IASB Agenda ref **3B**

FASB Agenda ref **235**

STAFF PAPER

12-14 June 2012

FASB | IASB Meeting

FASB Education Session 6 June 2012
IASB Education Session 6 June 2012

Project	**Leases**		
Paper topic	Lessee accounting approaches		

CONTACT(S)	Cullen Walsh	cdwalsh@fasb.org	+1 203 956 5354
	Danielle Zeyher	dtzeyher@fasb.org	+1 203 956 5265
	Patrina Buchanan	pbuchanan@ifrs.org	+44 207 246 6468

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

Introduction

1. This paper summarizes the following three approaches to lessee accounting:
   (a) Approach 1 treats all lease contracts as the purchase of a right-of-use (ROU) asset, which is financed separately.
   (b) Approach 2 treats all lease contracts as paying for access to (and use of) the underlying asset over time and links the ROU asset and the lease liability throughout the lease term.
   (c) Approach 3 does not view all lease contracts as being the same, and therefore, proposes that some lease contracts be accounted for under Approach 1 and others be accounted for under Approach 2.
2. All three approaches require the same initial and subsequent measurement of the liability to make lease payments (lease liability) and the same initial measurement of the ROU asset.
3. The question for the Boards relating to this paper is included in paper 3A/234.
4. If the Boards select Approach 2 (or Approach 3), then the Boards will need to consider other tentative decisions (for example, presentation and disclosure) that may require reconsideration as a consequence of changing the expense

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

recognition pattern from Approach 1 to Approach 2 (or a combination of Approaches 1 and 2–Approach 3), which will be addressed in a paper for a future meeting.

5. In addition, if the Boards select Approach 3, the Boards will need to determine how to distinguish between leases accounted for under Approach 1 and leases accounted for under Approach 2. This is discussed in agenda paper 3D/237.

6. This structure of this paper is as follows:

   (a) Approach 1 (paragraphs 7-17)

   (b) Approach 2 (paragraphs 18-32)

   (c) Approach 3 (paragraphs 33-50)

   (d) Staff recommendations (paragraphs 51-52)

   (e) Appendix A, illustrations of Approaches 1 and 2

Approach 1

Overview of Approach 1

7. Approach 1 is the Boards' current tentative decisions. The Boards have tentatively decided that a lessee would recognise:

   (a) A 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 (plus initial direct costs) 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, which typically would be on a straight-line basis.

8. Under Approach 1, 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.

9. Refer to illustrations in Appendix A for the application of the Approach 1 to example leases.

Rationale for Approach 1

10. Under Approach 1, a lessee finances the acquisition of a ROU asset and the accounting is similar to financing the acquisition of other assets. That ROU asset is a non-financial asset, which Approach 1 measures 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 amortisation or depreciation pattern of the ROU asset is based on the expected pattern of consumption of benefits from the ROU asset and there is no relationship between the pattern of consumption of benefits from the ROU asset and the manner of financing, which is consistent with accounting for other assets.

Reasons to support Approach 1

11. The subsequent measurement of the ROU asset and the lease liability and the reducing lease expense recognition profile that results from that measurement is conceptually consistent with a ROU model, whereby the lessee recognises lease assets and liabilities separately. As noted above, the ROU asset is a non-financial asset, which the lessee typically pays for over time. The lease liability is a financial liability. Therefore, supporters of this approach think 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.

12. After a lessee enters into a lease contract (regardless of the reasons why), every lessee has the right to use the underlying asset and has an obligation to pay for

that right. Accordingly, those supporting Approach 1 think that all lessees should account for the rights and obligations arising from a lease contract in the same manner as other non-financial assets and financial liabilities.

13. 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 lease contracts, and place much less stress on distinguishing between the lease and purchase of an asset than any other approach. In that respect, the Boards' tentative decisions reduce complexity.

14. A substantial majority of financial statement users that we spoke to in April and May 2012 preferred a single model for lessee accounting rather than a dual-model approach. In addition, those users thought Approach 1 was straightforward to understand.

15. 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 aggregate. These disclosures should facilitate identifying the amount of lease payments made in the period, which can be used to make projections about future periods.

16. 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 (shown below). Although this is not necessarily a reason to support Approach 1, it might alleviate the concerns of some preparers. 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

Concerns about Approach 1

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

    (a) Some preparers 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. They would argue that 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) Other preparers think that leases of particular types of assets are not financing transactions. Rather, in those contracts, the lessee is paying simply to use an asset over a specified period of time and then return that asset to the lessor in a condition similar to what it was at lease

commencement. In addition, when pricing those contracts, the lessor is simply charging a constant return on its investment in the underlying asset, which retains its value during the lease. Consequently, they do not think lease payments for some leases should be presented as two separate components in the income statement.

(c) Some are concerned about the impact of Approach 1 on a lessee's equity. Even if a lessee has a static number and profile of lease contracts, the Boards' tentative decisions will result in a potentially significant decrease in the reported equity of some lessees. This is because the lease liability typically will be higher than the ROU asset throughout the lease term.

Approach 2

Overview of Approach 2

18. The initial and subsequent measurement of the lease liability and the initial measurement of the ROU asset would be the same under Approach 2 as it would be under Approach 1.

19. Under Approach 2:

(a) The lessee would allocate the total cost of the lease contract (which would include lease payments plus other amounts included in the ROU asset under Approach 1, such as direct costs) evenly over the lease term resulting in straight-line total lease expense in each period. This would be the case even if the pattern of lease payments is not even throughout the lease term.

(b) The lessee would present the total expense each period as lease expense and there would be no separate interest component or amortization component in the income statement.

(c) The lessee would measure the ROU asset each period as a balancing figure such that the liability would be subsequently measured as previously described under Approach 1, and the total lease expense

would be recognized on a straight-line basis, regardless of the timing of lease payments.

20. Refer to illustrations in Appendix A for the application of Approach 2 to example leases.

Rationale for Approach 2

21. Approach 2 considers the ROU asset and the lease liability that arise from a lease contract to be one unit of account when initially and subsequently measuring those balances. This approach views the ROU asset as being different from other non-financial assets and different from the underlying asset itself. That is because the ROU asset is inextricably linked to the lease liability, not only at lease commencement, but also throughout the lease term.

22. Because this approach also does not view a lease contract as financing the acquisition of an asset, the accounting proposed is different from financing the acquisition of other assets.

Reasons to support Approach 2

23. The subsequent measurement of the ROU asset and the lease liability, and the resulting straight-line expense recognition profile that results from that measurement, is consistent with a ROU model that links the measurement of the ROU asset and the lease liability throughout the lease term. Approach 2 does not view leases as financing the acquisition of an asset. Therefore, supporters of this approach think that a lease contract is different from purchasing any other non-financial asset and separately financing that purchase, and should be accounted for differently.

24. Approach 2 is straight-forward—all lease contracts are accounted for the same way. Approach 2 for all lease contracts would eliminate the need to draw a distinction between different types of lease contracts, which reduces complexity.

25. A substantial majority of financial statement users that we spoke to in April and May 2012 preferred a single model for lessee accounting rather than a dual-model

approach. In addition, many users indicated that they would find straight-line expense information useful in their analysis.

26. Additional disclosures could be required to provide users with information about accretion on the lease liability. Most users that we spoke to in April and May 2012 indicated that they would find this information useful.

27. Approximately half of the preparers that were heard from in the outreach activities think that the expense recognition pattern in Approach 1 is a distortion of the economics of their lease transactions. Approach 2 would be responsive to those concerns.

28. Some supporters of Approach 2 think it would be responsive to user requests for one expense recognition pattern. They also think the costs of applying Approach 2 would be less than Approach 3 because one expense recognition pattern would apply to all leases under Approach 2.

Concerns about Approach 2

29. Some lessees and users think Approach 1 represents the economics of all lease transactions. Therefore, applying Approach 2 to all leases may lead to the same level of concern that some raised about applying Approach 1 to all leases. That is, the straight-line total lease expense recognition profile does not reflect the economics of all lease contracts.

30. If Approach 2 applies to all leases, then there would be a significant difference in the expense recognition pattern for a lease that is substantially similar to a purchase (for example, a lease of a piece of equipment for a substantial majority of its life) and a purchase that is separately financed. Consequently, an entity may be able to select the form of the arrangement to achieve a particular accounting outcome. Those that do not support Approach 2 think this would reduce the usefulness of information for users and may make it necessary for users to make adjustments. Therefore, they think any benefit to users to having one expense profile for all leases would be offset by this structuring opportunity.

31. Having a straight-line lease expense recognition pattern in the income statement combined with the recognition of a ROU asset and lease liability may be difficult to defend from a conceptual standpoint. The Boards may be able to overcome this potential criticism because almost all users we spoke to in April and May 2012 think that recognizing a lease asset and lease liability on a lessee's balance sheet is an improvement to financial reporting.

32. The measurement of the ROU asset has little meaning under Approach 2. It does not represent the historical cost of the ROU asset or the fair value of the ROU asset. It is merely a balancing figure as described above. Again, this criticism could potentially be countered by views from users who generally noted that it is the recognition of the contractual lease liability on a lessee's balance sheet that is most useful to them in performing their analyses. The ROU asset and its measurement basis is less relevant with the approaches the staff is considering.

Approach 3

Overview of Approach 3

33. The initial and subsequent measurement of the lease liability and the initial measurement of the ROU asset would be the same under Approach 3 as it would be under Approaches 1 and 2.

34. Under Approach 3, the subsequent measurement of the ROU asset and the total expense recognition pattern would depend on the economics of the lease transaction by looking through to the underlying asset and the terms of the lease contract.

    (a) For some leases, the subsequent measurement of the ROU asset and the expense recognition pattern would be the same as Approach 1. Refer to paragraphs 7 through 9 for additional information on this approach.

    (b) For other leases, the subsequent measurement of the ROU asset and the expense recognition pattern would be the same as Approach 2. Refer to paragraphs 18 through 20 for additional information on this approach.

Rationale for Approach 3

35. For all leases, the lessee receives a right to use the underlying asset and has an obligation to pay for that right. Leases are different from service contracts because the lessor has delivered the underlying asset to the lessee and the lessee has a contractual obligation to pay for the right to use the underlying asset. Although the lessor may have incremental obligations to the lessee beyond delivering the underlying asset (for example, an obligation to provide maintenance of common area space in a multi-tenant facility), the incremental obligations do not change the fact that the underlying asset was delivered (that is, made available) to the lessee at lease commencement. Accordingly, it is appropriate that a lessee recognize a ROU asset and lease liability for all leases. Most users of financial statements indicated that including lease assets and lease liabilities is a significant improvement to financial reporting.

36. Most would agree that the expense recognition pattern in Approach 1 is typically what one would expect from recognizing a lease liability (a financial liability) and the ROU asset (a non-financial asset) as separate elements. However, some would suggest that the accounting that typically results from recognizing a non-financial asset and a financial obligation is not always the best reflection of the economics of all lease contracts. This is because there is a wide spectrum of different lease contracts, ranging from those that look similar to a service contract to those that look similar to the purchase of the underlying asset.

37. In saying that, most would not suggest that we should build a lease accounting model with numerous different lease expense recognition patterns because of the complexity and cost of such an approach. However, those supporting Approach 3 think that having two different lease expense recognition patterns would more accurately reflect the differing economics across the spectrum of lease contracts that exist. We think the reason that lease contracts are often viewed as having differing economics is because the underlying asset, and not the right-of-use, is often the predominant feature of a lease contract for both the lessee (when determining whether to enter into the arrangement) and the lessor (when pricing the contract).

38. Supporters of Approach 3 think that the presence of the underlying asset makes the 'right-of-use' that arises from a lease contract somewhat different from other intangible rights, both for lessees and lessors, and also for users who often try to compare entities who lease assets with those who buy assets. Some users indicated that they currently make different operating lease adjustments depending on the nature of the underlying asset. Accordingly, an approach that has a different income statement expense recognition pattern based on looking through to the underlying asset and the nature of the lease contract has the potential to better reflect the economics of some lease contracts.

39. Supporters of this view acknowledge that it is more difficult to defend Approach 3 than Approach 1 from a conceptual perspective. However, they think it would provide valuable information to users of financial statements to better reflect in the income statement what a lessee economically obtains in a lease contract.

40. Therefore, under Approach 3, for some lease contracts the lessee would recognize interest expense and amortization of the ROU asset consistent with Approach 1, reflecting that, for those leases, the lessee is financing the acquisition of a ROU asset. For other lease contracts, the lessee would recognize total lease expense on a straight-line basis reflecting that, for those leases, the lessee is simply paying to use the underlying asset.

Reasons to support Approach 3

41. Given the spectrum of different lease contracts that exist and the different views of preparers expressed during outreach in April and May 2012 about whether Approach 1 or Approach 2 was preferable, Approach 3 has the potential to better reflect the differing economics of more lease contracts than either Approach 1 or Approach 2.

42. Although a minority view, some users that we spoke to in April and May 2012 indicated that reflecting the economic difference between, for example, a five-year land lease and a five-year car lease in a lessee's income statement would provide better information to users. Although they supported such a differentiation in the income statement, they thought it was useful to include a

lessee's contractual obligations arising from all lease contracts on the balance sheet.

43. Approach 3 is responsive to the views of some preparers that the economics of some of their lease transactions is not properly captured in the income statement under Approach 1. Some constituents do not think all lease transactions are equivalent to the purchase of an asset or involve a significant financing element, and therefore, they think Approach 1 would distort the economics of their transactions in the income statement.

44. Because Approach 3 would always require the lessee to recognise a lease liability on its balance sheet, there would be less pressure (than on the existing operating/finance lease line) on where the line is drawn to differentiate the different income statement effects of different leases.

45. Some supporters of Approach 3 consider the economics of lease transactions from the perspective of the lessor. They think the economics of transactions for lessors vary for different reasons. They support two income recognition patterns for lessors. Consequently, they think a single expense recognition pattern for lessees is not appropriate.

Concerns about Approach 3

46. The Boards will need to establish the principle and/or the criteria that can be used to determine which model a lessee would apply to each lease contract. This has proven difficult in the past, and there is a risk that supporters of Approach 3 would not reach a consensus on the appropriate principle and/or criteria.

47. Based on the staff's outreach in April and May 2012, a substantial majority of financial statement users prefer to have one lessee model; therefore, Approach 3 is not preferable for all users.

48. Approach 3 adds complexity and cost for:

    (a) Some lessees because they will need to assess which model to apply to each lease; and

(b) Users because they will need to assess which model applies to which leases for each entity analysed (with a significant lease portfolio).

49. Some preparers may structure contracts to achieve an accounting outcome. Although both of the expense recognition patterns in Approach 3 involve the recognition and measurement of lease liabilities, the expense recognition pattern would be different. Some think lease contract structuring will continue under Approach 3, particularly for entities that are income statement focused and/or are growing.

50. Having a straight-line lease expense recognition pattern in the income statement combined with the recognition of a ROU asset and lease liability may be difficult to defend from a conceptual standpoint. The Boards may be able to overcome this potential criticism because almost all users think that recognizing a lease asset and lease liability on a lessee's balance sheet is an improvement to financial reporting.

Staff recommendations

51. A majority of staff members recommend that the Boards retain their current tentative decisions (Approach 1). The primary reasons are:

(a) The expense recognition pattern is conceptually consistent with a ROU model, whereby the lessee recognizes a ROU asset and a lease liability separately. The subsequent measurement of that non-financial asset (the ROU asset) and financial liability (the lease liability) under Approach 1 is consistent with the subsequent measurement of other non-financial assets and financial liabilities.

(b) Approach 1 is a coherent model for all leases which reduces complexity and cost for users, preparers, and auditors. In addition, a substantial majority of users we spoke to during April and May 2012 preferred one approach to lessee accounting.

(c) There is significant diversity in views about the economics of lease transactions. Developing a principle and/or criteria for determining

which expense recognition pattern to apply to each contract is likely to be arbitrary, and will inevitably be subject to criticism given the diversity of views among constituents. Consequently, the staff supporting Approach 1 do not think Approach 3 would provide users with more useful or relevant information than Approach 1.

52. Other staff members recommend Approach 3. The primary reasons are:

(a) The expense recognition pattern would vary depending on the economics of different lease contracts. Because there is a spectrum of different lease contracts, a single expense recognition pattern would ignore the different economics of some lease contracts. The staff supporting Approach 3 have been persuaded by the views of some users and preparers that Approach 1 would not reflect, economically, what the lessee obtains in some lease contracts, for example, a short-term real estate lease.

(b) They think appropriate disclosure requirements coupled with the recognition and measurement in Approach 3 will meet the needs of users in a similar fashion as Approach 1.

(c) Because there is significant diversity in views about the economics of lease contracts, it is important not to try to fit all lease contracts into one model. Therefore it is important to differentiate the expense recognition patterns of different lease contracts. Because lessees will recognise a ROU asset and a lease liability for all lease contracts (except short-term leases), the pressure on determining which expense recognition pattern to apply to each lease contract is not as great as under current lease guidance (where the difference resulted in either on- or off-balance sheet lease liabilities).

The Boards have tentatively concluded that there are two different models for lessor accounting. Therefore, the staff that support Approach 3 think that symmetry between lessee and lessor accounting, at least in

theory, is important and therefore prefer a two-model approach for lessees.

APPENDIX A

Lessee Accounting - Even Payments

Assumptions:

Lease term in years	5
Interest rate	6.00%
Lease payments	60

Periods	0	1	2	3	4	5
Approach 1						
Balance Sheet						
Right-of-use asset	253	202	152	101	51	-
Liability to make lease payments	253	208	160	110	57	-
Income Statement						
Interest on lease obligation		15	12	10	7	3
Amortisation expense		51	51	51	51	51
Total Lease Expense		**66**	**63**	**60**	**57**	**54**

Periods	0	1	2	3	4	5
Approach 2						
Balance Sheet						
Right-of-use asset	253	208	160	110	57	-
Liability to make lease payments	253	208	160	110	57	-
Income Statement						
Total Lease Expense		**60**	**60**	**60**	**60**	**60**

Total Lease Expense by Approach	1	2	3	4	5
Approach 1	**66**	**63**	**60**	**57**	**54**
Approach 2	**60**	**60**	**60**	**60**	**60**

Example calculation of period 1 expense and change in liability and asset

Expense each period equals the average payment each period
Total lease payments: 300
Lease term: 5 years
Annual expense: 60 (300/5)

Change in liability each period equals difference between payments and accretion (using discount rate)
Payments: 60
Accretion: 15 (253 * 6%)
Change in liability: 45 (60 - 15)

Change in asset each period equals difference between expense and accretion
Expense: 60
Accretion: 15
Change in asset: 45

Lessee Accounting - Uneven Payments

Lease Payments

1	70
2	85
3	100
4	115
5	130

Assumptions:

Lease term in years	5
Interest rate	6.00%

Periods	0	1	2	3	4	5
Approach 1						
Balance Sheet						
Right-of-use asset	414	331	248	166	83	-
Liability to make lease payments	414	369	306	224	123	-
Income Statement						
Interest on lease obligation		25	22	18	13	7
Amortisation expense		83	83	83	83	83
Total Lease Expense		**108**	**105**	**101**	**96**	**90**

Approach 2						
Balance Sheet						
Right-of-use asset	414	339	261	179	93	-
Liability to make lease payments	414	369	306	224	123	-
Income Statement						
Total Lease Expense		**100**	**100**	**100**	**100**	**100**

Total Lease Expense by Approach					
Approach 1	**108**	**105**	**101**	**96**	**90**
Approach 2	**100**	**100**	**100**	**100**	**100**

Example calculation of period 1 expense and change in liability and asset

Expense each period equals the average payment each period
Total lease payments: 500
Lease term: 5 years
Annual expense: 100 (500/5)

Change in liability each period equals difference between payments and accretion (using discount rate)
Payments: 70
Accretion: 25 (414 * 6%)
Change in liability: 45 (70 - 25)

Change in asset each period equals difference between expense and accretion
Expense: 100
Accretion: 25
Change in asset: 75 (100-25)