STAFF PAPER

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Working Group Meeting

Project	Leases
Paper topic	Should different accounting models be applied to different types of lease contracts?

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Introduction

1. Working Group Paper 2 discusses each of the following lessee accounting approaches. In this table, we have analysed whether we think the approach could or should be applied to all lease contracts and, thus, whether it is necessary to distinguish between different types of leases, or between a lease and a purchase, when applying the approach:

Approach	**Applied to all lease contracts?**
A: Boards' tentative decisions	Yes, with the exception of short-term leases. ROU asset measured consistently with purchases of PPE so no need to distinguish between a lease and a purchase.
B: Interest-based amortisation approach	Need to distinguish between leases that give rise to ROU assets and contracts for the purchase (or in-substance purchase) of PPE (see paragraphs 4-12 below).
C: Modified whole asset approach	Gross leased asset measured consistently with purchases of PPE so no need to distinguish between a lease and a purchase. But for operational reasons, should this approach be applied only to some leases with, for example, Approach E applied to others?

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D: OCI approach	Need to distinguish between leases that result in a straight-line profit or loss recognition pattern and those that do not (see paragraphs 4-28 below).
E: Extend operating lease accounting	Need to distinguish between leases that get off-balance sheet accounting and those that do not (see paragraphs 29-31 below).

2. On the basis of the analysis above, if the Boards decide to do anything other than retain their current lessee accounting decisions, there is likely to be a need to 'draw a line' either somewhere along the spectrum of lease contracts, or between a lease and a purchase.

3. We think there are a number of different ways to draw that distinguishing line:

   (a) Distinguish between the lease and purchase of an asset (see paragraphs 4-12 below)

      (i) Using today's current operating/finance lease line.

      (ii) Distinguishing between lease contracts that give rise to ROU assets and contracts that transfer control of the leased asset to the lessee.

   (b) Identify lease contracts for which the value of the leased asset does not decline significantly over the lease term (see paragraphs 13-24 below).

      (i) For practical reasons, this could be real estate / land and building leases (see paragraphs 21-24 below).

   (c) Distinguish based on the business purpose of the lease transaction (see paragraphs 25-28 below).

   (d) Extend the short-term lease definition or define core/non-core assets (see paragraphs 29-31 below).

Distinguishing between the lease and purchase of an asset

4. A lessee should account for contracts that transfer the leased asset to the lessee as the purchase of that leased asset, regardless of whether the contract is in the form of a

lease. In that case, the lessee would recognise the leased asset itself and not a ROU asset.

5. 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.

The current operating/finance lease distinction

6. 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 leased asset by the lessee, whereas the alternative approach (whether that be Approach B or D) would be applied to current operating leases.

7. 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.

8. 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. However, because all leases (except short-term leases) would now be on-balance sheet, 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.

9. 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 perspective. If that were the case, the lessor accounting model would distinguish between:

   (a) finance leases, which are treated as 'in substance' sales of the leased assets, and accounted for similarly to current finance/capital leases;

(b) leases of investment property (that are not finance leases), which are accounted for similarly to current operating leases; and

(c) leases of non-investment property (that are not finance leases), which are accounted for under the receivable and residual approach.

This would potentially add complexity to the lessor accounting proposals.

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

10. Under this approach, a lessee would distinguish between lease contracts that give rise to a ROU asset and those that transfer control of the leased asset to the lessee. Control in this context could be defined similarly to the revenue recognition proposals.[1] If a contract is in the form of a lease but the terms of the contract are such that the lessee obtains (and the lessor transfers) control of the leased asset, then the lessee would account for the transaction as a purchase of the leased asset. In that case, the purchaser would recognise the leased 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 alternative approach (again, either Approach B or D). This approach is likely to result in some of today's finance leases being accounted for under the alternative approach and some continuing to be accounted for similarly to the purchase of an asset.

11. 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. This is also the case from the lessor perspective. There would be no need to create two different lease accounting models (beyond the tentative decision to account for investment property leases differently from other leases from a lessor's perspective).

12. 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

[1] A lessee would obtain control of the leased asset if it has the ability to direct the use of and obtain substantially all of the *remaining benefits* from that leased asset. In that case, the lessor would retain minimal residual asset risk.

(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.

Identify lease contracts for which the value of the leases asset does not decline significantly over the lease term (using the rationale of the 'modified whole asset' approach as a basis for drawing the line)

13. Even if the Boards were to conclude that the 'modified whole asset' approach would be too complex to apply, an alternative would be to use the rationale for that approach to justify applying an alternative approach (which typically results in a straight-line lease expense) to lease contracts for which the value of the leased asset does not decline significantly over the lease term, ie to reflect the fact that, in such leases, the majority of the lease payments represent a return on the residual, which is essentially flat over the lease term (refer to paragraphs 60-76 of Working Group Paper 2 for information about the 'modified whole asset' approach). As illustrated in the land example in Working Group Paper 2A: Illustration 2, when the leased asset is expected to retain its value over the lease term, the lease payments represent a straight-line lease expense under the 'modified whole asset' approach. As shown in Working Group Paper 2A: Illustration 3, under that approach, leases with 0% and 10% consumption (insignificant) have an expense profile that is closer to straight-line, while leases with 50% and 100% consumption have an expense profile that is closer to the Boards' tentative decisions.

14. The 'modified whole asset' thinking provides a basis for distinguishing between different types of leases, and achieving a straight-line recognition pattern for some leases, that has a sound economic basis. Many have viewed previous attempts to achieve such an expense pattern as simply that, an attempt to achieve an outcome.

15. The same arguments used to justify the straight-line expense recognition pattern for lessees could be used to justify a straight-line income recognition pattern for lessors. We could use the same definition of investment property/real estate (or alternatively, the same characteristics of a lease as discussed in paragraphs 17 and 18 below) to

distinguish leases on both the lessee and lessor side.[2] Refer to Working Group Paper 3 for further discussion about lease contracts scoped out of the 'receivable and residual' approach.

16. The alternative approach used in this case, again, could be Approach B or D.

Drawing the line based on the characteristics of the lease

17. If the Boards were to support using the 'modified whole asset' approach as a way of distinguishing between leases, one possible route would be to focus on the characteristics of the lease. For example, the accounting resulting from the 'modified interest-based amortisation' approach or the OCI approach could be applied to leases for which the decrease in value of the leased asset over the lease term is expected to be insignificant, relative to the leased asset's value at lease commencement. In other words,

    (a) the value of the leased asset consumed by the lessee during such a lease, offset by any expected appreciation in value, is insignificant relative to the leased asset's value at lease commencement; and/or

    (b) the lease term is insignificant relative to the full economic life of the leased asset.

18. Guidance could then be developed to help apply that principle. Based on the work performed by the staff, under the 'modified whole asset' approach, once the asset's level of consumption is above 10%, the expense profile shifts from more of a straight-line profile to more of a front-loaded profile. Practically speaking, *insignificant* consumption of the asset could be determined to be 10% or less.

19. The main advantage of this approach is that it provides a principle that fits with the rationale supporting the approach, and would apply to all leases, regardless of the nature of the leased asset. Accordingly, it may capture a more accurate population of lease contracts.

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[2] However, it should be noted that, alternatively, the lessor accounting decision regarding leases of investment property could be justified for practical/operational reasons because the 'receivable and residual' approach would have been difficult and costly to apply to many real estate leases. Therefore, the lessor accounting decision regarding investment property leases does not necessarily need to be tied to lessee accounting decisions.

20. The main disadvantage is that it creates a new 'bright line' based on potentially subjective estimates of the decline in value of an asset. Nonetheless, there would be less pressure on that bright line than on the operating/finance lease line today because it would not be the difference between on and off-balance sheet accounting for leases.

Drawing the line based on the nature of the leased asset

21. Another way to 'draw the line' would be to focus on the nature of the leased asset. The accounting proposed under the 'modified interest-based amortisation' approach could be applied, for example, to real estate leases, ie any lease that directly or indirectly includes land as part of the asset being leased.

22. From a practical perspective, this might be a relatively straight forward way to 'draw the line'. Because land typically appreciates in value, some would argue that such an approach could be justified by concluding that any lease that includes land (either directly or indirectly, for example, a lease of a building or floor of a building) would represent a lease for which the value of the leased asset does not decline significantly over the lease term. Even for a lease of a building for, say, 25 years, the value of the leased asset (considering the land and building together) may not decline significantly over that 25-year lease term.

23. However, focussing on the nature of the leased asset may not work in all cases. For example, it might be difficult to argue that the value of the leased asset does not decline significantly when the lease is for a warehouse, a manufacturing facility or even commercial real estate for 25 years. Those buildings might have very little value at the end of 25 years.

24. In addition, concerns raised about the lessee accounting model go beyond real estate leases. If the Boards were to support distinguishing real estate leases from other leases, it is inevitable that some constituents will argue that other leases should also have a straight-line lease expense recognition pattern.

Distinguishing based on the business purpose of the lease transaction

25. Another approach that was considered by the Boards early in 2011 was to look at the business purpose for entering into a lease transaction. For example, the Boards' tentative decisions for lessee accounting, consistent with the 2010 ED, may be appropriate if the lessee's business purpose were to finance the acquisition of a right-of-use asset. Some of the indicators used could be the following:

    (a) The lessee considered leasing versus purchasing and decided to lease, rather than purchase, the leased asset.

    (b) The business model of the lessor is to provide direct financing or is a manufacturer/dealer.

    (c) The financing element is significant.

    (d) There is no significant, continuing involvement by the lessor after the date of commencement of the lease, except for credit risk in the collection of lease payments.

    (e) The lessee does not intend to return the underlying asset to the lessor; asset risk is transferred to the lessee.

    (f) Lease payments are driven by current interest rates.

26. Alternatively, if the lessee's business purpose was to rent the leased asset, without any intention of owning the asset or taking on risks of ownership, perhaps a straight-line method of income recognition would more appropriately reflect the economics of the transaction. Some of the indicators used could be the following:

    (a) The lessee wants to avoid the inflexibilities of ownership.

    (b) The lessee wants to mitigate the risk of ownership (for example, technological obsolescence).

    (c) The lessee wants to outsource significant maintenance/services of the asset.

    (d) The lessor uses the leased asset to generate cash flows throughout the lease term from, for example, the provision of services associated with the asset.

    (e) Lease payments are a function of a market rate.

27. Some of the advantages of this approach are as follows:

    (a) It removes the current “bright-lines” in existing leases literature.

    (b) It recognises the importance of the business purpose for entering into a lease transaction as a determinant of reflecting the economics of the transaction in the income statement.

    (c) It could result in the lessee’s balance sheet being the same for all leases, with the income statement being differentiated based on whether the business purpose of the transaction was primarily financing or a rental.

    (d) This approach was supported by many of the parties involved in our targeted outreach performed in early 2011.

28. The disadvantage to this approach is that the principle and indicators are subjective and it may be difficult to apply in practice. Transactions at either end of the spectrum may be clear, whereas others closer to the line might not. This could lead to inconsistent application in practice and implementation issues questioning exactly where the line is intended to be. Some would suggest that business purpose could potentially be used to distinguish between lease contracts from a lessor’s perspective, but that such an approach would not be appropriate from a lessee’s perspective.

Applying operating lease accounting to a population of leases, larger than short-term leases (Approach E in Working Group Paper 2)

29. As noted in Working Group Paper 2, if the Boards were to support Approach E (extending the application of current operating lease accounting), 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). Guidance could be provided indicating that leased assets are ‘non-core’ when they are not directly used in the lessee’s revenue generating activities.

30. The Boards previously discussed and rejected extending operating lease accounting to a larger population of lease contracts for a number of reasons:

    (a) It would be extremely difficult to define ‘non-core leases’ with sufficient clarity to ensure that the ‘right’ population of leases are recognised on a lessee’s balance sheet. No matter how tightly defined, interpreting the definition would always be subjective to some extent and, thus, could potentially be interpreted differently by different entities. Surely, every leased asset could be argued to be essential to a lessee’s operations; otherwise, why did the lessee enter into the agreement? There would be significant pressure on the definition because of the difference in the accounting on either side of that definition.

    (b) The Boards’ main objective in adding the 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. Extending the short-term lease exception would not only encourage contracts to be written for just less than 24 or 36 months, but could potentially result in material assets and liabilities not being included on a lessee’s balance sheet, resulting in the project failing to meet its main objective. For those reasons, a number of Board members would prefer not to include *any* short-term lease exception and might therefore not be willing to extend the short-term lease exception.

31. Nonetheless, extending the application of current operating lease accounting would be responsive to the significant cost concerns raised about the lessee accounting proposals and, yet, could retain most of the informational benefit from those proposals. The leasing industry has informed us that lease transactions, in essence, fall into two categories—a relatively small number of ‘large ticket’ leases (eg real estate and large capital equipment) and a relatively large number of ‘small ticket’ leases (eg copiers, cars, etc.). There is very little in between. Some constituents have expressed significant doubt as to whether application of the proposed lessee accounting model to such ‘small ticket’ leases is cost beneficial.