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Boards issue preliminary views on lease accounting

On 19 March 2009, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) took a significant step toward revamping existing lease accounting rules by issuing a discussion paper (DP) outlining their preliminary views on a new accounting model. Current lease accounting under International Financial Reporting Standards (IFRSs) and Generally Accepted Accounting Principles in the US (US GAAP) is often criticised as being too reliant on subjective judgments and rigidly defined thresholds. Many believe that such reliance has resulted in economically similar transactions being accounted for differently and has presented opportunities for entities to structure transactions to achieve a desired accounting effect.

The scope of the leasing project has been the subject of much debate by both boards. Initially, the boards agreed that the scope should include both lessee and lessor accounting, but they later decided to limit the scope to lessee accounting. The DP discusses various issues associated with lessor accounting, but the boards had no preliminary views on them (and, consequently, they are not dealt with in this newsletter). The timing for the resolution of those issues will be determined over the next several months.

The IASB has requested comments on the DP by 17 July 2009.

The table on the next page summarises the preliminary views of each board as presented in the DP. A more detailed discussion on each topic is set out below.

Scope

The DP states that the scope of the proposed model should be based on the scope of existing leasing standards because those standards are familiar to constituents. The boards concluded that their time was better spent focusing on other aspects of the new accounting model before they addressed any potential changes to the scope. Therefore, contracts currently accounted for as leases would continue to be accounted for as leases under the DP's proposed model.

The boards discussed whether non-core-asset leases (i.e. leases of assets not essential to an entity's operations) and short-term leases (i.e. leases typically of less than one year) should be excluded from the DP's scope but did not come to any preliminary views on either of those issues.

The boards have acknowledged that further consideration should be given to scope differences between their current standards. For example, IAS 17 *Leases* applies broadly to assets (with certain exceptions) whereas FASB Statement No. 13 *Accounting for Leases* only applies to leases involving property, plant, and equipment (i.e. intangible assets are not in the scope of Statement 13).

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Topic	IASB's preliminary view	FASB's preliminary view
Scope	Based on the scope covered in the existing leasing standards. Limited to lessee accounting.	Same as IASB view.
Overall model	Recognise a single right-of-use asset and a single liability for the obligation to pay rentals.	Same as IASB view.
Measurement – right-of-use asset	Initially measure at cost, which would equal "the present value of the lease payments discounted using the lessee's incremental borrowing rate". Subsequently measure the asset on an amortised cost basis over (1) the shorter of the lease term or the economic life or (2) if the lessee is expected to obtain title, the economic life.	Same as IASB view.
Measurement – obligation to pay rentals	Initially measure at "the present value of the lease payments, discounted using the lessee's incremental borrowing rate". Subsequently measure by using an amortised cost based approach in which interest is accrued on the outstanding obligation to pay rentals.	Same as IASB view.
Measurement – reassessment of the incremental borrowing rate	Rate **is subsequently reassessed** to reflect current market conditions, but no clarification on whether this occurs at each reporting date or only when there is a change in estimated cash flows.	Rate is **not subsequently reassessed** to reflect current market conditions.
Measurement – changes in estimated cash flows	Adjust carrying amount of the liability to the present value of the revised estimated cash flows (catch-up approach) by using a **revised** incremental borrowing rate.	Adjust carrying amount of the liability to the present value of the revised estimated cash flows (catch-up approach) by using the **original** incremental borrowing rate.
Determining lease term	Lessee's lease term is based on the most likely lease term that may include renewal and purchase options.	Same as IASB view.
Reassessment of lease term	Reassessment of lease term required as of each reporting date on the basis of any new facts and circumstances. Change in obligation to pay rentals is an adjustment to the carrying amount of the right-of-use asset.	Same as IASB view.
Contingent rentals and residual value guarantees – initial measurement	Lessee's obligation to pay rentals is included in the lease obligation and is based on a **probability-weighted estimate of amounts payable**.	Lessee's obligation to pay rentals is included in the lease obligation and is based on the **most likely rental payment**. However, if rentals are contingent on changes in an index or rate, the lessee would initially measure the obligation to pay rentals by using the index or rate existing at inception of the lease.
Contingent rentals and residual value guarantees – reassessment	Change in obligation to pay rentals is an **adjustment to the carrying amount of the right-of-use asset**.	Change in obligation to pay rentals is recognised in **profit or loss.**
Presentation – statement of financial position	Presentation of right-of-use asset depends on nature of leased item and is separate from owned assets. Obligation to pay rentals is **not required to be separately presented.**	Presentation of right-of-use asset depends on nature of leased item and is separate from owned assets. Obligation to pay rentals is presented **separately** from other financial liabilities.
Presentation – statement of comprehensive income	Based on asset and liability classification.	Same as IASB view.
Presentation – statement of cash flows	No preliminary views expressed.	No preliminary views expressed.

General model

In a lease contract, the lessee obtains a right to use a leased asset for a specified period. Under current standards, a lessee accounts for this right either as an asset and a liability (i.e. a capital/finance lease) or as an executory contract (i.e. an operating lease) depending on the terms of the lease. According to the boards, these accounting differences have led to inconsistent treatment for what is essentially the same transaction: the right to use a leased asset for a specified period.

Because the boards believe that the current accounting model is inconsistent with the current definitions of an asset and a liability, they have proposed a model that will require the lessee to recognise an asset and a liability for all lease contracts. The asset represents the lessee's right to use the leased item for the lease term (a 'right-of-use' asset) and the liability represents its obligation to pay rentals.

> The proposed model would eliminate the operating lease classification for lessees. This is the most significant change proposed for the existing lessee accounting model, and it is aimed at ensuring consistent accounting for arrangements throughout industries. Therefore, if this proposal were adopted in a final standard (subject to possible scope exceptions), operating leases would no longer be "off-balance sheet" and rental expense would no longer be straight-lined over the lease term. Rather, an asset and a liability would be recognised in the statement of financial position, and amortisation and interest expense would be recognised in profit or loss. See the 'Measurement' section below for further discussion.

The DP also discusses the accounting for other 'complex' leases that include options, residual value guarantees and contingent rentals. Specifically, the boards discussed whether these items should be recognised separately from the right-of-use asset. While the boards acknowledge that these items may individually meet the definition of an asset or a liability, under the proposed model they would not be separately recognised (a component approach is not adopted). Rather, the lessee would recognise both a single right-of-use asset and a single obligation that incorporates the effect of these items.

Measurement

As noted above, under the DP's general model, the lessee would reflect its right to use a leased asset by recording a right-of-use asset and an obligation to pay rentals. The following discussion summarises the DP's proposals for initial and subsequent measurement of this right and obligation.

Right-of-use asset

The proposed model would require the lessee to initially measure the right-of-use asset at cost. Cost is defined as "the present value of the lease payments discounted using the lessee's incremental borrowing rate". The right-of-use asset would be subsequently amortised either (1) over the shorter of the lease term and the economic life of the asset, or (2) if the lessee is expected to obtain title at the end of the lease term, over the economic life of the asset. Although the boards believe that the right-of-use asset should be reviewed for impairment, they have yet to reach a preliminary view on how to perform that determination.

Obligation to pay rentals

The lessee would initially measure the liability for its obligation to pay rentals at "the present value of the lease payments discounted using the lessee's incremental borrowing rate". The liability would be subsequently amortised using an amortised cost based approach under which interest would be accrued on the outstanding obligation to pay rentals.

The boards considered whether it would be appropriate for lessees to discount lease payments using the rate implicit in the lease (in line with current standards), but they ultimately excluded this as an option. The boards believe that (1) the implicit interest rate may be difficult to determine and complex for preparers to apply, and (2) its use reduces comparability for users.

The boards will decide later whether to allow a fair value measurement of the obligation to pay rentals.

Reassessment of the incremental borrowing rate

The DP discusses whether the incremental borrowing rate used to discount lease payments should be subsequently reassessed to reflect current market conditions. Such a reassessment could provide more relevant information about the lessee's obligation to pay rentals and would be consistent with the approach in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

The IASB and the FASB disagree on this point. The IASB believes that the incremental borrowing rate should be reassessed because it may affect the lessee's obligation to pay rentals, while the FASB believes that the rate should not be reassessed. However, the IASB did not reach a conclusion on the timing or frequency of the reassessment (i.e. at each reporting date or only when there is a change in estimated cash flows).

Changes in estimated cash flows

Some lease contracts may include rental payments that are not fixed because of the existence of items such as extension or termination options, obligations to pay variable or contingent rentals, or residual value guarantees. Because these items may affect the lessee's obligation to pay rentals, the boards believe that the lessee should adjust the obligation to reflect the revised estimated cash flows by using a catch-up approach. Under this approach, the lessee would adjust the carrying amount of the liability to the present value of the revised estimated cash flows, discounted by an appropriate rate.

As discussed above, the IASB and the FASB did not reach an agreement on the reassessment of the incremental borrowing rate. Consequently, they also differ on what discount rate a lessee should apply when adjusting the carrying amount of the liability. The IASB believes that the lessee should use a revised incremental borrowing rate while the FASB believes that the lessee should apply the catch-up approach using the original incremental borrowing rate.

Other complex lease items

The DP would require the lessee to recognise a single right-of-use asset and an obligation to pay rentals that takes into account renewal and purchase options, contingent rentals and residual value guarantees. The following discussion summarises the boards' tentative views on each of these items.

Term and purchase options

Lease contracts often include renewal options that allow the lessee to extend the lease term beyond the initial lease period. Alternatively, lease contracts may contain an option to allow the lessee to terminate the lease after a specified period. In either case, the DP would require the lessee to recognise its obligation to pay rentals using the "most likely lease term" based on reasonable and supportable assumptions. In addition, the DP sets out contractual, non-contractual, business and lessee-specific factors that lessees should use when making this assessment and also indicates that lessee-specific factors (i.e. past practice and the lessee's intentions) should not be considered.

The following example, adapted from Example 5 in paragraph 6.35 of the DP, illustrates how a lessee would determine the "most likely lease term".

A lessee enters into a five-year lease of real estate. At the end of the first five years, the lessee has an option to renew the lease at the market rental rate (at the time of renewal) for another five years (the lessee then has the same option at the end of year 10). The lessee constructs significant leasehold improvements on the real estate that have a 10-year life.

Lease term	5 years	10 years	15 years
Probability	25%	45%	30%

The probabilities reflect the fact that the lessee generally will need more than five years to recover its investment in the location; however, there is a chance that it would be willing to bear the costs of non-renewal.

Because of the existence of the leasehold improvements, management concludes that the most likely lease term is 10 years (i.e. the lease term with the highest probability). Consequently, under this approach, the lessee would determine that the lease term is 10 years.

Purchase options can be viewed as the ultimate renewal option and are treated in the same manner as renewal and termination options. If a lease contract contains a purchase option, the lessee should evaluate this option when determining the most likely lease term.

The boards believe that, similar to changes in estimated cash flows, the lease term should be reassessed as of each reporting date if new facts and circumstances arise. If the reassessment of the lease term results in a change in the obligation to pay rentals, the change would be recognised as an adjustment to the carrying amount of the right-of-use asset.

Contingent rentals and residual value guarantees

Because contingent rentals and residual value guarantees have similar characteristics (e.g. both result in variable lease payments), the DP requires them to be accounted for similarly (residual value guarantees should not be separated from the lease contract and accounted for as derivatives). The boards believe that the lessee's obligation to make rental payments should include the effects of contingent rentals and that residual value guarantees and reassessment of those obligations should be performed as facts and circumstances warrant reassessment.

Under existing lease accounting standards, contingent rentals that are based on usage or the lessee's performance are generally excluded from the calculation of minimum lease payments and are recognised as expenses in the period in which they are incurred. Contingent lease rentals that are based on an existing index are included in minimum lease payments on the basis of the current level of the index.

The boards differ on how a lessee should consider these effects. The IASB believes that the measurement of the lessee's obligation to pay rentals should include a **probability-weighted estimate** of amounts payable under contingent rentals and residual value guarantees. This approach is consistent with the IASB's position on the changes in the lessee's obligation as a result of lease-term changes.

In addition, the IASB believes that changes to the obligation to pay rentals due to changes in estimated contingent rentals and payments under residual value guarantees should be recognised as an adjustment to the carrying amount of the right-to-use asset (similar to the approach adopted for decommissioning liabilities in IFRIC 1).

The FASB believes that, like the measurement of renewal and purchase options, the measurement of the lessee's obligation to pay rentals should be based on the **most likely rental payment,** which may include amounts payable under contingent rentals and residual value guarantees. It believes that this approach is easier for users of financial statements to understand and is less complex for preparers. In addition, the FASB believes that changes to the obligation to pay rentals due to changes in estimated contingent rentals and payments under residual value guarantees should be recognised in profit or loss (because the FASB thinks that such changes do not increase or decrease the value of the right-to-use asset).

The example below, adapted from Example 9 in paragraph 7.14 of the DP, illustrates the measurement of a lessee's obligation to pay rentals under the boards' different approaches.

A lessee enters into a five-year lease of a retail store. The lease is non-cancellable and the lessee has no option to extend the lease. The lessee is required to make fixed annual payments of CU100. In addition, the lessee is required to make payments equal to 1 percent of sales from the leased store. The lessee forecasts the following sales for the store and assigns each outcome a probability.

Total forecasted sales, years 1-5 (CU)	10,000	20,000	35,000
Probability that forecasted sales will occur	10%	60%	30%
Total fixed rentals, years 1-5 (CU)	500	500	500
Total contingent rentals -1% of forecast sales (CU)	100	200	350
Total estimated rentals, years 1-5 (CU)	600	700	850

The obligation to pay rentals using the IASB's probability-weighted estimate approach, ignoring the effects of discounting, is CU735 ((600 x 10%) + (700 x 60%) + (850 x 30%)).

The obligation to pay rentals using the FASB's 'most likely rental payment' approach equals CU700 (i.e. the rental payment with highest probability).

Presentation (based on existing requirements)

The DP proposes that the presentation of the right-of-use asset in the statement of financial position should be based on the nature of the leased items. However, the boards acknowledge that because leased assets are different from owned assets, leased assets should be presented separately from owned assets.

The boards disagree on the presentation of the obligation to pay rentals. The IASB believes that the obligation to pay rentals is no different from that of a secured borrowing that does not require separate presentation. The IASB thus believes that separate presentation of the obligation to pay rentals is not required. In contrast, the FASB believes that the obligation differs from most other financial liabilities (i.e. the obligation to pay rentals includes amounts payable in optional periods). It therefore believes that separate presentation of the obligation is appropriate.

The DP further states that the classification in the statement of comprehensive income is governed by the asset and liability classification in the statement of financial position. For example, if a right-of-use asset is recorded as property, plant, and equipment, any reduction in the carrying amount of the asset should be recorded as depreciation expense in the statement of comprehensive income. Similarly, if the obligation to pay rentals is separately presented in the statement of financial position, any interest expense on that obligation should be separately presented in the statement of comprehensive income. The boards have not discussed the presentation of lease contracts in the statement of cash flows.

Next steps

Comments on the DP have been requested by 17 July 2009. It is expected that both boards will issue an exposure draft in the first half of 2010 and a final standard in 2011. The method of transition and the effective date will be discussed by the boards after comments are received and will be included in a future exposure draft of the proposed standard.

The DP indicates certain items on which the boards have not stated their preliminary views. The boards plan to address the following areas before they publish an exposure draft:

- the timing of initial recognition;
- sale and leaseback transactions;
- initial direct costs;
- leases that include service arrangements; and
- disclosures.

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