STAFF PAPER

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Project	Leases		
Paper topic	Lessee transition—measurement of the ROU asset		
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Purpose

1. At the June 2012 meeting the boards tentatively decided that there are two different expense recognition patterns for different leases. Some leases should be accounted for using an approach similar to that in the 2010 leases Exposure Draft (ED) (referred to in this paper as the 'interest and amortisation' approach) and other leases should be accounted for using an approach that results in the lessee recognising a straight-line lease expense (referred to in this paper as the 'single lease expense' approach).

2. The objective of this paper is to discuss whether on transition, when applying the single lease expense approach, right-of-use (ROU) assets should be measured on the basis of the proportion of the liability to make lease payments at lease commencement, relative to the remaining lease payments (ie the modified retrospective approach as tentatively decided by the boards for the interest and amortisation approach and illustrated in Appendix B).

3. This paper also considers whether any of the boards' other tentative decisions in respect of transition requirements need to be reconsidered as a consequence of applying the single lease expense approach.

Background

4. At their 19 October 2011 meeting the boards tentatively decided that on transition for each current operating lease, at the beginning of the earliest comparative period presented, a lessee should measure ROU assets on the basis of the proportion of the liability to make lease payments at lease commencement, relative to the remaining lease payments (as illustrated in Appendix B). Any difference between the liabilities to make lease payments and the ROU assets at transition should be taken to retained earnings.

5. At the October 2011 meeting the boards also tentatively decided that on transition:

   (a) a lessee should account for any uneven lease payments. Therefore, on transition a lessee would adjust the ROU assets for any existing lease prepayments or accruals; and

   (b) to permit a lessee to apply a fully retrospective transition approach.

Staff analysis and recommendation

Measurement of ROU assets at transition using the modified retrospective approach

6. When the boards tentatively decided to apply the modified retrospective approach at transition, this decision was made in the context of the interest and amortisation approach being applied to all leases and, therefore, not in the context of the single lease expense approach. The boards decided to change from the simplified retrospective approach proposed in the ED (whereby the ROU asset is made equal to the liability at transition) to the modified retrospective approach to address respondents' concerns about the 'front loading' of expenses that would result from the proposals in the ED.

7. In contrast to the interest and amortisation approach, the single lease expense approach results in a straight-line expense pattern in the income statement. Consequently, the boards' rationale for changing to the modified retrospective approach is not applicable when considering the single lease expense approach,

because the ‘front loading’ concerns raised by respondents to the ED is not an issue under the single lease expense approach.

8. Measuring the ROU asset at transition on the basis of the proportion of the liability to make lease payments at lease commencement, relative to the remaining lease payments gives the measurement of the ROU asset more meaning for leases when applying the interest and amortisation approach. This is because this approach calculates a ROU asset that approximates the ROU asset under a fully retrospective approach. However, under the single lease expense approach, this is generally not the case.

9. The staff note that, when applying the single lease expense approach, if lease payments are even or relatively even over the lease term, the ROU asset recognised under a fully retrospective transition approach would be similar to the measurement of the liability to make lease payments on transition. Accordingly, we think that permitting lessees to measure the ROU asset at the same amount as the liability to make lease payments on transition would be a simplified way to retrospectively apply the new proposals for many leases. When lease payments are uneven, the results of applying the simplified approach (ie measuring the ROU asset at the same amount as the liability to make lease payments) and a fully retrospective approach may not always be similar. However, adjusting the right-of-use asset by the amount of any recognised prepaid or accrued lease payments will provide a similar result to that of a fully retrospective approach.

10. Consequently, under the single lease expense approach, the staff recommend that, at transition, a lessee be permitted to recognise an ROU asset for each outstanding lease, measured at the amount of the related liability to make lease payments (ie the simplified retrospective approach). This is because:

    (a) for many leases, this will result in measuring the ROU asset at a similar amount to a fully retrospective approach; and

    (b) the single lease expense approach does not result in the front loading of expenses in the income statement.

11. The staff also recommend that, consistent with the current tentative decisions on transition as described in paragraph 5, a lessee should:

    (a) account for any uneven lease payments by adjusting the right-of-use asset recognised at the beginning of the earliest comparative period presented by the amount of any recognised prepaid or accrued lease payments;

    (b) be permitted to apply a fully retrospective transition approach.

Question 1 – measurement of the ROU asset at transition
Do the boards agree with the staff recommendation that at transition when applying the single lease expense approach, a lessee should be permitted to either: (a) recognise an ROU asset for each outstanding lease, measured at the amount of the related liability to make lease payments, adjusted for any uneven lease payments, or (b) apply a fully retrospective transition approach?

Other transition requirements

12. The staff think that, with respect to the transition requirements, the measurement of ROU assets is the only decision that needs to be reconsidered as a result of the boards' tentative decision that some leases should be accounted for using the single lease expense approach. This is because the staff think that how the ROU asset is subsequently measured after transition does not affect the rationale for any of the boards' other tentative decisions relating to transition.

13. Consequently, the staff do not recommend changing any of the other current decisions regarding transition as the rational for those decision remains the same (see appendix A for a list of the current tentative decisions on transition requirements).

Question 2 – other transition requirements
Do the boards agree with the staff recommendation not to change any of the other tentative decisions regarding transition (as listed in Appendix A)?

Appendix A

(a) At their 19 October 2011 meeting, the boards tentatively decided that for each operating lease at the beginning of the earliest comparative period presented, a lessee should recognise a liability to make lease payments at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate as of the effective date for each portfolio of leases with reasonably similar characteristics. The incremental borrowing rate for each portfolio of leases should take into consideration the lessee's total leverage, including leases in other portfolios.

(b) when lease payments are uneven over the lease term, a lessee should adjust the right-of-use asset recognised at the beginning of the earliest comparative period presented by the amount of any recognised prepaid or accrued lease payments.

(c) for capital or finance leases existing at the beginning of the earliest comparative period presented, a lessee would not be required to make any adjustments to the carrying amount of the lease assets and lease liabilities. However, the entity would reclassify the lease assets and lease liabilities as right-of-use assets and liabilities to make lease payments.

(d) lessees and lessors should provide transition disclosures that are consistent with IAS 8 *Accounting Policies, Changes in Estimates and Errors* or Topic 250, *Accounting Changes and Error Corrections*. However, entities would not need to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods adjusted retrospectively. In addition, if an entity elects any of the available reliefs, the entity should disclose which reliefs it elected. Notwithstanding all of the above tentative decisions on transition, the boards tentatively decided that a lessee or lessor could choose to apply the requirements in the new leases standard retrospectively in accordance with IAS 8.

(e) lessees and lessors may elect the following reliefs:

(i) An entity is not required to evaluate initial direct costs for contracts that began before the effective date.

(ii) An entity may use hindsight in comparative reporting periods including the determination of whether or not a contract is a lease or contains a lease.

Appendix B

B1. This appendix contains an extract from paragraph 35, agenda paper 2G/211 from the October 2011 meeting, showing how the modified retrospective approach works.

> For example, if transitioning in the fourth year of a 10-year lease, with yearly payments of 1,000CU and a discount rate at the effective date of 5.7 percent, the lessee would calculate the lease liability at transition as 4,967CU. The lessee then determines the liability at the beginning of the lease term as 7,472CU and calculates the ROU asset for the proportion of the term remaining (6 of the 10 years) at 4,483CU as described below.

Revised modified transition approach

This calculation derives the transition ROU asset (or an approximation thereof) that would be produced from full retrospective application but it only uses 4 pieces of data - the first three inputs are needed to calculate the transition liability (discount rate, term, lease payments) and the fourth input is the calculated liability itself. The transition liability is calculated the same as it would be under the simplified retrospective approach in the ED.

Proportion of term remaining = 6 / 10

a. Calculated liability at transition = 4,967
b. Discount rate = 5.7%
c. Calculated amount of periodic payment that is necessary to pay down the lease liability at transition to zero= 1,000

Total liability at beginning of lease term, as derived only from inputs (a., b. and c.) above = 7,472

ROU Asset = 60% x 7,472 = 4,483

In this example, the calculation results in an identical ROU asset as calculated under the full retrospective transition because: (1) the lease payments are constant throughout the lease term and (2) the transition incremental borrowing rate is set equal to the rate at initial application. If one or both of these is assumptions is not true then the transition asset will be an approximation only.

The modified retrospective transition approach would serve to reduce the increase in expense (from lessee's perspective) in the periods immediately following transition as compared to the simplified retrospective approach in the ED.