STAFF PAPER

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Project	**Leases**		
Paper topic	Lessee accounting: subsequent measurement of the right-of-use		
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Purpose

1. The purpose of this paper is to provide GPF members with an update on the leases project and the outreach work the staff will be undertaking in the coming weeks.

2. The paper discusses three different ways to subsequently measure a lessee's right-of-use asset (Approaches A, B or C). The boards have directed the staff to do further research on these approaches, and in particular on the operationality of these approaches for preparers.

3. We would be interested in finding out whether any GPF members are interested in participating in the outreach that we will conduct over the coming weeks.

Background

4. The boards' primary objective in adding a leases project to their respective agendas was to address the criticisms of the existing lease accounting model. The boards have been informed that many users consider leases to be financing transactions and they routinely adjust the amounts in the financial statements in an attempt to recognise the assets and liabilities that arise from lease contracts.

5. In addition, the boards hoped to remove the dividing line between operating and finance leases, which is often applied as a 'bright line' in practice. The difference in the accounting on either side of that line and, in particular, the off-balance-sheet treatment that lessees achieve when a contract is an operating lease, has led to

some contracts being written with the sole objective of achieving a particular accounting outcome.

6. The boards' current tentative decisions are that a lessee recognises:

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

   (b) an ROU asset initially measured at an amount equal to the lease liability and subsequently measured at amortised cost.

7. The boards' tentative decisions mean the total lease expense for an individual lease would typically decrease over the lease term because (a) the interest expense recognised by the lessee 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.

8. Many constituents agree (or at least accept) that a lessee should recognise an asset and a liability. However, some have expressed concerns about the lease expense recognition profile that would arise from the boards' proposals.

9. Because of the concerns raised and the significance of the changes being proposed to the existing lessee accounting model (both in terms of the accounting outcome and the costs involved (eg systems changes)), the boards have decided that it would be appropriate to re-discuss the lessee accounting proposals before publishing the *Leases* re-exposure document.

Lessee accounting approaches to consider

10. The boards are considering three approaches to subsequently measuring the ROU asset[1]:

    (a) **Approach A**: the boards' current tentative decisions. Approach A treats a lease contract as being equivalent to the purchase of an asset, which is financed separately. As noted above, under Approach A, the

[1] For a more comprehensive discussion and analysis for these approaches, please refer to Agenda Paper 2C at the February meeting at http://www.ifrs.org/Meetings/IASB+1+and+2+March+2012.htm

lessee's total lease expense for an individual lease would typically decrease over the lease term.

(b) **Approach B:** the 'interest-based amortisation' (IBA) approach. Approach B treats a lease contract differently from the purchase of a non-financial asset, which is financed separately. The ROU asset is subsequently measured at amortised cost at the present value of remaining economic benefits, discounted using the discount rate used to initially measure the ROU asset. The amortisation or depreciation pattern is based on the expected pattern of consumption of benefits from the asset and there is no relationship between the pattern of consumption of benefits and the manner of financing. For a typical lease in which the lessee expects to obtain (or consume) benefits from using the underlying asset evenly over the lease term and pays even amounts over the period that the benefits are consumed, Approach B would result in a straight-line lease expense. This is because the lessee would take account of the time value of money when subsequently measuring both the ROU asset and the lease liability. The amortisation charge on the ROU asset would typically be lower in the early years of a lease, offsetting the higher interest expense on the lease liability in those years. The total lease expense pattern would not be straight-line if lease payments are not even over the lease term or if the lessee does not expect to consume benefits from using the asset on a straight-line basis.

(c) **Approach C:** the 'underlying asset' (UA) approach. Under Approach C, the ROU asset is also subsequently measured at amortised cost. The amortisation charge is comprised of two components: (a) depreciation (typically, straight-line) on the piece of the underlying asset consumed by the lessee over the lease term; and (b) interest on the residual asset (ie the piece of the underlying asset not consumed by the lessee). Approach C is based on how a lessor prices many lease contracts and, thus, on what the lessee is paying for when making lease payments. Rationally, a lessor would wish to charge lease payments that cover three components: (a) a payment for the part of the asset that the lessee

consumes during the lease term (ie the expected decline in value of the asset over the lease term); (b) finance charged on that part of the asset consumed because the lessee typically pays for it over the lease term; and (c) a required return on the residual value of the asset (ie the part of the asset that the lessee does not consume) because the residual asset cannot be used by the lessor while under lease. The resulting lease expense profile under the 'underlying asset' approach would vary based on the expected level of consumption of the underlying asset over the lease term. The greater the consumption of the underlying asset over the lease term, the steeper the total expense profile would become, and vice versa. The mechanics to apply Approach C is in paragraph **Error! Reference source not found.**.

11. At their recent joint board meeting:

    (a) the FASB indicated an initial leaning towards applying Approach A for existing finance leases and Approach B for existing operating leases.

    (b) the IASB indicated an initial leaning towards applying Approach C for all leases, but with some simplifications.

12. Illustrations of all three approaches are in pages 5 - 8 of this paper – illustration 1 shows two leases—one for which the lessee is expected to consume 50% of the underlying asset and another is a lease of land, for which the lessee is assumed to have consumed 0% of the underlying asset. In addition, illustration 2 sets out the lease expense profile for different leases under each of approaches. Please note that the illustrations are for an individual lease.

Illustration 1

EQUIPMENT - 50% Consumption

Assumptions:

Lease term in years	**5**
Interest rate	**6.00%**
FV of underlying asset	**1,000**
Estimated residual value	**500**
Portion of asset consumed	**500**
Lease payments	**149**

Periods	**0**	**1**	**2**	**3**	**4**	**5**
Boards' Tentative Decisions (Current)						
Balance Sheet						
Right-of-use asset	626	501	376	251	125	-
Liability to make lease payments	626	515	397	273	140	-
Income Statement						
Interest on lease obligation		38	31	24	16	8
Amortisation expense		125	125	125	125	125
Total Lease Expense		**163**	**156**	**149**	**142**	**134**

Interest-Based Amortisation Approach (IBA)						
Balance Sheet						
Right-of-use asset	626	515	397	273	140	-
Liability to make lease payments	626	515	397	273	140	-
Income Statement						
Interest on lease obligation		38	31	24	16	8
Amortisation expense		111	118	125	132	140
Total Lease Expense		**149**	**149**	**149**	**149**	**149**

Underlying Asset Approach (UA)						
Balance Sheet						
Right-of-use asset	626	504	380	255	128	-
Liability to make lease payments	626	515	397	273	140	-
Income Statement						
Interest on lease obligation		38	31	24	16	8
Interest on residual asset (not presented separately)		*22*	*24*	*25*	*27*	*28*
Depreciation on asset consumed (not presented separately)		*100*	*100*	*100*	*100*	*100*
Amortisation expense		122	124	125	127	128
Total Lease Expense		**160**	**155**	**149**	**143**	**137**

Total Lease Expense by Approach					
Boards' Tentative Decisions	**163**	**156**	**149**	**142**	**134**
Interest-Based Amortisation	**149**	**149**	**149**	**149**	**149**
Underlying Asset	**160**	**155**	**149**	**143**	**137**

LAND - 0% Consumption

Assumptions:

Lease term in years	**5**
Interest rate	**6.00%**
FV of underlying asset	**1,000**
Estimated residual value	**1,000**
Portion of asset consumed	**-**
Lease payments	**60**

Periods	**0**	**1**	**2**	**3**	**4**	**5**
Boards' Tentative Decisions (Current)						
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**

Interest-Based Amortisation Approach (IBA)						
Balance Sheet						
Right-of-use asset	253	208	160	110	57	-
Liability to make lease payments	253	208	160	110	57	-
Income Statement						
Interest on lease obligation		15	12	10	7	3
Amortisation expense		45	48	50	53	57
Total Lease Expense		**60**	**60**	**60**	**60**	**60**

Underlying Asset Approach (UA)						
Balance Sheet						
Right-of-use asset	253	208	160	110	57	-
Liability to make lease payments	253	208	160	110	57	-
Income Statement						
Interest on lease obligation		15	12	10	7	3
Interest on residual asset (not presented separately)		*45*	*48*	*50*	*53*	*57*
Depreciation on asset consumed (not presented separately)		-	-	-	-	-
Amortisation expense		45	48	50	53	57
Total Lease Expense		**60**	**60**	**60**	**60**	**60**

Total Lease Expense by Approach						
Boards' Tentative Decisions		**66**	**63**	**60**	**57**	**54**
Interest-Based Amortisation		**60**	**60**	**60**	**60**	**60**
Underlying Asset		**60**	**60**	**60**	**60**	**60**

Illustration 2

13. Illustration 2 compares the total lease expense profiles for an individual lease for each approach with respect to the expected use (or consumption) of the leased asset over the lease term. If the lease has 0% use or consumption, the asset is not expected to decrease in value over the lease term (eg a shorter-term real estate lease). If the lease has 100% use or consumption, the asset is expected to have no value at the end of the lease term.

14. Each of the leases below is for an asset with a fair value of CU1,000 at lease commencement, over a lease term of 5 years, and the interest rate implicit in the lease is 6%. Again, for each lease illustrated, the lessee is expected to both use the underlying asset (consume economic benefits), and make lease payments, on a straight-line basis over the lease term.

15. For each of the given leases:

    (a) Approach A, the boards' tentative decision (current), produces a reducing lease expense recognition profile,

    (b) Approach B, the 'interest-based amortisation' (IBA) approach, produces a straight-line expense profile, and

    (c) Approach C, the 'underlying asset' (UA) approach, produces a variety of results that are summarised on the next page in the graph Approach C-Expense Profile Spectrum. The 'underlying asset' approach lease expense profile shifts from straight-line (akin to IBA) to a reducing expense profile (akin to the boards' tentative decisions) as the percentage of use (consumption) increases.

Summary of P&L Effects