STAFF PAPER

24 January, 2012

Working Group Meeting

Project	**Leases**
Paper topic	Lessee Accounting

Background

1. The 2009 *Leases* discussion paper (DP) and 2010 exposure draft (ED) proposed that a lessee 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.

2. Many respondents 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 lease expense recognition profile that would arise from the Boards' proposals (referred to in this paper as the 'front-loaded expense effect'). Many were also concerned about the costs of applying the lease accounting proposals, noting in particular the proposals in the 2010 ED relating to variable lease payments and lease payments in optional periods. The Boards have addressed many of the concerns raised during their 2011 redeliberations (eg the tentative decisions regarding the definition of a lease, short-term lease contracts, variable lease payments and options to extend or terminate a lease). However, having discussed alternatives to address the concerns raised about the front-loaded expense effect, 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.

3. Since reaching those tentative decisions, comments and objections continue to be raised by constituents 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, those constituents remain concerned about the front-loaded expense effect that, in their view, does not reflect the economics of all lease transactions.

Structure of the paper and questions for working group members

4. This paper (Working Group Paper 2) explains the Boards' current tentative lessee accounting decisions, and sets out a number of alternative approaches that the Boards could adopt, including the reasons for, and concerns about, each approach. Those alternative approaches are as follows:

   Approach A – retain the Boards' current tentative decisions

   Approach B – use a 'modified interest-based amortisation' approach for the ROU asset

   Approach C – use a 'modified whole-asset' approach

   Approach D – use OCI to achieve a straight-line expense recognition pattern

   Approach E – extend the application of current operating lease accounting to some leases that do not meet the current definition of a short-term lease

5. Working Group Paper 2A provides illustrations of each of the above approaches, an expense profile analysis for various leases, and a comparison to the lessor 'receivable and residual' approach.

6. Working Group Paper 2B discusses each of the above approaches to lessee accounting with respect to whether each approach would necessitate distinguishing between different types of leases, or between a lease and a purchase. That paper also addresses

potential knock-on consequences for lessor accounting if a 'line is drawn' distinguishing between leases from a lessee's perspective.

7. To help the Boards determine whether they should re-address their tentative decisions relating to the lessee accounting model before re-exposing those proposals, the Boards would like your views.

Question 1: Bearing in mind the reasons for, and concerns about, each approach (and the Boards' objective in undertaking the leases project set out in paragraphs 8 and 9 below), do you think that the Boards should re-open lessee accounting before publishing the *Leases* re-exposure document? The alternative would be for the Boards to expose their current tentative decisions, setting out in the basis the alternative approaches explored, and asking particular questions about those alternatives.

If your answer to Question 1 is 'yes':

Question 2: Do you support any of the alternative approaches set out in this paper? If so, why? Is there another viable approach that we have not identified that you prefer? If so, explain that approach and the rationale supporting it.

(a) If you support Approach B, do you prefer the 'interest-based amortisation' approach or the 'modified interest-based amortisation' approach? Why? Do you think there are many lease contracts for which the accounting outcome under the 'interest-based amortisation' approach would be different from the 'modified interest-based amortisation' approach (ie are there many lease contracts for which the pattern of payments does not correspond with the pattern of consumption of benefits from use of the leased asset)? What population of contracts should this approach be applied to (refer to Working Group Paper 2B)?

(b) If you support Approach C (the 'modified whole asset' approach), do you think that the approach would be operational for all lease contracts (ie from your experience, do you think that lessees would be able to estimate with sufficient reliability the expected decline in value of the leased asset during the lease term or the fair value of the leased asset at

lease commencement)? Explain why. If not, is there any way that we could make the approach more operational by, for example, applying it only to some lease contracts and applying, for example, Approach E to others?

(c) If you support Approach D (the OCI approach), what arguments could the Boards use to justify using this approach?

(d) If you think there are different types of leases that should be accounted for differently by the lessee, where should that distinguishing 'line' be drawn? Should the same line be used from a lessor's perspective? [See Working Group Paper 2B]

A reminder of the objective of the project in the context of lessee accounting

8. 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.

9. 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.

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

10. In the *Leases* DP and 2010 ED, the Boards 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 leased asset throughout the lease term (recognised as a ROU asset).

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

11. This approach treats lease contracts differently from executory contracts.[1] A lease contract is defined as one in which the right to use an asset (hereafter referred to as the 'leased asset') is conveyed for a period of time, in exchange for consideration. Accordingly, a lease contract transfers control of the right-of-use to the lessee at lease commencement, which the lessee is paying for over time. The lessor has fully performed when the leased asset is made available for use by the lessee and, as such, the lease contract is not an executory contract.

12. Nonetheless, some hold the view that at least some lease contracts are executory contracts, based on the premise that the lessee's right to use the leased asset is conditional on making payments under the lease. Similarly, the lessee's obligation to make payments is assumed to be conditional on the lessor permitting the lessee to use the item throughout the lease term. Under this view, the lessor performs on a daily basis throughout the lease term as the asset is made available to the lessee.

13. Following this rationale, lease contracts could be accounted for on either a net or gross basis.

Executory contract accounting on a net basis

14. If accounted for on a net basis, we think that the outcome would be that the net leased asset or liability is likely to be zero for most leases on the basis that the lessee is paying for, and receiving, access to the leased asset in the same reporting periods

[1] 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.

throughout the lease term. Consequently, the accounting that would result would be very similar to current operating lease accounting for most leases, with no lease assets or liabilities recognised on the lessee's balance sheet. Such an approach would fail to meet the objective of the project to address the criticism that the current lease accounting model fails to meets the needs of users.

Executory contract accounting on a gross basis

15. If accounted for on a gross basis, the lessee would recognise an asset and liability for the promises in the contract. Because executory contracts are not typically recognised gross on an entity's balance sheet, the measurement of the asset and liability is unclear but there would be an argument for measuring the asset and liability on a similar basis, both on initial and subsequent measurement. One such approach would be what the DP described as the linked approach. The carrying amount of the ROU asset and the lease liability would be the same on both initial and subsequent measurement because the ROU asset and lease liability would be amortised in the same way. The amortisation of the asset and liability would net to zero in the statement of comprehensive income (hereafter, referred to as the 'income statement') with rental payments recognised as an expense on a straight-line basis.

16. The accounting outcome from applying such an approach would be similar in many cases to the 'modified interest-based amortisation' approach discussed in paragraphs 47-59 of this paper. However, the rationale would be different. The linked approach considers a lease contract to be an executory contract whereas the 'modified interest-based amortisation' approach treats lease contracts as financing transactions, but proposes a different method of amortising the ROU asset. The linked approach could also lead to an increasing carrying amount for the ROU asset in some lease contracts with stepped or escalating rental payments, which would not occur under the 'modified interest-based amortisation' approach.

17. If the Boards were to propose that they consider lease contracts to be executory contracts that are accounted for on a gross basis, it would appear difficult to justify why lease contracts are being recognised on-balance sheet when other executory contracts are either not recognised or recognised on a net basis. It would also imply

that service components of lease contracts should not be separated from lease components and accounted for differently. This would arguably then lead to a conclusion that all non-financial executory contracts should also be on-balance sheet. This would be beyond the scope of the leases project and appears premature before the Boards have progressed further with the conceptual frameworks project.

18. For these reasons, we have not explored this thinking further in this paper.

Summary of lessee accounting approaches discussed in the remainder of this paper

19. The table on the following pages summarises the various approaches to lessee accounting discussed in the remainder of this paper. Paragraphs 20-87 that follow the table provide further information about each of the approaches.

	Subsequent measurement of assets and liabilities	Income statement presentation	Reasons to support the approach	Concerns about the approach	Effect on lessor accounting decisions
Approach A: Boards' tentative decisions	*ROU asset*: amortised to reflect the pattern of consumption of expected future economic benefits from use of the leased asset. *Lease liability*: measured at amortised cost, using the effective interest method.	Amortisation expense and interest expense	Accounts for the ROU asset (which is a non-financial asset) consistently with other non-financial assets. Applies to all leases. Does not require distinction between 'types' of leases, or between leases and purchases.	Always produces a front-loaded expense profile at an individual contract level that many think does not reflect the economics of all lease transactions.	
Approach B: 'Interest-based amortisation' approach	*ROU asset*: amortised to reflect the present value of remaining future economic benefits from use of the leased asset. *Lease liability*: as under Boards' tentative decisions.	Amortisation expense and interest expense – could be combined as "rent/lease expense" with disclosure of the two components in the notes	Would achieve a more even lease expense profile that many think better reflects the economics of lease transactions. ROU asset is measured independently of lease liability, on a basis that some view as consistent with the principles for depreciation in existing standards.	Creates tension between leases and purchases (ROU asset measured differently to how PPE measured). Concerns related to 'back-end loaded' amortisation expense (interest-based depreciation for PPE not allowed under US GAAP). Creates tension on the impairment of the ROU asset.	If the approach is used only for some leases (for example, if the current operating/finance lease distinction is retained), possible that a similar distinction should also be made on the lessor side.

	Subsequent measurement of assets and liabilities	Income statement presentation	Reasons to support the approach	Concerns about the approach	Effect on lessor accounting decisions
Approach B: 'Modified interest-based amortisation' approach	*ROU asset*: amortised so that the total lease expense reflects the pattern of consumption of expected economic benefits from use of the leased asset. *Lease liability*: as under Boards' tentative decisions.	Amortisation expense and interest expense – could be combined as "rent/lease expense" with disclosure of the two components in the notes	Would achieve a lease expense profile that reflects the pattern of benefits obtained by the lessee from the lease contract, which many think better reflects the economics of lease transactions. Reflects that the ROU asset and the lease liability arise from the same contract.	Measurement of ROU asset can be affected by lease payment profile. Concerns noted above about the 'interest-based amortisation' approach also apply to this approach.	If the approach is used only for some leases, possible that a similar distinction should also be made on the lessor side.
Approach C: 'Modified whole asset' approach	*Net leased asset:* (made up of the fair value of the leased asset, net of an obligation to return the asset to the lessor, initially measured on a discounted basis); depreciate the gross leased asset and accrete the residual obligation to its expected value at the end of the lease term. *Lease liability*: as under Boards' tentative decisions.	Depreciation expense, interest expense on lease liability, and accretion of residual obligation.	Single approach (applied to all lease contracts) that can justify various expense profiles, depending on lessee's consumption of the leased asset. Consistency between the lease and purchase of an asset.	Is the approach operational? Potentially costly and complex to apply—lessee required to have knowledge of fair value/ residual value of leased asset.	

	Subsequent measurement of assets and liabilities	Income statement presentation	Reasons to support the approach	Concerns about the approach	Effect on lessor accounting decisions
Approach D: The OCI approach	*ROU asset and lease liability*: as under the Boards' tentative decisions. The straight-line profit or loss pattern is achieved through OCI.	Amortisation expense, interest expense, and amount to achieve straight-line profit or loss recognised in OCI. Amounts recycled from OCI to achieve desired profit or loss pattern.	Accounts for the ROU asset consistently with other non-financial assets, while addressing the concerns about the front-loaded expense effect.	Would increase the use of OCI at a time when the Boards have not yet decided on what the objectives should be for using OCI.	If the approach is used only for some leases, likely that a similar distinction should also be made on the lessor side.
Approach E: Extend application of operating lease accounting	Lease assets and liabilities not recognised (only accrued/prepaid rentals recognised, if applicable).	Straight-line lease/rental expense.	Significant reduction in costs for less material lease contracts, without losing significant benefit for users from lease accounting proposals. Approach can be applied in conjunction with any of the other approaches discussed above.	Difficult to draw a line that captures the 'right' population of leases, ensuring that material lease assets and liabilities do not remain off-balance sheet. Significant difference in accounting on either side of that line likely to encourage structuring.	

Approach A: Boards' current tentative decisions

Overview of the Boards' tentative decisions

20. The Boards' tentatively decided for all leases (except short-term leases) that a lessee would:

    (a) recognise a lease liability, initially measured at the present value of lease payments and subsequently measured at amortised cost using the effective interest method.

    (b) recognise a ROU asset, initially measured at an amount equal to the lease liability (plus any initial direct costs and prepaid lease payments) and subsequently measured at amortised cost using a systematic basis that reflects the pattern of consumption of the expected future economic benefits.

21. Under this ROU model, the 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.

22. Refer to Working Group Paper 2A: Illustrations 1 and 2 for the mechanics of the Boards' lessee accounting tentative decisions to individual lease contracts.

Rationale for the Boards' tentative decisions

23. As noted in paragraph 11 above, the leases model that the Boards are developing treats all lease contracts as financing transactions, differently from executory contracts.

24. At lease commencement, the lessee receives the right to use the leased asset, which it recognises as an asset (a ROU asset). At the same time, the lessee recognises a lease liability, which is accounted for similarly to other financial liabilities. The Boards' tentative decisions reflects the fact that the lessee has received something of value at lease commencement—the ROU asset—that it pays for over time.

25. This rationale also flows through to the Boards' tentative decisions on lessor accounting—the 'receivable and residual' approach treats a lease contract as one in

which the lessor has transferred or 'sold' the right to use the leased asset to the lessee in exchange for a receivable; the lessor also has a residual interest in that leased asset.

26. The ROU asset is a non-financial asset that is measured consistently with other non-financial assets. The Boards' tentative decisions treat a lease contract as equivalent to the purchase of a non-financial asset that is financed separately. The components of the lease contract (ie the ROU asset and the lease liability) are recognised separately—although linked on initial measurement, they are subsequently measured independently of each other. Supporters of the Boards' tentative decisions think that the manner in which an asset is financed is not a relevant factor when subsequently measuring that asset on a cost basis. 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

27. The subsequent measurement of the ROU asset and the lease liability, and the front-loaded lease expense effect 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.

28. 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 lessee accounting model reduces complexity. However, we acknowledge a new distinction is created between a lease and a service.

29. The front-loaded expense effect 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 front-loaded expense effect 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 front-loaded expense effect 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

30. The Boards' tentative decisions include several disclosure requirements for lessees that should provide users with information to understand the lease expense recognised in the current period and the cash flows for the current and future periods. Those requirements include disclosure of the breakdown of the different elements of lease expenses recognised in the reporting period, in a tabular format, to be followed by disclosure of the principal and interest paid on the lease liability. This disclosure should facilitate identifying the amount of lease payments made in the period.

31. Some users of financial statements, particularly credit analysts, support the Boards' tentative decisions. 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.

Concerns about the Boards' tentative decisions

32. Some constituents think the front-loaded expense effect does 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 leased asset to the lessee, are *not* the same as purchasing of an asset and separately financing that purchase. The asset and liability that arise from a lease contract are inextricably linked. Consequently, they do not think the front-

loaded expense effect reflects the economics of all lease transactions. In a typical lease, the lessee receives equal benefits from use of the asset in each period and, therefore, those constituents 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 an expense recognition pattern that better reflects the timing of cash flows. 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 expense recognition pattern 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 anticipated benefit for users from including lease assets and liabilities on a lessee's balance sheet. However, supporters of the Boards' tentative decisions would note that 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 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.

33. Although enhancing comparability between items of PPE that are leased and those that are purchased, the Boards' tentative decisions do not result in wholly comparable amounts being recognised, unless the ROU is for all (or close to all) of the useful life of the leased asset. The only way to ensure comparability between the lease and

purchase of an asset would be to apply a whole asset approach (see paragraphs 60-76 of this paper for further information about the 'modified whole asset' approach).

Approach B: A different way to subsequently measure the ROU asset

34. Some constituents have suggested using a different method of amortisation for the ROU asset, interest-based amortisation, acknowledging that this would be different from the methods conventionally used to amortise or depreciate non-financial assets. This method would result in the recognition of a total lease expense that is generally more even over the lease term.

35. We think there are two different ways that the approach could be articulated, set out in this paper as the 'interest-based amortisation' and 'modified interest-based amortisation' approaches. For leases that have a flat, or gradually increasing, payment profile, the accounting that would result from both of these approaches would be the same or very similar. Only when lease payments are significantly skewed, for example, if there is a large 'bubble' lease payment at the beginning or end of the lease term, would the approaches result in a different amount of amortisation being recognised on the ROU asset.

'Interest-based amortisation' approach

Overview of the 'interest-based amortisation' approach

36. The 'interest-based amortisation' approach treats lease contracts as financing transactions, similarly to Approaches A, C and D in this paper. At lease commencement, the lessee obtains a ROU asset, which it pays for over time.

37. Consequently, under the 'interest-based amortisation' approach, a lessee would initially measure both the ROU asset and the lease liability, and subsequently measure the lease liability, as it would under the Boards' tentative decisions. The lessee would then subsequently measure the ROU asset at amortised cost at the present value of remaining benefits, discounted using the discount rate used to initially measure the ROU asset.

38. Refer to Working Group Paper 2A: Illustrations 1 and 2 for the mechanics of the 'interest-based amortisation' approach. Working Group Paper 2B discusses the population of lease contracts to which the 'interest-based amortisation' approach could apply, should the Boards support the approach.

Rationale for the 'interest-based amortisation' approach

39. The Boards have tentatively decided that a lessee should subsequently measure a ROU asset at amortised cost, consistently with how other non-financial assets are measured. IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* state that 'the depreciation (amortisation) method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity', and that method should allocate the cost of the asset over its useful life on a systematic basis. US GAAP is less prescriptive but states that depreciation is a method of allocating cost on a systematic basis over the estimated period of use of an asset.

40. If everything is perfectly valued, the cost (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.

41. Interest-based methods of amortisation take into account a time value of money approach when allocating the cost of an asset over its period of expected use. This method would use the implicit interest rate that exists in the lease liability. That rate is also used when initially measuring the ROU asset.

Reasons to support the 'interest-based amortisation' approach

42. 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 it is a method of amortisation that systematically allocates the cost of the asset to reflect the pattern in which the 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.

43. 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 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.

Concerns about the 'interest-based amortisation' approach

44. 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 this approach 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.

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

46. The 'interest-based amortisation' approach would result in the ROU asset being reflected on the lessee's balance sheet at an amount that is greater than it would be if amortised on a straight-line basis. That may result in an impairment charge being recognised on the ROU asset more frequently than under the Boards' tentative

decisions. Some view this as an indication that the 'interest-based amortisation' approach is flawed.

'Modified interest-based amortisation' approach

47. An alternative to applying the 'interest-based amortisation' approach that would, in most cases, result in a similar outcome would be to apply what we have called the 'modified interest-based amortisation' approach. This approach would be a practical way of recognising a total lease expense that is more even over the lease term.

48. Under the 'modified interest-based amortisation' approach, the lessee would amortise the ROU asset so that the total lease expense (ie the interest expense on the lease liability plus the amortisation of the ROU asset) reflects the pattern of consumption of the expected economic benefits from use of the leased asset. For leases for which the lessee expects to consume benefits on a straight-line basis, the ROU asset would be amortised on a basis that would result in a total lease expense that is straight-line.

49. Refer to Working Group Paper 2A: Illustrations 1 and 2 for the mechanics of the 'modified interest-based amortisation' approach.

Rationale supporting the 'modified interest-based amortisation' approach

50. A lease contract is one in which the lessee obtains the right to use an asset for a period of time, which it typically pays for over the same time period. The lessee often expects to obtain (or consume) benefits from using the leased asset on a straight-line basis and often pays for those benefits on a similar straight-line basis over the period that the benefits are consumed. Thus, payments are often made, and benefits consumed, in the same reporting period.

51. The Boards have tentatively decided that the measurement basis for both the ROU asset and the lease liability is cost. Thus, when subsequently measuring both the asset and liability, the question on which supporters of this approach focus is how to allocate the costs associated with the asset and liability (which both arise from the same lease contract) on a systematic basis over the period that the lessee derives benefit from use of the leased asset. Some think this approach would better reflect the

economics of lease contracts because it considers the *total* cost of the lease contract when allocating the aforementioned costs.

52. Supporters of this approach do not view the amortisation expense under this approach as a means to achieve a straight-line lease expense. 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.

53. Those supporters think the nature of a lease contract is not the same as financing the purchase of the leased asset and, thus, a ROU asset is different from purchasing the leased asset itself. In fact, it could be argued that this is the essence of the changes that the Boards are proposing in the leases project:

    (a) Current lease accounting guidance focuses on the leased asset itself. The test as to whether a lessee recognises an asset and liability is whether the lessee has, in substance, purchased the leased asset. If that is the case (ie the contract is a finance/capital lease), the lessee recognises and measures the leased asset itself. The measurement of the lease liability flows from the measurement of the asset.

    (b) In contrast, the ROU model that the Boards have developed requires a lessee to recognise a ROU asset and a lease liability for all leases. The lessee recognises and measures the lease liability similarly to other financial liabilities. The measurement of the ROU asset flows from that measurement of the liability.

54. At one end of the spectrum, the difference between a ROU asset and the asset being leased is clear. For example, a one-week lease of a lawnmower or a two-year lease of a ship is not equivalent to purchasing the lawnmower or the ship. However, at the other end of the spectrum, a ROU asset may look very similar to the leased asset itself.

55. Nonetheless, supporters of the 'modified interest-based amortisation' approach would argue that the rights and obligations that arise from a lease contract are different from purchasing the asset and separately obtaining funding for that purchase. Lease assets and liabilities arise from the same enforceable contract and, accordingly, are inextricably linked. The asset does not exist without the liability, and vice versa. If

the contract is terminated or sold, those two components—the asset and the liability—are settled or traded together. Although the Boards are proposing that a lessee recognise those two components separately on the balance sheet, in the real world, they cannot be settled or traded separately.[2]

Reasons to support the 'modified interest-based amortisation' approach

56. The 'modified interest-based amortisation' approach provides a basis for amortising the ROU asset differently from how other non-financial assets are amortised/depreciated.

57. The reasons set out in paragraphs 42-43 of this paper relating to the 'interest-based amortisation' approach also apply to the 'modified interest-based amortisation' approach.

Concerns about the 'modified interest-based amortisation' approach

58. Similar to the 'interest-based amortisation' approach, this approach creates tension between the lease of an asset and the purchase of an asset. The amortisation of the ROU asset that arises from this approach does not necessarily reflect the pattern of consumption of benefits from the asset itself, ie the amortisation of the ROU asset can be affected by the lease payment profile. Consequently, some have conceptual concerns about this approach.

59. The concerns set out in paragraphs 44-46 of this paper regarding the 'interest-based amortisation' approach also apply to the 'modified interest-based amortisation approach'.

[2] For example, even when a lessee sub-leases an asset for the entire period of the original lease, that lessee/sub-lessor typically would not legally settle or discharge its obligation (or rights) arising from the initial lease. Instead, it would assign its right-of-use to the new lessee in a separate contract. From an accounting perspective, we may conclude that the sub-lessor has 'sold' the ROU asset. However legally the ROU asset has not been sold separately from the associated lease liability.

Approach C: The 'modified whole asset' approach

Overview of the 'modified whole asset' approach

60. The 'whole asset approach' to lease accounting was discussed, and rejected, by the Boards at the DP stage of the project. Under the whole asset approach, a lease contract is treated as the purchase of the leased asset, with the lessee having an obligation to return the leased asset (hereafter, referred to as 'residual obligation') at the end of the lease term and an obligation to make lease payments. Some users support such a model for comparability reasons—under a whole asset approach, the asset recognised by the lessee would be comparable to purchasing the asset and, thus, would be useful when assessing the operational performance of the lessee (for example, when calculating Return on Capital Employed). Nonetheless, respondents to the DP and Board members rejected the approach, mainly because they were opposed to the lessee having to recognise a liability to return the leased asset, which they did not think would meet the definition of a liability. They also concluded that the lessee's assets would be overstated under such an approach.

61. However the whole asset approach could be modified to address those concerns and some of the concerns about the front-loaded expense effect of the Boards' tentative decisions. The 'modified whole asset' approach would link the obligation to return the leased asset to the leased asset itself.

62. Under the 'modified whole asset' approach, a lessee would recognise a net leased asset, initially measured as the net of two components: the fair value of the leased asset less a residual obligation equal to the present value of the expected residual asset value at the end of the lease term. Subsequently, the lessee would depreciate the gross leased asset in accordance with existing PPE guidance, and the residual obligation would be accreted to its expected value at the end of the lease term. The amount initially recognised as a net leased asset would be the same as recognised as a ROU asset under the Boards' tentative decisions.

63. If applied to all leases, the 'modified whole asset' approach would produce an expense recognition pattern that varies based on the extent to which the value of the leased 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 leased 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 leased asset. For example, a leased 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).

64. If the value of the leased asset does not decrease over the lease term, the 'modified whole asset' approach yields a straight-line lease expense. If the value of the leased asset declines to zero over the lease term, the 'modified whole asset' approach yields a front-loaded expense pattern that is the same as the Boards' tentative decisions.

65. Refer to Working Group Paper 2A: Illustrations 1 and 2 for the mechanics of the 'modified whole asset' approach. Illustration 3 in that paper details the lease expense profiles for leased assets that decline in value to varying degrees over the lease term.

Rationale for the 'modified whole asset' approach

66. The 'modified whole asset' approach offers an alternative that measures the lease asset and liability recognised by the lessee consistently with other non-financial assets and financial liabilities. It does not propose to change the accounting for the lease liability, nor does it propose to amortise or depreciate the non-financial asset recognised on a basis that is different from other non-financial assets (although some might disagree in relation to the recognition and measurement of the residual obligation—see paragraph 76 below). The 'modified whole asset' approach is, thus, consistent with the Boards' conclusion that all lease contracts are financing transactions, similar to financing the purchase of a non-financial asset.

67. The basis of this approach is that, economically, 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).[3] Consequently, the profile of the interest piece of the lease payments is flatter than implied by the Boards' tentative decisions when the leased asset has any residual value at the end of the lease term. The greater the residual value of the leased asset, the flatter the interest profile. At the extreme, if the residual value of the leased asset is expected to be the same (or higher) than its value at lease commencement, all of the lease payments made by the lessee would represent a straight-line interest expense over the lease term (see the 0% consumption land example in Working Group Paper 2A: Illustration 2).

68. Supporters of the 'modified whole asset' approach think that the Boards' tentative decisions are forcing all lease contracts into an extreme front-loaded expense pattern. The only time the 'modified whole asset' approach expense profile aligns with the Boards' tentative decisions is when the asset depreciates fully during the lease term.

Reasons to support the 'modified whole asset' approach

69. The 'modified whole asset' approach is a single approach to lessee accounting that can justify both a straight-line and front-loaded expense 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.

70. The 'modified whole asset' approach allows for consistency between the lease and purchase of an asset. For example, if the asset's value is fully consumed over the lease term, one would consider that to be similar to the purchase of that asset. The 'modified whole asset' approach would produce exactly the same expense profile when leasing an asset for all of its useful life as would be produced when purchasing that asset on credit (eg an instalment purchase). 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 leased asset), the more the

[3] The required return on the residual value of the leased 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. 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.

expense recognition profile would mirror the profile that would result from purchasing the asset and separately financing it.

71. This approach arguably could provide the most useful information to users about the operating performance of the lessee if the gross leased asset is disclosed in the lessee's financial statements. This is because the gross leased asset is comparable to purchasing an asset and selling it after a particular period of use. For example, some airlines purchase aeroplanes and dispose of them when they are no more than 10 years old, even though the aeroplanes may have a useful life of 25-30 years. The 'modified whole asset' approach would allow users to more accurately compare such an airline to a competitor who also uses aeroplanes that are less than 10 years old, but who leases as well as purchases aeroplanes.

72. Illustration 4 in Working Group Paper 2A contrasts the lessor's accounting under the 'receivable and residual' approach with the lessee's accounting under the 'modified whole asset' approach. The illustration demonstrates that, under the 'modified whole asset' approach, the interest expense and accretion expense recognised by the lessee would be the same as the interest income and accretion income recognised by the lessor under the 'receivable and residual' approach. Therefore some would conclude that the 'modified whole asset' approach would be more consistent with the lessor 'receivable and residual' approach than the other lessee approaches discussed in this paper.[4]

Concerns about the 'modified whole asset' approach

73. The approach could potentially be complex and costly to apply. A lessee would need to be able to estimate with sufficient reliability either the fair value of the leased asset at lease commencement (eg CU1,000 in the equipment example in Working Group Paper 2A: Illustration 1), the estimated residual value at the end of the lease term (eg CU500 in the equipment example) or the estimated change in value of the leased asset over the lease term (eg 50% decrease in value in the equipment example). For lessees

[4] However, it should be noted that we view Approaches A, B and D as being consistent with the lessor 'receivable and residual' approach because they all treat lease contracts as financing transactions, whereby the lessor has transferred (and the lessee received) a ROU asset at lease commencement, which the lessee typically pays for over time.

making lease or buy decisions, we would expect them to have this information. Indeed, new or second-hand valuation information is readily available on the internet for many assets that are commonly leased. Nonetheless, some lessees may find it difficult to estimate this information without incurring significant costs or asking the lessor for information about its pricing that the lessor might be reluctant to divulge.

74. The 'modified whole asset' approach functions well when all lease payments are either fixed or variable but linked to an index or rate. However, the approach becomes complex when payments that vary based on performance or sales are effectively included in pricing the contract and calculating the discount rate.[5]

75. The 'modified whole asset' approach could be more complex to apply when testing the leased asset for impairment. The lessee may need to test both the gross leased asset and the residual obligation for impairment in order to identify whether the impairment relates to the portion of the asset that the lessee consumes during the lease term. Such an approach might require lessees to continue to monitor the leased asset's fair value and estimated residual value. Nonetheless, if the Boards were to support this approach, as a simplification, the Boards could require lessees to apply the impairment guidance in existing standards to the net leased asset.

76. This approach potentially opens up some fundamental issues, such as whether the lessee's obligation to return the leased asset should be effectively recognised on the lessee's balance sheet. Although the residual obligation would be presented as a contra-asset together with the gross leased asset rather than as a liability, some may question the measurement of that obligation. The residual obligation would be accreted over the lease term. Thus, although the lessee would subsequently measure the gross leased asset consistently with other non-financial assets, the net leased asset would be measured in a manner that is not typically applied to non-financial assets.

[5] The Boards have tentatively decided that variable lease payments not linked to an index or rate are not included in the lease liability.

Approach D: the OCI approach

77. If the Boards disagree with Approaches B and C but think that a straight-line expense recognition pattern would better reflect the economics of some or all lease contracts, other comprehensive income (OCI) could be used to achieve that objective.

78. The OCI approach would work as follows: the lessee would initially and subsequently measure the ROU asset and lease liability according to the Boards' tentative decisions. The liability would be amortised using the effective interest method and the ROU asset amortised typically on a straight-line basis (assuming another pattern of usage is not present). The straight-line profit or loss recognition pattern would be achieved through the use of OCI, and by adjusting the amortisation component of the lease expense recognised by the lessee.

79. Refer to Working Group Paper 2A: Illustrations 1 and 2 for the mechanics of this approach.

80. The main advantage of this approach is that it provides a means of achieving a straight-line profit or loss recognition pattern, without changing the measurement of the asset or liability. The ROU asset would be measured consistently with other non-financial assets and the lease liability consistently with other financial liabilities. All lease transactions would be largely comparable in that the straight-line expense effects are contained within OCI.

81. However, such an approach would increase the use of OCI at a time when the Boards have not yet decided on what the objectives should be for using OCI. The 'extra' expense in the early years of a lease would be 'tucked away' in OCI and then released or 'recycled' in the later years to achieve a straight-line lease expense recognition pattern.

82. In addition, if the pattern of consumption of benefits is not even over the lease term, applying the OCI approach would be complicated. Alternatively, the approach could be applied to achieve a straight-line profit or loss recognition pattern in all cases, regardless of the pattern of consumption of benefits from use of the leased asset.

Approach E: Apply operating lease accounting to a population of leases, larger than short-term leases

83. Many are concerned about the complexity of, and costs associated with, the lessee accounting model proposed by the Boards when compared to current operating lease accounting. Some respondents to the 2010 ED suggested that, from a cost/benefit perspective, the Boards should not require application of the ROU model to some leases that are currently classified as operating leases.

84. As mentioned in paragraph 2 of this paper, the Boards have addressed many of those cost concerns during their 2011 redeliberations. Nonetheless, some have suggested that further relief should be provided by allowing or requiring operating lease accounting (which would result in the lessee *not* recognising lease assets and liabilities) for some leases.

85. The Boards have already tentatively decided that a lessee can elect to apply operating lease accounting to short-term leases (ie lease contracts of 12 months or less) to provide practical relief. Approach E would propose to extend that practical relief to a larger population of lease contracts. This could be done in a number of ways, for example:

    (a) The short-term lease exception could be extended to, say, 24 or 36 months.

    (b) Operating lease accounting could be permitted for leases of assets that are not essential to a lessee's operations (ie leases of 'non-core' assets).

86. Those different ways to define the population of lease contracts to which operating lease accounting could apply are discussed in Working Group Paper 2B.

87. Approach E could be implemented in conjunction with any of the other approaches discussed in this paper. For example, the Boards could retain their current tentative decisions but provide further relief by applying operating lease accounting to a larger population of contracts. Alternatively, those supporting the 'modified whole asset' approach might combine Approach E with that approach. Given that it may be difficult for a lessee to obtain the information required to implement the 'modified whole asset' approach for *all* leases, the 'modified whole asset' approach could be

required in conjunction with extending the short-term lease exception to, for example, 24 or 36 months.