

STAFF PAPER

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FASB | IASB Meeting

Project	Leases
Paper topic	Lessee accounting—approaches (addendum regarding Approach C)
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Approach C—how a lessee might apply the underlying asset approach in practice***Information required by the lessee to apply Approach C***

1. In order to apply the underlying asset approach, the lessee is required to have three pieces of information:
 - (a) The lease payments
 - (b) The discount rate (which is also required under Approach A and Approach B also)
 - (c) Any one of the following:
 - (i) The fair value of the underlying asset at lease commencement.
 - (ii) An estimate of the residual value of the underlying asset at the end of the lease term.
 - (iii) An estimate of the percentage consumption (ie estimated decline in value) of the underlying asset during the lease term.
2. In practice, for example, when a lessee is making a lease or buy decision, it is likely that the lessee will have information about what it would have cost to purchase the underlying asset at the date of lease commencement. In that case, the lessee could use that fair value information about the underlying asset, together with the discount rate and the lease payments, to work out the amortisation expense for the ROU asset under Approach C.

3. Alternatively, for example, in the case of a lease of property (and in particular when a lessee leases a portion of a building (eg 2 floors of a building)), the lessee is unlikely to have information about the value of the portion of the building leased. In that case, the lessee would simply need to estimate the percentage consumption of the building over the lease term in order to apply Approach C. For example, the lessee might estimate 10% consumption of the 2 floors of a building over a 10-year lease term. Using that information, the lessee would be able to apply Approach C by inputting that information in, for example, excel and modelling the expected fair value of the underlying asset at the beginning and end of the lease term.

Sensitivity of Approach C to estimation error

4. Concerns have been raised about the operationality of Approach C for lessees. We have done some testing of Approach C in terms of its sensitivity to estimation error to assess whether Approach C could be operational.
5. Our findings are that Approach C is relatively insensitive to estimation error in calculating the percentage consumption of the asset. To illustrate, the following tables set out an airplane lease and a building lease. In both cases, it is assumed that the lessee does not have information about the fair value of the underlying asset at either the beginning or end of the lease term. Consequently, the lessee estimates the percentage consumption of the underlying asset during the lease term when applying Approach C.

Airplane - 8 year lease		Lessor assumptions		Lessee assumptions							
Assumptions:											
Lease term in years	8			8							
Interest rate	6.0%			6.0%							
FV of underlying asset	150,000										
Estimated residual value	90,000										
Portion of asset consumed (as %)	40%			32%	calculated as 8 years of 25 year assumed useful life						
Lease payments	15,062			15,062							
Periods	0	1	2	3	4	5	6	7	8		
Underlying Asset Approach (UA) - assuming the lessee has information about the fair value of the underlying asset											
Balance Sheet											
Right-of-use asset	93,533	82,645	71,554	60,247	48,712	36,934	24,900	12,594		0	
Liability to make lease payments	93,533	84,083	74,066	63,447	52,192	40,261	27,615	14,210		-	
Income Statement											
Interest on lease obligation		5,612	5,045	4,444	3,807	3,132	2,416	1,657		853	
Amortisation expense		10,888	11,091	11,307	11,535	11,777	12,034	12,306		12,594	
Total Lease Expense		16,500	16,136	15,751	15,342	14,909	14,450	13,963		13,447	
Underlying Asset Approach (UA) - assuming the lessee estimates the % consumption of the underlying asset											
Balance Sheet											
Right-of-use asset	93,532	82,832	71,880	60,663	49,164	37,367	25,253	12,804		0	
Liability to make lease payments	93,533	84,083	74,066	63,447	52,192	40,261	27,615	14,210		-	
Income Statement											
Interest on lease obligation		5,612	5,045	4,444	3,807	3,132	2,416	1,657		853	
Amortisation expense		10,701	10,952	11,217	11,499	11,797	12,114	12,449		12,804	
Total Lease Expense		16,313	15,997	15,661	15,306	14,929	14,529	14,106		13,657	
Total Lease Expense											
Underlying Asset Approach (assuming perfect information)	16,500	16,136	15,751	15,342	14,909	14,450	13,963	13,447			
Underlying Asset Approach (assuming lessee's estimates)	16,313	15,997	15,661	15,306	14,929	14,529	14,106	13,657			

BUILDING - 10 year lease		Lessor assumptions		Lessee assumptions								
Assumptions:												
Lease term in years	10			10								
Interest rate	6.0%			6.0%								
FV of underlying asset	1,000											
Estimated residual value	880											
Portion of asset consumed (as %)	12%			5%								
Lease payments	69			69								
Periods	0	1	2	3	4	5	6	7	8	9	10	
Underlying Asset Approach (UA) - assuming the lessee has information about the fair value of the underlying asset												
Balance Sheet												
Right-of-use asset	509	467	424	379	332	282	231	177	121	62	0	
Liability to make lease payments	509	470	429	386	340	291	239	185	127	65	-	
Income Statement												
Interest on lease obligation		31	28	26	23	20	17	14	11	8	4	
Amortisation expense		41	43	45	47	49	51	54	56	59	62	
Total Lease Expense		72	71	71	70	70	69	68	67	67	66	
Underlying Asset Approach (UA) - assuming the lessee estimates the % consumption of the underlying asset												
Balance Sheet												
Right-of-use asset	509	469	427	383	336	287	236	181	124	64	0	
Liability to make lease payments	509	470	429	386	340	291	239	185	127	65	-	
Income Statement												
Interest on lease obligation		31	28	26	23	20	17	14	11	8	4	
Amortisation expense		40	42	44	46	49	52	54	57	60	64	
Total Lease Expense		70	70	70	70	69	69	69	68	68	68	
Total Lease Expense												
Underlying Asset Approach (assuming perfect information)	72	71	71	70	70	69	68	67	67	66		
Underlying Asset Approach (assuming lessee's estimates)	70	70	70	70	69	69	69	68	68	68		