting that is comparable to purchasing the underlying PPE and financing that purchase separately for a period

that corresponds to the lease term. Those staff believe that such a transaction is economically comparable to a lease and, accordingly in their view, Approach C produces decision-useful information.

32. Nonetheless, on balance, all of those staff who recommend modifying the Boards' tentative decisions recommend **Approach B** because they think that the accounting that flows from Approach B provides a more faithful depiction of the economics of lease contracts. They are of the view that lease contracts are transactions with economic substance that are not equivalent to either services or purchases of the underlying PPE. Accordingly, and because the Boards are developing a new ROU model that gives rise to a new asset (the ROU asset), they believe that there is a basis for subsequently measuring the ROU asset differently from other non-financial assets.

33. Approach B would be applied to contracts that give rise to a ROU asset. Consequently, if the Boards were to support Approach B, the staff also recommend distinguishing between such contracts and contracts that transfer control of the underlying asset (refer to the appendix of agenda paper 2C/227 for further information). This is because we think that distinguishing on the basis of the transfer of control of the underlying asset is consistent with the rationale behind Approach B and with existing PPE guidance. That rationale is that a ROU asset is sufficiently different from the purchase of the underlying asset to warrant a different method of amortisation than is conventionally applied in practice for purchases of PPE. Consequently, those staff think that it is more consistent with that thinking for a lessee to recognise a ROU asset, and not the underlying asset itself, when a lease contract does not transfer control of the underlying asset to the lessee. In addition, those staff think it is more consistent with existing PPE guidance to recognise an item of PPE only when an entity has obtained control of that item, rather than when it has entered into an 'in substance' purchase.