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Project	**Leases**		
Paper topic	How to determine 'the line' for different types of leases		

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Introduction

1. The purpose of this paper is to discuss the application of Approach 3 (as described in paper 3B/235) assuming that the Boards decide that they want to move forward with a dual expense recognition approach to lessee accounting. Specifically, this paper considers alternatives for where 'the line' should be drawn that would determine when the different lease expense recognition patterns should be applied,
2. For each alternative presented, we have also considered what the rationale would be if the line was the same under lessor accounting, as well as whether the indicators for determining the line for lessees could be used for lessors. Our analysis and recommendation of where the line should be for lessors is considered in more detail in paper 3C/236.

Overview

The criteria the staff used to assess the line

3. Approach 3 is an alternative intended to address criticisms of Approach 1 (as described in paper 3B/235), based on the view that the economics of lease contracts can be different and that difference should be reflected in the lessee's income statement.

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4. Consequently, the staff has analysed the various potential approaches to determining the line with the following questions in mind:
   (a) Would the proposed line address criticisms raised by some constituents (particularly commercial property lessees) that Approach 1 does not reflect the economics of their lease contracts?
   (b) Would the proposed line mean that some lease contracts that should result in Approach 1 accounting, now result in Approach 2 accounting (as described in paper 3B/235)? In other words, would the proposed line fix one problem, but in doing so create another problem?
   (c) Is the proposed line founded on an underlying principle?
   (d) Would the proposed line be understandable for preparers (and users) and not too costly to implement?

The possible alternatives for drawing a line

5. With the above criteria in mind, the staff is presenting four options for determining the line:
   (a) **Option 1:** Determination based on the transfer of substantially all of the risks and rewards of ownership (using the principle outlined in IAS 17 *Leases*).
   (b) **Option 2:** Determination based on whether the ROU asset represents the acquisition of a more than insignificant portion of the underlying asset.
   (c) **Option 3:** Determination based on the nature of the underlying asset.
   (d) **Option 4:** Determination based on the lessee’s business purpose for entering into the lease arrangement.
6. The staff has also included several examples in Appendix A to this paper to illustrate how we think the income statement profile would be presented when applying the four options to example lease contracts.

Analysis of the options for determining the line

Option 1: Transfer of substantially all of the risks and rewards of ownership

7. Under Option 1, the determination of the line would be based on whether or not substantially all of the risks and rewards of ownership of the underlying asset have been transferred to the lessee, using a principle similar to that in IAS 17. If the Boards were to select this option, there may be a need to reconsider the exact wording of the principle and/or reconsider some of the supporting guidance in IAS 17 to better align with the ROU model being developed. We think that the following paragraphs from IAS 17 could be used as the starting point for developing the supporting guidance::

> 7. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.
>
> 8. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.
>
> 10. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
>
> (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
>
> (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

11. Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

12. The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

Assessment against the staff criteria for the most appropriate line

8. In considering the staff criteria for determining the most appropriate line, Option 1 has the following advantages:

   (a) Is likely to address the criticism from preparers who think Approach 1 in agenda paper 3B/235 does not represent the economics of all of their lease arrangements.

(b) Promotes a smoother transition between the current accounting and the proposed lease model, specifically if the intent of the Boards is to maintain a line that is relatively consistent with that applied in current practice. In other words, the costs involved in applying Option 1 would be relatively lower than the other options.

(c) Adopts the principles underlying current US GAAP under ASC Topic 840: *Leases*, without bright-line tests.

9. Option 1 has the following disadvantages:

(a) The principle in IAS 17 in effect differentiates between a lease which, in substance, represents a purchase of the underlying asset (that is, finance leases) and all other lease contracts that are treated as executory contracts (that is, operating leases). Consequently, this method in IAS 17 was developed for a different purpose and may not be appropriate under a right-of-use model.

(b) As noted in paper 3B/235, we think that it would be difficult to defend the recognition of lease assets and liabilities by a lessee if, for all leases (except those currently classified as finance leases), the lessee is required to recognise a straight-line lease expense (excluding an interest component) when some of those leases are clearly financing transactions. In other words, although Option 1 would address the concerns raised by some constituents, it might introduce concerns for other constituents and fail to achieve one of the key objectives of this project, namely to depict the financing element that is not shown in current operating lease accounting. For example, a 20 year airplane lease is likely to not be presented as a financing arrangement under Option 1.

Lessor Implications of Option 1

10. *Rationale* – If the line under Option 1 is used for lessor accounting, the rationale would be the same as that under current IAS 17 accounting, that is, the receivable

and residual approach should apply only to leases that, in substance, represent a sale of the underlying asset to the lessee.

11. *Indicators* – The indicators that would be applied for lessors would be consistent with those used for lessees.

Option 2: The acquisition of a more than an insignificant portion of the underlying asset

12. Under Option 2, the determination of the line would be based on whether the ROU asset represents the acquisition of a 'more than insignificant portion' of the underlying asset.
13. In many leases, the lessee is paying to finance the acquisition of a portion of the underlying asset, which the lessee then consumes to generate economic benefits over the lease term. In other cases, the lessee is paying only to use the underlying asset over the lease term, but does not acquire and consume any of the underlying asset. This logic is similar to the logic of Approach C as outlined at the February 2012 Board meeting.
14. Consequently, in leases for which the ROU asset represents the acquisition of a more than insignificant portion of the underlying asset, a lessee would apply the accounting treatment under Approach 1 of agenda paper 3B/235. In other leases, the lessee is not economically financing the purchase of a portion of the underlying asset (that is, not consuming a more than insignificant portion of the underlying asset). The lessee is, in substance, paying only for use of the asset, similar to an entity that pays interest on an interest only loan. Consequently in those leases, the lessee would apply the straight-line amortisation approach as explained in paper 3B/235.
15. We think this principle is similar to what some Board members referred to as the 'inverse of IAS 17' at the May 2012 Board meeting.

Indicators to determine the line

16. To assist in distinguishing between a lease for which the ROU asset represents the acquisition of a more than insignificant portion of the underlying asset, the staff has developed the following indicators:

   (a) At lease commencement, the underlying asset is expected to retain a significant portion of its value throughout the lease.

      (i) This indicator is linked with the underlying principle of Option 2 regarding the acquisition of a portion of the underlying asset.

      (ii) The lessee should include expectations of what the lessee/lessor plan to do to maintain the asset over its useful life. In other words, if the lessee expects the asset to be worth at least the same value at the end of the lease as it is worth at lease commencement, it is logical to assume that the lessee did not purchase and consume any of the underlying asset over the lease term.

   (b) At lease commencement, all else being equal, the lessee would expect to pay approximately the same lease payments at the end of the lease if it renewed the lease at that time.

      (i) This is a similar indicator to that described above in paragraph 16(a). Assuming the lessor charges a constant yield on the underlying asset, if the amount a lessee would be expected to pay remains constant, then the implication is that the underlying asset has not decreased in value and, therefore, the lessee did not purchase and consume a more than insignificant portion of the underlying asset.

      (ii) This should exclude future market expectations, for example inflation and significant changes in supply and demand.

Assessment against the staff criteria for the most appropriate line

17. The advantages of applying Option 2 are that:

(a) The staff thinks that the application of Option 2 would address comments made by those constituents who expressed the most significant concerns with Approach 1 as described in paper 3B/235. For example, the expense profile for most property leases would be recognized on a straight-line basis as an operating expense, rather than as interest and amortization.

(b) When the underlying asset is not expected to lose any significant value over the lease term, the lessee is compensating the lessor only for using the underlying asset. Accordingly, for such leases, a straight-line rental expense could be supported from an economic perspective. In other words, the line under Option 2 would tie into the rationale for applying Approach 3 as described in paper 3B/235 and proponents of this view would argue that the economics of the lease transactions would be better reflected in the income statement.

18. The disadvantages of applying Option 2 are that:

(a) Applying the principle may be relatively more complex than the line under IAS 17 because it would introduce a new concept, resulting in increased cost for both preparers in applying judgement and for users in understanding the dividing line.

(b) Application guidance might need to be developed to help preparers apply judgment to determine when a more than insignificant portion of the underlying asset is acquired.

(c) There may be other lease contracts that do not reflect a significant financing decision on the part of the lessee, which some would argue should be accounted for on a straight-line basis in the income statement. For example, a lessee might lease a fleet of cars for its employees on three year lease terms. Although the lessee is consuming a more than insignificant portion of the value of the underlying car, some may argue that the transaction should not be depicted as a financing arrangement if the lessee does not think the transaction represents a financing

arrangement (for example, if the lessee thinks of the arrangement as an annual employee compensation expense)..

Lessor Implications of Option 2

19. *Rationale* – If the line under Option 2 is used for lessor accounting, the rationale would be that the line represents the sale by the lessor of a more than insignificant portion of the underlying asset. In other words, when the lessor is deemed to have 'sold' a more than insignificant portion of the underlying asset to the lessee, the lessor would reflect the accounting under the receivable and residual model as follows:

    (a) For the portion of the underlying asset that is deemed to be sold to the lessee, the lessor would recognise this as a receivable and also recognise profit on the sale of that portion at lease commencement; and

    (b) For the portion of the underlying asset that is not deemed to be sold to the lessee, the lessor would reclassify this as a residual asset and not recognise any profit on this portion of the underlying asset.

    Proponents of this line for lessors would argue that, as part of any lessor business model, a lessor would analyse the underlying asset in a way that is reflected by the receivable and residual method when there is a more than insignificant consumption of the underlying asset.

    (a) *Indicators* – The indicators used by lessors would be similar to those used by the lessee. An advantage for a lessor of the indicator in paragraph 16(a) (that is, looking to the expected value of the underlying asset at the end of the lease as a proxy for consumption) is that a lessor would always have at least the same if not better information regarding the underlying asset than the lessee. The other indicator in paragraph 16(b) (that is, expected lease charge if the lease were renewed) would need to be adjusted to look at the transaction from the lessor's perspective but the overall principle would remain the same. In other words, at lease commencement, the lessor's expectation is that, all else being equal, the

lessor would expect to charge approximately the same lease payments at the end of the lease if a lessee renewed the lease at that time.

Option 3: The nature of the underlying asset

20. The underlying rationale for Option 3 is the same as that explained for Option 2 above – the economics of lease transactions are different depending on whether the lessee acquires and consumes a more than insignificant portion of the underlying asset over the lease term.
21. However, instead of the supporting indicators mentioned above in paragraph 16, the line could be based on the type of underlying asset through the application of the following practical expedient:

(a) Leases of property (defined as land or a building – or part of a building – or both) should be accounted for using a straight-line presentation in the income statement (the accounting treatment outlined in Approach 2 of agenda paper 3B/235) *unless:*

(i) The lease term is for the major part of the economic life of the underlying asset; or

(ii) The present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.

(b) Leases of assets other than property should be accounted for under Approach 1 as described in agenda paper 3B/235 *unless:*

(i) The lease term is an insignificant portion of the economic life of the underlying asset;

(ii) The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

Assessment against the staff criteria for the most appropriate line

22. The advantages of this option are that:

    (a) It addresses the majority of the concerns raised by constituents, who were mostly lessees of property.

    (b) The approach is relatively simple and easy to apply and understand.

    (c) Similar to Option 2, proponents of this option would argue that there is an economic basis to support the application of a straight-line rent expense approach to (mainly) property leases.

23. The disadvantages of this practical expedient are that:

    (a) If the Boards do not agree with the definition as stated above, the Boards would be required to define property.

    (b) Although this option is intended as a practical expedient, the identification of in-substance purchases of property and insignificant consumption of equipment would introduce judgement and might reduce the benefit of having a practical expedient in the first place.

Lessor Implications of Option 3

24. *Rationale* – As explained in paragraph 20 above, the underlying rationale for Option 3 is the same as that explained for Option 2 above, that is, the economics of lease transactions are different depending on whether the lessor 'sells' a more than insignificant portion of the underlying asset.

25. *Indicators* – Because Option 3 is a practical expedient for Option 2, the same indicators for lessees would be used for lessors. In other words:

    (a) Leases of property (defined as land or a building – or part of a building – or both) should be accounted for based on current operating lease accounting *unless:*

        (i) The lease term is for the major part of the economic life of the underlying asset; or

(ii) The present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.

(b) Leases of non-property should be accounted for under the receivable and residual method *unless:*

(i) The lease term is an insignificant portion of the economic life of the underlying asset;

(ii) The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

Option 4: Business Purpose

26. Under Option 4, the determination of the line would be based on the lessee's business purpose for entering into this lease arrangement, focusing mainly on whether the lessee considered the lease to be a financing arrangement.

Supporting indicators of a financing arrangement

27. In some cases, it might be difficult for the lessee to determine whether they entered into the lease contemplating a financing arrangement. To assist in making this determination, the staff thinks that it should be presumed that the lessee has entered into a financing arrangement and apply Approach 1 (as described in paper 3B/235) to the income statement presentation unless the indicate otherwise:

(a) Underlying asset:

(i) The underlying asset is not available to be purchased by the lessee or sold by the lessor.

(ii) The underlying asset is expected to lose an insignificant portion of its value over the lease term.

(b) There is no evidence that management of the lessee made a 'lease/buy decision' when considering the lease.

(c) Length of lease term – The duration of the term of the lease is an insignificant portion of the economic life of the underlying asset.

Assessment against the staff criteria for the most appropriate line

28. The advantages of Option 4 are that:

    (a) It would address the majority of the concerns raised by constituents, who were mostly lessees of property;

    (b) It allows lessees the flexibility to reflect in their income statement their assessment of the economics of the transaction.;

    (c) One of the primary objectives of the leases project was to reflect the financing that is economically inherent in lease contracts. Option 4 results in the income statement reflecting this on the basis of what the lessee considers to be a financing transaction.

29. Disadvantages of Option 4 are:

    (a) This option's underlying principle is based on the intention of the lessee in determining whether the lease transaction was primarily entered into as a financing arrangement or not. This has the potential to create comparability issues for users. In other words, because the determination of the income statement profile is largely 'in the eyes of the beholder', the judgement applied by management may vary by entity, meaning that it may be more difficult for users to understand when and how management have applied their judgement to different lease contracts, both within the same entity and between entities.

    (b) The indicators identified by the staff to apply this option might in some cases be conflicting, which might result in additional preparation and audit cost to obtain the most appropriate treatment for the lessee, particularly when a lessee enters into multiple lease contracts. For example, a lessee might have made a lease/buy decision but the underlying asset is expected to lose an insignificant portion of its value over the lease term.

    (c) If the principle described in Option 4 is used for lessee and lessor accounting, this would not always mean that a lessee and lessor would

account for the same transaction in a similar way. For example a three year car lease is likely to be priced as a financing transaction for a lessor, but might not be viewed as a financing transaction by the corresponding lessee (this is discussed in more detail in paper 3C/236).

Lessor Implications of Option 4

30. *Rationale* – If the line under Option 4 is used for lessor accounting, the rationale would be that the line represents the different economic business decisions made by the lessor (paper 3C/236 explains this rationale in more detail).

    Indicators – As explained in paragraph 29 above, it may be difficult in practice to determine whether the lessee knowingly entered into a financing transaction in the context of a lease. The indicators provided for the lessee are intended to assist a lessee in making this determination. However, when considering the line from a lessor's perspective, we think that a lessor's business model will provide a clear indication as to whether the lessor views the transaction as a financing arrangement or not, because we think it will be evident from the way in which the lessor prices the contract internally. Consequently, we think that the indicators from a lessor perspective could be simplified as follows:

    (a) Where lessors price lease contracts based on estimates of the value of the asset at the beginning and end of the lease contract to obtain a desired return, the lessor should apply the receivable and residual method to account for the lease.

    (b) Where lessors price lease contracts to obtain a desired return on the whole underlying asset over the entire period that they intend to hold the asset, the lessor should account for the transaction using current operating lease accounting.

Staff recommendation

31. In the context of the criteria described in paragraph 4, the staff considered the options as follows:

(a) Some staff members support Option 1 for two primary reasons. First, they think Option 1 is easier for users and preparers to understand and to explain than the other options. If a lease is similar to a purchase, Approach 1 (as described in paper 3B/235) is applied, which is similar to the expense profile for purchased assets that are separately financed. If a lease is not similar to a purchase, Approach 2 (as described in paper 3B/235) is applied. Second, they think the cost of applying Option 1 for preparers and auditors is less than the other options. Preparers and auditors are familiar with the application of Option 1 to lease contracts. In addition, they may not need to reassess each lease contract at transition to determine the expense recognition pattern to apply because they would have completed the assessment to apply the current leases guidance.

(b) However, other staff support Option 3. Those staff members think the rationale for this option provides a sound economic basis to support a straight-line lease expense profile for leases in which there is little consumption of the underlying asset. In addition, those staff members think that this option will address the majority of the criticism raised by constituents, without requiring leases that are clearly entered into for financing reasons to be accounted for under Approach 2 (ie, without recognising the financing element inherent in those leases in the lessee's income statement). At this stage, the staff cannot think of any 'real life' examples where the application of Option 3 would result in an income statement presentation that is contrary to the principle developed for this option. Consequently, in considering the criteria that the staff developed in paragraph 4 above to determine the most appropriate line, these staff members recommend Option 3 for drawing the line for different types of lease contracts because they think it will be less costly and more easily understandable than Option 2.

Appendix A - Illustrative examples for applying the staff proposal

A1. The staff has put together the following examples to illustrate how particular types of lease contracts might be classified under the four options presented in this paper for determining 'the line'. The types of lease arrangements considered by the staff are:

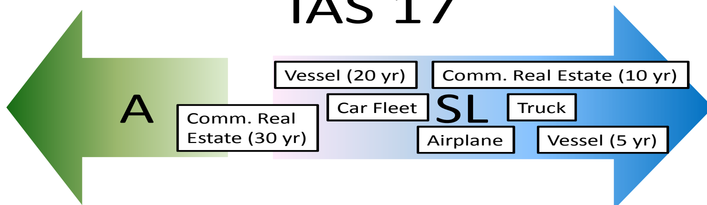
a. Car Fleet – 3 years (6 year life)
b. Truck – 4 years (10 year life)
c. Airplane – 10 years (25 year life)
d. Commercial Real Estate – 10 years (40 year life)
e. Commercial Real Estate – 30 years (40 year life)
f. Time Charter Vessel – 5 years (40 year life)
g. Time Charter Vessel – 20 years (40 year life)

A2. Each of the lease arrangements is classified depending on whether we think that type of lease would result in an income statement profile that is either:

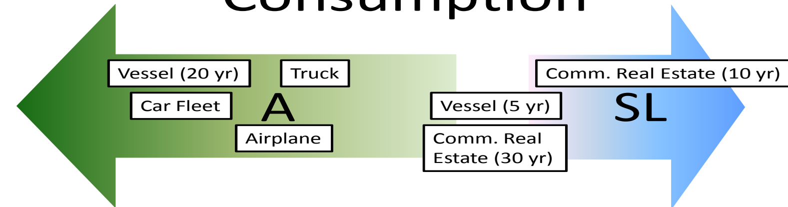
a. Approach 1 as explained in paper 3B/235 (labeled as 'A' in the diagrams); or
b. Approach 2 as explained in paper 3B/235, that is, straight-line with no interest expense presented in the income statement (labeled as 'SL' in the diagrams).

A3. Lease arrangements that are depicted in the middle of the continuum of A and SL are leases for which we think there is no clear answer. The classification in these examples represents the staff's initial thinking based on simplified assumptions. The staff understands that a detailed analysis based on all facts and circumstances specific to a 'real life' lease contract may result in a different outcome. However, the staff thinks it may be helpful for the Boards to see how each alternative would generally be applied to the classification of various lease arrangements.

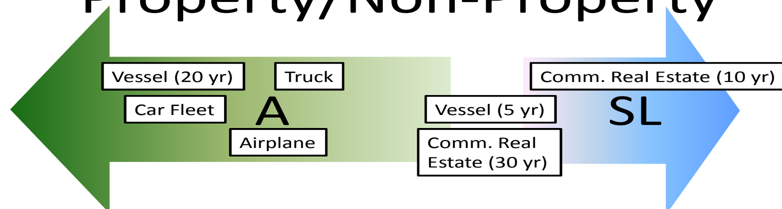
Option 1 – IAS 17



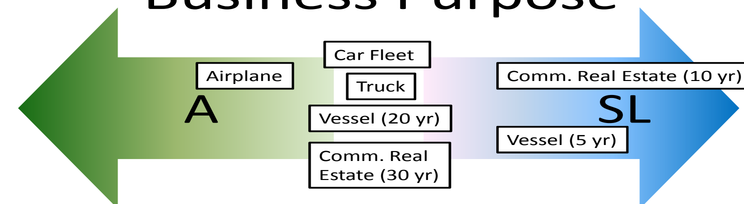
Option 2 – Consumption



Option 3 – Property/Non-Property



Option 4 – Business Purpose



Summary

	Car Fleet (3/6)	Truck (4/10)	Airplane (10/25)	Commercial Real Estate (10/40)	Commercial Real Estate (30/40)	Time Charter Vessel (5/40)	Time Charter Vessel (20/40)
Option 1 (IAS 17)	SL	SL	SL	SL	Depends	SL	SL
Option 2 (Consumption)	A	A	A	SL	Depends	Depends	A
Option 3 (Property/ Non-Property)	A	A	A	SL	Depends	Depends	A
Option 4 (Business Purpose)	Depends	Depends	A	SL	Depends	SL	Depends