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Introduction

1. This paper sets out three different approaches to subsequently measuring the right-of-use (ROU) asset recognised by the lessee:

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

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

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

2. 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.

3. The questions for the Boards relating to this paper are included in agenda paper 2B/226.

Approach A: Boards' current tentative decisions

Overview of the Boards' tentative decisions

4. The Boards have tentatively decided 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 ROU asset, initially measured at an amount equal to the lease liability and subsequently measured at amortised cost. The ROU asset would be amortised consistently with other non-financial assets, using a systematic basis that reflects the expected pattern of consumption of benefits from using the underlying asset.

5. Under Approach A, the lessee's total lease expense for an individual lease would typically decrease over the lease term because (a) the interest expense is based on the liability balance, which decreases as the lessee makes payments and (b) the ROU asset would typically be amortised on a straight-line basis.

6. Refer to illustrations 1 and 2 of agenda paper 2D/228 for an illustration of the application of the Boards' tentative decisions to an individual lease contract.

Rationale for the Boards' tentative decisions

7. As explained in agenda paper 2B/226, under a lease contract, a lessee obtains a ROU asset. That ROU asset is a non-financial asset, which Approach A proposes to measure consistently with other non-financial assets. The lease liability is a financial liability, which is measured consistently with similar financial liabilities. The components of the lease contract (that is, the ROU asset and the lease liability) are recognised separately—although linked on initial measurement, they

are subsequently measured independently of each other. The manner in which an asset is financed is not a relevant factor when subsequently measuring that asset on a cost basis, which is consistent with accounting for other assets. The amortisation or depreciation pattern is based on the expected pattern of consumption of benefits from the asset and there is no relationship between the pattern of consumption of benefits and the manner of financing.

Reasons to support the Boards' tentative decisions

8. The subsequent measurement of the ROU asset and the lease liability, and the reducing lease expense recognition profile that results from that measurement, can be supported conceptually. As noted above, the ROU asset is a non-financial asset, which the lessee typically pays for over time. Therefore, supporters of this approach would argue that a lease contract is no different from purchasing any other non-financial asset and separately financing that purchase, and should be accounted for as such.

9. The Boards' tentative decisions are straight-forward—all lease contracts are accounted for similarly to financing the purchase of a non-financial asset. The tentative decisions eliminate the need to draw a distinction between different types of leases contracts or between the lease and purchase of an asset. In that respect, the Boards' tentative decisions reduce complexity.

10. The reducing lease expense recognition profile may not be significant in many circumstances because of the effect of holding a portfolio of leases that begin and end at different times. The following table illustrates the effect on the income statement for a lessee with multiple lease contracts. The example demonstrates that the reducing lease expense recognition profile would often be far less pronounced when a lessee has many leases that begin and end in different reporting periods. It should be noted, however, that the example is simplistic (it assumes consistent lease payments, discount rate and volume of leases). Nonetheless, it does demonstrate that the reducing lease expense recognition profile would often not be as pronounced for a portfolio of leases in a steady state

as it would be for an individual lease or a lessee that is increasing its lease portfolio.

Year of reporting	Lease commencing in									*Total lease expense per year*
	2015	2016	2017	2018	2019	2020	2021	2022	2023	
2019	88	95	100	106	111					500
2020		88	95	100	106	111				500
2021			88	95	100	106	111			500
2022				88	95	100	106	111		500
2023					88	95	100	106	111	500

11. The Boards' tentative decisions include several disclosure requirements for lessees that should provide users with information to help understand the lease expense recognised in the current period and the cash flows for the current and future periods. Those requirements include disclosure of both total lease expense and the breakdown of the different elements of lease expense recognised in the reporting period, in a tabular format, to be followed by disclosure of the principal and interest paid on the lease liability. In addition, the disclosure requirements include a summary of undiscounted cash flows included in the lease liability for each of the next five years (at a minimum) and the remaining periods in the aggregate. These disclosures should facilitate identifying the amount of lease payments made in the period and using the information to make projections about future periods.

12. Some users of financial statements, particularly credit analysts, but also some equity analysts, support the Boards' tentative decisions in terms of the effects on both the balance sheet and income statement. They have viewed leases to be similar to financing the purchase of an asset for many years and believe that the tentative decisions are a significant improvement compared to existing standards. In particular, some have noted that the tentative decisions are relatively straight-forward to understand and treating all leases on a similar basis (thus removing the current operating/finance lease distinction) is a significant improvement compared to existing standards. The lessee decisions are also generally supported by auditors, and supported by some preparers.

13. The purpose of the income statement is not to reflect cash flows—that is the purpose of the cash flow statement. There is sometimes a difference between an operating lease expense and cash flows under existing standards because the expense is recognised on a straight-line basis and the payments can change each period (for example, when there are fixed rental increases or rent-free periods included in a lease). Consequently, if users wish to identify actual cash flows associated with leases, they are currently required to make adjustments to the amounts recognised in the income statement under existing standards.

Concerns about the Boards' tentative decisions

14. Some constituents think the Boards' tentative decisions, and more specifically the reducing lease expense recognition profile, do not reflect the economics of all lease transactions. Their reasons include the following:

    (a) Some think that lease contracts, which do not transfer control of the underlying asset to the lessee, are not the same as purchasing a non-financial asset and separately financing that purchase. The asset and liability that arise from a lease contract are inextricably linked. In a typical lease, the lessee receives equal benefits from use of the asset and pays equal amounts in each period. Those constituents, therefore, see no reason for allocating the total cost of the lease so that proportionately more total lease expense is recognised in the earlier years of a lease than in the later years.

    (b) Some users prefer a more even lease expense recognition pattern. In their view, this would provide more useful information about a lease. Those users are not suggesting that the income statement become a cash flow statement. However, they think that there needs to be strong arguments made for a model that results in a lease expense that is further from actual cash flows and would not reflect that the lessee typically obtains equal benefit from the lease in each period. Those users think the proposed expense recognition pattern (interest expense and amortisation expense) adds complexity to the analysis of financial statements. They

would suggest that it is likely to require analysts to make various adjustments to the income statement figures, negating much of the expected benefit for users from including lease assets and liabilities on a lessee's balance sheet.

15. Many who support the Boards' tentative decisions do so because they view a lease as being equivalent to financing the purchase of an item of PPE. Consequently, they think that leases should be accounted for consistently with purchases of PPE. Although enhancing comparability between items of PPE that are leased and those that are purchased, the Boards' tentative decisions do *not* result in comparable amounts being recognised, unless the ROU is for all (or close to all) of the useful life of the underlying asset. The only way to ensure comparability between the lease and purchase of an asset would be to apply an approach that focuses on the underlying asset (see paragraphs 43-59 of this paper for further information about the underlying asset approach).

16. Even if a lessee is in a 'steady state' (as referred to in paragraph 10 of this paper) in having a static number and profile of lease contracts, the Boards' tentative decisions will result in a potentially significant decrease in the equity of the lessee. This is because the lease liability will be higher than the ROU asset throughout the lease term. Those who disagree with Approach A do not think that such a permanent reduction in a lessee's equity is an accurate depiction of the financial position of a lessee. They would note that, if the ROU asset and the lease liability (which both arise from the same contract) were to be measured at fair value, the reduction in equity (if any) would be likely to be much less significant for a lessee.

Approach B: Interest-based amortisation approach

Overview of the 'interest-based amortisation' approach

17. The 'interest-based amortisation' approach proposes that a lessee would subsequently measure the ROU asset at amortised cost at the present value of

remaining economic benefits, discounted using the discount rate used to initially measure the ROU asset.

18. Under this approach, the lessee could either:

    (a) present the amortisation charge on the ROU asset separately from the interest expense on the lease liability in the income statement, similarly to the Boards' current tentative decisions; or

    (b) present the amortisation charge on the ROU asset together with the interest expense on the lease liability as one amount—lease expense—in the income statement. The lessee would then disclose those two components separately as part of the roll-forward disclosures for the ROU asset and lease liability.

19. If the Boards support this approach, the staff, on balance, would recommend presenting one total lease expense in the income statement, with the two components making up that amount presented in the notes.

20. Under Approach B, the total lease expense for an individual lease would typically be more even over the lease term than under Approach A. This is because the lessee would take account of the time value of money when subsequently measuring both the ROU asset and the lease liability. The amortisation charge on the ROU asset would typically be lower in the early years of a lease, offsetting the higher interest expense on the lease liability in those years.

21. Refer to Illustrations 1 and 2 in agenda paper 2D/228 for the mechanics of the 'interest-based amortisation' approach. The appendix to this paper discusses the population of lease contracts to which the 'interest-based amortisation' approach would apply, should the Boards support the approach.

Rationale for the 'interest-based amortisation' approach

22. As noted previously, the Boards have tentatively decided to subsequently measure the ROU asset at amortised cost using a systematic basis that reflects the expected pattern of consumption of benefits from using the underlying asset. Supporters of

Approach B would argue that an interest-based amortisation approach does just that.

23. If everything is perfectly valued, the cost of (ie consideration paid for) an asset would be the present value of the future economic benefits expected to be derived from that asset, taking into account the time value of money. Thus, when allocating that cost over the period of expected use through depreciation or amortisation, arguably the best measure of the economic benefits consumed in any period would be the expected change in the value of those benefits over that period. This is what an interest-based amortisation/depreciation method seeks to achieve.

24. Interest-based methods of amortisation take into account the time value of money when allocating the cost of an asset over its period of expected use. The amortisation charge is adjusted, based on the economic benefits expected to be consumed in each period, to take account of the implicit interest cost of acquiring those benefits some time before they are consumed.

25. Because the ROU asset is acquired at lease commencement, the economic cost of the benefits consumed in later years is greater as a result of the implicit interest cost of acquiring those benefits some years in advance of their consumption. Consequently, this approach would result in a higher amortisation charge in the later years of a lease (and lower in the early years) than under Approach A.

Effect of this approach in the context of leasing

26. For a typical lease in which the lessee expects to obtain (or consume) benefits from using the underlying asset evenly over the lease term and pays even amounts over the period that the benefits are consumed, this approach would result in a straight-line total lease expense. That lease expense pattern would reflect the fact that, when considering the lease contract as a whole, essentially there is no financing effect because the lessee is paying for, and consuming the benefits from, the ROU asset in the same reporting period. Consequently, supporters of this approach would argue that it is appropriate that the total lease expense in each

period would equal the amount of cash paid (refer to illustrations 1 and 2 in agenda paper 2D/228).

27. In contrast, if the lessee makes prepayments or there are rent-free periods such that the cash payments and the consumption of benefits do not occur in the same reporting period, the total lease expense would not be straight-line, nor should it be. There could be an overall financing effect in such leases, even when considering the lease contract as a whole, because for example the lessee is essentially receiving financing from the lessor if there are rent-free periods at the beginning of a lease. The lessee has the right to use the asset and typically would be expected to consume benefits from use during those rent-free periods, even though it does not pay for those benefits until later periods. Refer to illustration 4 in agenda paper 2D/228 for an example of the application of Approach B to lease contracts for which the timing of cash payments and consumption of benefits are different.

The nature of the ROU asset

28. The 'interest-based amortisation' approach would permit amortisation of the ROU asset using a method that is different from the methods conventionally used to amortise or depreciate non-financial assets. Although many of those supporting this approach would argue that this method of amortisation is consistent with the principles for depreciation/amortisation in existing PPE and intangibles guidance, Approach B would result in subsequently measuring a ROU asset differently from PPE or intangible assets, in the light of how existing guidance is applied in practice.

29. Consequently, the rationale supporting Approach B is that a lease contract gives rise to rights and obligations that are different from those that arise from purchasing a non-financial asset and separately financing it. The ROU asset and the lease liability arise from the same enforceable contract and, accordingly, are inextricably linked. As a consequence, the ROU asset could be viewed as being different from other non-financial assets (and from the underlying asset itself). In

fact, some would say that this is the essence of the changes that the Boards are proposing in the leases project.

30. Existing lease accounting guidance focuses on the underlying asset itself. The test as to whether a lessee recognises an asset and liability is whether the lessee has, in substance, purchased the underlying asset. If that is the case (ie the contract is a finance/capital lease), the lessee recognises and measures the underlying asset, and the contract is essentially accounted for similar to the purchase of PPE that is financed separately. In contrast, if the lessee has not 'purchased' the underlying asset, the contract is accounted for similar to a service.

31. In fact, existing standards could be viewed as not including an accounting model for leases—the existing standards split lease contracts into two types which are either accounted for as purchases of the underlying asset (ie finance/capital leases) or as services (ie operating leases).

32. The ROU model the Boards have developed is different. A lessee is required to recognise a ROU asset and a lease liability for all leases. The initial measurement of the ROU asset flows from that measurement of the liability. Although the definition of a lease focuses on the underlying asset in distinguishing between a lease and a service, the asset that is recognised (the ROU asset) is not the underlying asset itself.

33. Many supporting Approach B would argue that a lease is a transaction with economic substance, which falls somewhere between a service and purchasing the underlying asset:

    (a) A lease is not equivalent to a service because the lessee controls the right to use the underlying asset when the asset is made available to it by the lessor. The lessee has obtained the right to use the asset, and the lessor has performed under the lease, at lease commencement.

    (b) A lease is often not equivalent to the purchase of the underlying asset, particularly when the lessor retains more than insignificant residual value risk. The lessee cannot sell or pledge the underlying asset, is often restricted in the ways that it can use the underlying asset and typically

does not take on the residual asset risk. Indeed, many real estate assets are leased because they cannot be purchased.

34. The Boards have already recognised this difference in the ROU model, whereby a lessee recognises a new asset—a ROU asset—that is different from other assets. On this basis, supporters of Approach B would argue that the Boards could justify proposing accounting for the ROU asset that is different from both executory contract accounting and the accounting for the purchase of the underlying asset.

35. In addition, they note that if a contract titled as a lease is equivalent to the purchase/sale of the underlying asset (eg if the lessor does not retain residual value risk), then under this approach, such a contract would be accounted similarly to purchasing the underlying asset and financing it separately (refer to the appendix to this paper for a discussion about distinguishing between a lease and a purchase).

Reasons to support the 'interest-based amortisation' approach

36. Supporters of the 'interest-based amortisation' approach would argue that this method of amortisation is generally consistent with the principles for depreciation/amortisation in existing standards, ie in their view, it is a method of amortisation that systematically allocates the cost of the asset on a basis that reflects the pattern in which future economic benefits are expected to be consumed by the lessee. Consequently, this approach is a way of addressing the front-loaded expense effect concerns raised about the Boards' tentative decisions, in a way that those supporters would contend has a sound conceptual basis.

37. This approach would measure the ROU asset at an amount that is likely to be close to a current measurement value (excluding variable lease payments and term options if the lessee does not have a significant economic incentive to extend the lease), assuming that there are no significant movements in market rates during the lease term. This arguably would provide better information about the value of the ROU asset to users of financial statements.

38. Supporters of this approach highlight that this approach is not a means to achieve a straight-line lease expense. In fact, as mentioned in paragraph 27 above, it

would not achieve a straight-line lease expense in some circumstances. They view it simply as another way to allocate the cost of the ROU asset in a manner that better reflects the economics of a lease contract by taking account of the time value of money when subsequently measuring both the ROU asset and lease liability.

39. In addition, it is worth noting that this approach would not always result in a lower amortisation charge in the early years of a lease. As shown in illustration 4 in agenda paper 2D/228, if the lessee expects to obtain greater benefit from use of the asset in the early years of a lease, then the amortisation charge under Approach B would be more in those early years than in later years, reflecting the higher consumption of benefits from the ROU asset in the early part of the lease (although the amortisation profile under Approach B would be flatter than under Approach A).

Concerns about the 'interest-based amortisation' approach

40. Those who think that a lease and a purchase of an asset should be accounted for consistently would argue that it is inappropriate to permit or require the use of interest-based amortisation for ROU assets, without also permitting this approach for PPE and intangible assets. An entity is explicitly prohibited from using interest-based depreciation/amortisation when subsequently measuring non-financial assets under US GAAP. Although not explicitly prohibited in IFRSs, we understand that practice has developed to effectively prevent the use of interest-based amortisation methods when subsequently measuring non-financial assets under IFRSs. Permitting the use of interest-based amortisation for non-financial assets would be a significant change in financial reporting. Changing the requirements for PPE and intangible assets would also go beyond the scope of the leases project.

41. Because leases would be accounted for differently from purchases of PPE, this approach requires the Boards to distinguish leases and purchases (see the appendix to this paper).

42. Some are opposed to interest-based amortisation because they think that it has not been demonstrated that this method of progressive amortisation reflects an acceptable pattern of consumption of a non-financial asset.

Approach C: the 'underlying asset' approach

Overview of the 'underlying asset' approach

43. The 'underlying asset' approach looks to how a lease contract is typically priced to justify applying a different amortisation method to the ROU asset than under Approach A.

44. The lessee would initially measure the ROU asset similarly to the Boards' tentative decisions. The amortisation charge relating to that ROU asset would then be calculated as the sum of two components: (a) depreciation on the piece of the underlying asset expected to be consumed by the lessee over the lease term (see paragraph 49 below for further information) and (b) unwinding of discount on the expected value of the underlying asset at the end of the lease term (at the interest rate used to initially measure the ROU asset).

45. The resulting lease expense profile under the 'underlying asset' approach would vary based on the level of consumption of the underlying asset over the lease term. The greater the consumption of the underlying asset over the lease term, the steeper the total expense profile would become, and vice versa.

46. Refer to Illustrations 1 and 2 in agenda paper 2D/228 for the mechanics of the 'underlying asset' approach.

Rationale for the 'underlying asset' approach

47. The 'underlying asset' approach, as its name suggests, focuses on the underlying asset when subsequently measuring the ROU asset. Under this approach, a lease is treated as the purchase of the piece of the underlying asset that the lessee is expected to consume over the lease term. The total lease expense recognised in each period under Approach C is exactly the same as the total income statement effect from purchasing an asset and separately obtaining a loan to finance the

purchase, when the asset is expected to be sold after a period of use that is the same as the lease term (see illustration 5 in agenda paper 2D/228).

48. The rationale for this approach is based on how a lessor prices many lease contracts and, thus, on what the lessee is paying for when making lease payments. Rationally, a lessor would wish to charge lease payments that cover three components: (a) a payment for the part of the asset that the lessee consumes during the lease term (ie the expected decline in value of the asset over the lease term); (b) finance charged on that part of the asset consumed because the lessee typically pays for it over the lease term; and (c) a required return on the residual value of the asset (ie the part of the asset that the lessee does not consume) because the residual asset cannot be used by the lessor while under lease. The required return on the residual value of the underlying asset would be a flat charge because the lessee is not paying the lessor for the residual asset during the lease term—the lessee simply returns the residual asset at the end of the lease term. Therefore, the return on the residual asset is economically similar to an interest-only loan.[1] Consequently, the profile of the interest piece of the lease payments is flatter than implied by the Boards' tentative decisions when the underlying asset has any residual value at the end of the lease term.

49. If applied to all leases, the 'underlying asset' approach would produce an expense recognition pattern that varies based on the extent to which the value of the underlying asset changes over the lease term. This varying level of change in asset value over the lease term is described in this paper in terms of 'consumption' of the asset—how much of the underlying asset is the lessee expected to consume during the lease term. The percentage consumption would be equal to the expected change in asset value over the lease term divided by the initial value of the underlying asset. For example, a underlying asset with an initial fair value of CU1,000 and an expected residual value at the end of the lease term of CU900 would have 10% consumption ((CU1,000 – CU900) / CU1,000).

[1] The finance charged on the part of the asset consumed by the lessee is economically similar to a loan for which the borrower makes principal and interest payments during the term of the loan.

50. The lower the percentage consumption of the underlying asset over the lease term, the flatter the lease expense profile that would result from this approach. At the extreme, if the value of the underlying asset is expected to be the same (or higher) than its value at lease commencement (eg a short-term real estate lease), all of the lease payments made by the lessee would represent a straight-line lease expense over the lease term. In contrast, if the value of the underlying asset declines to zero over the lease term, the 'underlying asset' approach yields a reducing lease expense recognition pattern that is the same as the Boards' tentative decisions. Refer to illustration 3 in agenda paper 2D/228 for an example of the varying lease expense profiles that result from applying Approach C to leases of assets with differing estimated consumption over the lease term.

Reasons to support the 'underlying asset' approach

51. The 'underlying asset' approach treats a lease as the purchase of a piece of the underlying asset that is financed separately. Supporters of Approach C would argue that this is the most faithful depiction of a lease contract and, consequently, would provide useful and understandable information to users of financial statements and, in particular, non-accountants. This is because Approach C results in accounting for a lease contract (in terms of the overall effect on the balance sheet and income statement) on a comparable basis to a real world transaction, ie the purchase of an item of PPE for which the purchaser obtains financing. The longer the lease term as a proportion of the useful life of the asset (and thus the more the lease contract is economically similar to financing the purchase of the asset), the more the total expense recognition profile would mirror the profile that would result from purchasing the asset and financing it separately.

52. The 'underlying asset' approach is a single approach to lessee accounting that can justify both a straight-line and reducing lease expense recognition profile depending on the consumption of the asset's value over the lease term. It could be applied to all leases, without the need to distinguish between different types of leases, or between a lease and a purchase.

53. Under the ‘underlying asset’ approach, the lessee would not be required to determine the fair value of the underlying asset or estimated future value of the residual asset. Instead, the lessee would only be required to estimate the percentage consumption of the underlying asset over the lease term. The percentage consumption of the underlying asset, in conjunction with assumptions related to lease term, lease payments, and discount rate, is sufficient to be able to apply the approach. Some would argue that this is no more difficult for many leases than estimating the residual/salvage value or the useful life of items of PPE.

54. Despite this, some may still have concerns about the subjectivity associated with estimating the percentage consumption of the underlying asset over the lease term. Would a lessee be able to estimate the percentage consumption with sufficient reliability? The staff have performed sensitivity analysis, with respect to the effect on the amortisation charge in each period, of estimation error relating to the consumption of the underlying asset (note: the total amortisation charge over the lease term will always be exactly the same as under Approaches A and B because the initial measurement of the ROU asset is the same as under those approaches). We have found that the resulting amortisation charge profile does not differ significantly, even when the estimate of consumption varies by 10-15%. For example, a 10% estimation error on an 8-year lease (ie the percentage consumption over the lease term was estimated to be 30% when it should have been 40%), using a discount rate of 6%, would lead to a maximum amortisation charge error in any one year of 2%. The shorter the lease, and the lower the interest rate, the less sensitive the amortisation charge is to estimation error. We have therefore concluded that a reasonable estimate of consumption of the underlying asset by the lessee would provide very similar accounting outcomes to those that would result from having perfect information.

55. Supporters of this approach consider the resulting amortisation to be a ‘systematic and rational’ method of cost allocation and thus, in their view, is consistent with the principles for depreciation/amortisation in existing standards.

Concerns about the 'underlying asset' approach

56. The 'underlying asset' approach is the least tested of the approaches proposed in this paper in terms of obtaining constituents' views. Those who are opposed to the Boards' tentative decisions may also be opposed to this approach because the outcome from applying this approach can be very similar to applying Approach A in many situations.

57. Despite the comments above regarding operationality, the 'underlying asset' approach is the most complex (of the three approaches in this paper) to apply from the lessee's perspective. This is simply because the lessee must estimate the percentage consumption of the underlying asset, as well as determine the discount rate, lease term and lease payments, to apply the approach. In response to that concern, practical expedients could be used when Approach C:

    (a) When the lease is for a large part of the useful life of the underlying asset, the accounting that results from applying Approach C would be similar to that which would result from applying Approach A, yet Approach A is likely to be simpler to apply. Accordingly, Approach A could be applied to particular leases with such characteristics.

    (b) For many real estate leases, there may be little, if any, consumption of the asset. For example, we understand that when pricing real estate contracts, the underlying real estate is expected to retain substantially all of its value if the lease is for less than 5 years. Even for a 10-year commercial property lease, the underlying asset could be expected to retain up to 90% of its value at lease commencement (taking into account expected inflation over that 10-year period). Accordingly, a lessee could assume 0% consumption in particular situations.

58. Because this approach is more complex to apply than the other approaches, some think it would be difficult to explain to constituents, including analysts.

59. Some are concerned about the verifiability of the estimations related to percentage consumption of the underlying asset. They think that the only way to verify the

estimates would be to estimate the fair value of the underlying, thereby making the approach potentially costly to apply.

APPENDIX

Distinguishing between the lease and purchase of an asset

A1. If the Boards support Approach B—the interest-based amortisation approach, there is a need to distinguish between the lease and purchase of an asset.

A2. The 'line' distinguishing between lease contracts that give rise to a ROU asset and contracts for the purchase of an asset could potentially be drawn in two different places.

Lease contracts that give rise to a ROU asset instead of an item of PPE

A3. Under this approach, a lessee would distinguish between lease contracts that give rise to a ROU asset and those that transfer control of the underlying asset to the lessee. Control in this context could be defined similarly to the revenue recognition proposals. If a contract is in the form of a lease but the terms of the contract are such that the lessee obtains control of the underlying asset, then the lessee would account for the transaction as a purchase of the underlying asset. In that case, the purchaser would recognise the underlying asset itself (and not a ROU asset), subsequently measuring it in accordance with, for example, PPE guidance. All other lease contracts would be accounted for according to the 'interest-based amortisation' approach. This approach is likely to result in some leases currently classified as finance/capital leases being accounted for under the 'interest-based amortisation' approach and some continuing to be accounted for similarly to the purchase of an asset.

A4. The main advantage of this approach is that it works well with the revenue recognition proposals and PPE guidance. When a lessee obtains control of an asset, it simply follows other pieces of literature when subsequently measuring the asset that arises from that contract.

A5. The main disadvantage is that it retains a 'line' that is a new line, and which may give rise to new implementation questions about exactly where that line should be drawn (eg at 95%, 98%, 99.9%). Some would view any change to a lessee's

accounting for current finance leases, which would reduce comparability with the purchase of an asset, as a step backwards.

The current operating/finance lease distinction

A6. Lease contracts that give rise to the recognition of a ROU asset could be determined to be only those that are currently considered to be operating leases, perhaps using the IAS 17 *Leases* principle and indicators as the basis for that distinction. A finance/capital lease could be viewed, and accounted for, as an 'in substance' purchase of the underlying asset by the lessee, whereas the 'interest-based amortisation' approach would be applied to current operating leases.

A7. The main advantage of this approach is that the 'line' drawn is the same as, or close to, the line drawn in current lease accounting literature. Finance/capital leases would continue to be accounted for similarly to how they are accounted for today. Accordingly, constituents would be familiar with applying that line in practice. Users of financial statements are also generally supportive of the current accounting for finance leases.

A8. The main disadvantage of this approach is that the leases project would fail to remove or change the dividing line between operating and finance leases, which is often applied as a 'bright-line' in practice. Some users have also noted the benefit of removing the current line and accounting for *all* leases on a consistent basis. However, because all leases (except short-term leases) would now be on-balance sheet, if the Boards decide to retain the current operating/finance lease distinction, there would be less incentive to structure contracts solely to achieve a particular accounting outcome. The line would affect only the pattern of lease expense recognition.

A9. In addition, retaining the operating/finance lease split from a lessee's perspective would also suggest that such a split should also be retained from a lessor's perspective.