STAFF PAPER

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Project	**Leases**		
Paper topic	Lessee accounting model		
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Introduction

1. This paper discusses three alternative approaches to recognising lease expenses in a lessee's income statement that are being considered by the IASB and the FASB (the boards) as part of their redeliberations on their joint proposed changes to lease accounting[1]. We would like to get CMAC members' feedback on these three approaches.

Background

2. In May 2013, the boards published lease accounting proposals for public comment. These included the following proposals for lessee accounting:

   (a) In the balance sheet, a lessee would recognise a right-of-use ('ROU') asset and a lease liability for all leases of more than 12 months, initially measured at the present value of the lease payments.

   (b) In the income statement, a lessee would:

      (i) classify most leases of assets other than real estate (that is, most equipment and vehicle leases) as Type A leases. Amortisation of the ROU asset would be presented in the same line item as other similar expenses (for example,

[1] The IASB's document is the 2013 Exposure Draft *Leases* (the '2013 ED').

Information about the Capital Markets Advisory Committee (CMAC) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/CMAC/Pages/CMAC.aspx depreciation of property, plant and equipment) and interest expense on the lease liability in the same line item as interest on other similar financial liabilities; and

(ii) classify most leases of real estate as Type B leases. Amounts paid to the lessor for the use of the asset would be presented as one amount (a single lease expense) in the income statement.

3. The comment period ended in September 2013. The boards and the staff obtained feedback from investors and analysts, preparers, accounting practitioners and other constituents in over 640 comment letters, at public round-table discussions, and at private outreach meetings, including fieldwork meetings. The feedback received includes a letter from the CMAC regarding lessee accounting. This letter states that the proposal for lessee accounting included in the 2013 ED, requiring the recognition of assets and liabilities for all leases other than short-term leases, is a better solution than a ‘disclosure only’ alternative. The consensus among the CMAC members was that the alternative of making no changes to the existing IFRS (IAS 17 *Leases*) is not acceptable.

4. Appendix A of this paper includes a high level summary of the feedback received regarding the lessee accounting model.

5. At the January 2014 joint board meeting, the boards began their redeliberations on lessee accounting. They did not make any decisions. We expect decisions to be made regarding lessee accounting at the March 2014 joint board meeting.

Lessee accounting approaches

6. The boards are considering three alternative approaches to lessee accounting. These approaches differ mainly in terms of what a lessee would recognise and present in its income statement. All three approaches would require a lessee to recognise an asset and liability for all leases of more than 12 months. The asset (ROU asset) would still be a non-financial asset, presented together with or alongside PPE. The liability (lease liability) would still be a financial liability, measured similarly to other similar financial liabilities.

7. The three approaches being considered by the boards can be described as follows:

(a) *Approach 1* is a single lessee accounting model, according to which a lessee would recognise amortisation of the ROU asset separately from interest on the lease liability for all leases (the ‘Type A’ lease accounting proposed in the 2013 ED for most equipment and vehicle leases).

(b) *Approach 2* is a dual lessee accounting model, with lease classification similar to that proposed in the 2013 ED. However, this approach offers targeted simplifications and improvements to the lease classification test. For all leases of assets other than real estate, a lessee would recognise amortisation of the ROU asset separately from interest on the lease liability (‘Type A’ lease accounting proposed in the 2013 ED). For most real estate leases, a lessee would recognise a single lease expense (the ‘Type B’ lease accounting proposed in the 2013 ED).

(c) *Approach 3* is a dual lessee accounting model, but with lease classification determined based on the criteria used to distinguish an operating lease from a finance lease today (IAS 17). For existing finance leases a lessee would recognise amortisation of the ROU asset separately from interest on the lease liability (‘Type A’ lease accounting), while for existing operating leases a lessee would recognise a single lease expense (‘Type B’ lease accounting).

8. The following table shows the expense recognition effect of each proposed approach, as compared to lease accounting today under IAS 17:

IAS 17	**Approach 1**	**Approach 2**		**Approach 3**
Depreciation Interest (Finance)	Amortisation Interest (Type A)	Amortisation Interest (Type A)		Amortisation Interest (Type A)
Rent expense (Operating)	Amortisation Interest (Type A)	<u>*Non-Real estate*</u> Amortisation Interest (Type A)	<u>*Real estate*</u> Single lease expense (Type B)	Single lease expense (Type B)

Changes from existing accounting

9. Compared to existing IAS 17 lessee accounting:

   (a) for existing finance leases, the proposed approaches would not change a lessee's income statement; and

   (b) for existing operating leases, only Approaches 1 and 2 would change a lessee's income statement. Approach 1 would change the income statement for all existing operating leases, and Approach 2 would change income statement presentation for operating leases of assets other than real estate.

10. The effect above would arise from a lessee recognising amortisation and interest expense separately whereas, under IAS 17, a lessee would recognise a single lease expense for existing operating leases.

11. Although none of the proposed approaches would modify the total amount of lease expense recognised in a lessee's income statement over the total lease term, the amount of expense recognised could differ in any single period depending on a lessee's lease portfolio. 'Type A' lease accounting typically results in a 'front-loaded' expense recognition pattern for an individual lease (because the lease liability is subsequently measured at amortised cost while the ROU asset is typically amortised on a straight-line basis). 'Type B' lease accounting typically results in a straight-line expense recognition pattern (accomplished by amortising the ROU asset in each period so that the lessee recognises the total lease cost on a straight-line basis over the lease term). Nonetheless, when a lessee has a portfolio of leases that start and end in different periods, any 'front-loaded' effect of Type A accounting would be mitigated.

Changes to performance measures

12. The changes to the income statement presentation of existing operating leases using Approach 1 and Approach 2 would have corresponding changes to particular performance measures.

13. The following tables illustrate the effect of each of the proposed approaches for a real estate and an aircraft existing operating lease, compared to the lessee accounting in IAS 17 today.

Real estate

	Approach 1	Approach 2	Approach 3
Operating expenses	Decrease	= No change	= No change
Financing expenses	Increase	= No change	= No change
EBIT	Increase	= No change	= No change

Aircraft

	Approach 1	Approach 2	Approach 3
Operating expenses	Decrease	Decrease	= No change
Financing expenses	Increase	Increase	= No change
EBIT	Increase	Increase	= No change

Questions for the Committee

Questions: Lessee accounting model

Single versus dual model

1. Which approach would provide you with the most useful information in the income statement (assuming that a lessee would recognise a non-financial asset (ROU asset) and a financial liability (lease liability) for all leases of more than 12 months)? Please explain your response.

(a) Single lessee accounting model (Approach 1)

(b) Dual lessee accounting model (Approaches 2 and 3)

2. If the boards conclude that a dual lessee model should be retained, which, between Approach 2 and Approach 3, do you support as your first choice? Why?

Type B accounting presentation and disclosure

16. As mentioned above, the Type B lease accounting proposed in the 2013 ED, and retained in Approach 2 and Approach 3, requires the recognition of a lease liability, measured at amortised cost, along with the presentation of a single lease expense combining the interest on the lease liability with the amortisation of the ROU asset.

17. Some of the feedback received on Type B accounting, particularly from some investors and analysts, focused on the tension arising from recognising a financial liability without presenting any corresponding interest expense in the income statement, and recognising a non-financial asset without any amortisation or depreciation.

Questions for the Committee

Questions: Lessee accounting model
Presentation and disclosure If the boards conclude that for some leases a lessee should not present interest expense in the income statement, do you think that: (a) the relevant lease liability should be presented as a ‘financial liability’ or an ‘operating liability’ in the lessee’s balance sheet? (b) interest expense should be disclosed separately in the notes to the financial statements? Please explain your responses.

Appendix A

Feedback received on the lessee accounting proposals included in the 2013 ED

This appendix includes a high level summary of feedback received on the proposals with respect to the recognition of lease expenses in a lessee's income statement, as well as comments received on the lease classification test proposed in the 2013 ED.

Recognition of lease expenses in a lessee's income statement

Investors and analysts

A1. Many users, including most industry-specific users, support the dual income statement proposals in the 2013 ED. They agree that there are economic differences between real estate leases and leases of assets other than real estate, and that the proposed dual model is a practical way to reflect this. Some of these users would, however, consider the lease expense for Type B leases to be more of a financing (interest) expense than a rent expense.

A2. Nonetheless, many users disagree with the income statement proposals in the 2013 ED. Most of those who disagree, including two of the three major credit rating agencies and most of the other credit analysts that provided feedback, proposed instead that a lessee should recognise amortisation separately from interest for all leases (ie apply Type A accounting to all leases). This reflects their view that all leases create assets and 'debt-like' liabilities.

A3. In contrast, some other users who disagree with the income statement proposals in the 2013 ED suggest that a lessee should recognise a single, straight-line lease expense for all leases currently classified as operating leases. This reflects their view that, for these leases, the benefit to the lessee is received evenly over the lease term. The accounting may more closely align lease expense with lease payments, which these users view as preferable.

Others

A4. Some other constituents, particularly lessees with real estate leases, support the proposed income statement accounting in the 2013 ED for real estate leases. They support the recognition of a single straight-line lease expense in the income statement for most real estate leases because, in their view, this accurately reflects the economics of such leases.

A5. However, a majority of other constituents (including most preparers) disagree with the dual model proposed in the 2013 ED, which is based on consumption of the underlying asset, and raised concerns about the costs and complexity of the proposals.

A6. Other constituents disagree with the classification principle on which the dual accounting model is based and prefer a dual model based on the principle in IAS 17 (ie Approach 3 in this paper).

A7. Constituents have also specific concerns about Type A and Type B accounting.

Type A: Some constituents criticise the proposed change from presenting rent expense to presenting interest and amortisation for existing operating leases of assets other than real estate, because they believe this change could create issues for particular transactions or in particular industries (eg when lease expenses are capitalised as part of the cost of another asset).

Type B: Some constituents raise concerns about the inconsistency of recognising a financial liability without presenting any corresponding interest expense in the income statement, and recognising a non-financial asset without any amortisation or depreciation.

Classification proposals

A8. Some constituents support the classification guidance as proposed in the 2013 ED. These constituents think that the classification guidance appropriately offers a core principle (that is, classification on the basis of consumption of the underlying asset) and an operational way to apply that principle (that is, classification based principally on the nature of the underlying asset, with exception tests designed to more closely align application with the underlying principle).

A9. Most constituents, however, are concerned about various aspects of the proposed classification guidance (for example, definition of property, leases of land and buildings, lease components with the right to use more than one asset) and suggest various modifications to that guidance.