

Technical Briefing Paper

Leases: Preliminary views

June 2009

In March 2009, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published for comment a Discussion Paper (DP) entitled *Leases: Preliminary Views*. As part of their long term project, to develop a common accounting standard on leasing this long-awaited paper focuses on putting assets and liabilities arising from all types of lease contracts in the statement of financial position.

By establishing a general principle that all leases give rise to liabilities (for future rental payments) and assets (right to use the leased asset) that should be reflected on an entity's balance sheet, the proposals are likely to have a significant impact on the current accounting for leases, especially those currently classified as operating leases. While there will clearly be an impact on balance sheets, the proposed changes will also affect income statements, and it is therefore important for companies to understand the proposals in the DP and assess how they could impact the financial statements.

Background

The question of lease accounting has been the subject of debate for a number of years. In 1996, the G4+1¹ group of standard setters published a discussion paper *Accounting for Leases: A New Approach*, with a follow-up paper entitled *Implementation of a New Approach*, published in February 2000. The 1996 study concluded that the distinction between operating leases and finance leases required by most existing accounting standards was arbitrary and unsatisfactory. It argued that the omission of material assets and liabilities arising from operating leases could distort a number of key performance measures such as indebtedness, debt-to-equity ratios, return on assets employed, and interest coverage. To ensure comparability of financial statements it was suggested that a consistent treatment should be applied to all leases. The latter paper provided practical guidance as to how the proposals in the 1996 discussion paper could be implemented.

Concerns about the existing models under US GAAP and IFRS similarly relate to the reliance on bright line rules and subjective judgements which can lead to substance quite similar transactions being accounted for differently, and therefore leading to transactions being structured in a manner that achieves a desired accounting effect. These factors were highlighted in report by the Securities and Exchange Commission (SEC) report² published in June 2005, which recommended the FASB to undertake a project on the accounting for leases. The project was subsequently added to the agendas of the IASB and FASB in 2006, as part of their long-running convergence project.

Scope

The scope of the project has essentially been limited to lessee accounting. While there is a discussion on certain aspects of lessor accounting (Chapter 10 of the DP), the Boards have not expressed any preliminary views on them.

Overall the scope for the proposed model will be based on the scope of the existing standards in the US (SFAS 13) and IFRS (IAS17), and therefore all contracts currently accounted for as leases would continue to be so. The Boards do recognise there are differences in scope between SFAS 13 (applies to leases with right to use property, plant and equipment) and IAS17 (broadly applies to right to use assets, including intangible assets).

The DP does include discussions on non-core asset leases, which are not essential to the operations of an entity and short-term leases, but does not provide any preliminary views on whether they should be included within the scope of a final standard on leasing. Some constituents have argued that the cost of measuring the right and obligations in such circumstances would outweigh the benefits, and that such contracts should continue to be accounted for as operating leases.

¹ The G4+1 comprise members of the national standard-setters of Australia, Canada, New Zealand, the United Kingdom and the United States of the International Accounting Standards Committee (the IASB's predecessor organisation).

² Report and Recommendations Pursuant to Section 401(c) of the SarbanesOxley Act 2002 Arrangements with Off-Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers, SEC, 2005

A single model for lessee accounting

Depending on the terms of the lease, the current model requires a lessee to account for the right to use a leased asset (for a specific period)

- as an asset or liability (finance lease) or
- as an executory contract (operating lease).

The Boards view is that essentially the same transaction will have occurred – the right to use the leased asset for a given period. This not only leads to inconsistent accounting treatments for similar transaction, but that this model is also inconsistent with the current definitions of assets and liabilities in the Framework. The DP argues that the right obtained by the lessee in any lease contract is the right to use the leased item for the lease term – a right that meets the definition of an asset. Similarly, the lessee also incurs an obligation to pay rentals in a lease contract, and that this obligation meets the definition of a liability.

Thinking ahead: Increasing lessee balance sheets

These changes would increase both sides of the balance sheet of any lessee by something like the present value of the operating lease commitments currently shown in the notes to the financial statements. It would apply to all leases of equipment, cars, and premises (unless non-core assets are excluded). It is likely to be a very significant change for many companies.

The Boards further conclude that the obligation to return the machine at the end of the lease term does not constitute a liability, because the lessee has no rights to economic benefits from the machine and will not have to make any payments after the end of the lease term.

Lease rights and obligations meet the definition of assets and liabilities

| Right / obligation | Past event | Economic benefit | Asset / liability |
|---|--|---|-------------------|
| Right to use machine | Delivery following signing of the lease contract | Future benefit | Asset |
| Obligation to pay rentals | Delivery following signing of the lease contract | Outflow of economic benefit – cash payments | Liability |
| Obligation to return machine at the end of the lease term | Delivery following signing of the lease contract | No | No |

Complex leases

While the initial example used in the DP to conclude on the accounting for rights and obligations arising from a lease contract was for a 'simple' contract, the paper also discusses the accounting for more 'complex' leases, that may include options, contingent rentals and guarantees. The Boards deliberated whether to use a components approach to separately recognise and measure the rights and obligations in a complex lease contract. However they concluded that due to the costs and complexity associated with measurement and the interrelation between components in most lease contracts, that a components approach would not be appropriate. Rather, a single right-of-use asset should be recognised under options, and a single obligation to pay rentals that include obligations arising under contingent rental agreements and residual value guarantees.

Measurement

Under the proposed model, a lessee will reflect its right to use a leased asset by recording a right-of-use asset and an obligation to pay rentals. These would initially be measured and recorded at the present value of the expected lease payments to be made over the term of the lease.

The right-of use asset

The initial measurement of the right-of-use asset would be at cost, which is equal to the present value of the lease payments discounted using the lessee's incremental borrowing costs.

The asset is then subsequently measured at amortised cost, similar to the current requirements of IAS 17 for finance leases, with amortisation period being the shorter of the lease term and the economic life of the leased asset. The boards do not provide any preliminary views on how to assess the impairment of right-of-use assets or whether the revaluation model would be permitted for a right-of-use asset.

Thinking ahead: Quality of assets on balance sheet

Some accountants are concerned at the quality of the assets that would be included in balance sheets under these proposals. They would often have little value when the liability to pay rentals is included as well. There is little flexibility for the lessee to sell the asset for example.

The obligation to pay rentals

Initial measurement of the liability for the lessee's obligation to pay rentals would be at the present value of the lease payments discounted using the lessee's incremental borrowing rate.

The liability is also subsequently measured using an amortised cost-based approach where interest is accrued on the outstanding obligation to pay rentals. Lease payments would be apportioned between a finance charge and a reduction of the outstanding obligation to pay rentals.

In their deliberations, the boards considered whether it would be appropriate for lessees to discount lease payment using the rate implicit in the lease, but they ultimately excluded it as an option, given the potential difficulties in determining the rate and that it would reduce comparability for users.

In deciding the amount of lease payments some estimates or assumptions would be required where there are for example

- options to extend or terminate the lease
- purchase options
- contingent rental arrangements or
- residual value guarantees.

Contingent rentals would include for example rents on retail units are based on the sales from those units and also mileage-based rentals on vehicles. Residual value guarantees transfers the risks on the residual values to the lessee so making the lease more like a borrowing.

The paper proposes for the various options the most likely choice should be included. Contingent rentals and payments under residual value guarantees should be estimated on a probability basis at the start of the lease.

Thinking ahead: Options, contingent rentals and guarantees

Options, contingent rentals and guarantees are all reasonably common features of leases so the accounting treatment is important and these choices and estimates of the contingent rentals could often have a material impact.

The discussion paper does not consider the possibility to measure lease liabilities (and so the asset) at the minimum commitment amount and perhaps deal with options at a value (if material) or by disclosure. Some consider that by including optional payments IASB have gone beyond how liabilities are defined in IAS39 and IAS37 (provisions).

Remeasurement of lease obligation

The lease obligation would be remeasured in subsequent reporting periods if there is a change in the assumptions about the lease term and / or the expected lease payments, which would include the options and estimates of contingent rentals for example.

As 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, an assessment would be performed at each reporting date to determine whether such changes have occurred, and the lessee would then remeasure the present value of expected lease payments using the revised assumptions, and an appropriate discount rate.

The DP proposes that the adjustment to the carrying amount of the liability be recorded against the carrying amount of the right-to-use asset as opposed to immediately recognising a gain or loss for the change in the liability.

Presentation

Statement of financial position

The boards propose that the presentation for the right-of-use asset should be based on the nature of the underlying items, and given that are different from owned assets, should be disclosed separately.

The obligation to pay rentals would be a liability, although there was disagreement between the boards as to whether they should be separated from other financial liabilities. While the FASB believe there should be separation, the IASB's preliminary view was that the obligation to pay rentals was in effect similar to a secured borrowing, which under IAS39 (and SFAS140) do not require separate presentation.

Income statement

The boards agree that the classification in the income statement should reflect that asset and liability classification in the statement of financial position. Thus if the right-of-use asset is shown as property, plant and equipment, reductions in the carrying amount would be recorded as a depreciation expense in the income statement. Should the liability be shown separately, then the interest expense would also have to be presented separately in the income statement.

Potential impact on current users of IFRS

Elimination of operating lease classification

The proposed single model for accounting for leases is a significant change from the existing hybrid model. This will have a major impact on many companies who currently account for operating leases which are effectively kept 'off-balance sheet'. Thus relatively simple operating lease contracts for rental of plant would under the current proposals, require lessees to recognise an asset in their balance sheets, for the right to use that plant over the lease term, and to provide for a liability in recognition for their obligation to pay future rentals under the contract.

The impact this will have on lessee balance sheets will therefore mean that performance measures such return on assets and debt-to-equity ratios will be affected and companies will also need to be conscious of the impact of debt covenants and capital requirements.

Potential complexity

While the preliminary views in the DP reflect the boards attempts to address a number of the criticisms related to lease accounting, there are some concerns that the requirements may impose additional burden on lessees, which could outweigh the benefits for the users of their financial statements, who often already adjust for uncapitalised lease payments.

The boards have in fact rejected certain proposed approaches in an effort to reduce complexity for preparers

- measurement of the lease obligation and right-of-use asset at the present value of expected lease payments, rather than applying fair value measures
- the single asset and liability approach in favour of the components approach.

The boards have not concluded on whether non-core assets or short term leases should be excluded from the scope. This is a potential area that could reduce the reporting burden for the bulk of lessees who use relatively immaterial lease transactions in their day-to-day business, but which are not a fundamental part of their business.

Other areas of complexity could arise where the lessee may have to make estimates about the lease term, contingent rentals and residual guarantees when reassessing their obligations.

Differences between the IASB and FASB

While there is agreement over the general model discussed, the boards have not reached agreement on certain issues, as shown in the table below

| Area of accounting | IASB view | FASB view |
|---|---|--|
| Reassessment of incremental borrowing rate | Support an approach that would require reassessment of the incremental borrowing rate – although undecided if this would be required at each reporting period, irrespective of whether there is a change in estimated cash flows | Rate is not reassessed |
| Accounting for changes in lease obligations | Support a remeasurement of the carrying amount of the liability using a revised incremental borrowing rate | Remeasurement using the original incremental borrowing rate |
| Initial measurement of contingent rental payments and residual value guarantees | Lease obligation based on a probability-weighted approach | Use a most likely outcome approach |
| Reassessment of contingent rental payments and residual value guarantees | Change in obligation should be an adjustment to the carrying amount of the right-of-use asset in all cases | Change in obligation recognised immediately as a gain or loss in the income statement . |
| Presentation of right-of-use-asset and obligation | Obligation not required to be separately presented | Obligation presented separately from other financial liabilities |

The DP is available on the [IASB's website](#), with the deadline for comments being 17 July 2009.

ACCA also welcomes members' comments on the IASB discussion paper. Appendix A of the DP summarises all the questions for respondents. While we would be interested in comments on any of those questions, we are particularly interested in hearing members' views on the questions for consideration below. Please submit these via e-mail to condoccomments@accaglobal.com by 3 July 2009.

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| <p>Questions for consideration</p> <p>Question1 Do you believe that the proposal to bring operating leases on balance sheet will provide decision-useful information?</p> <p>Question2 Do you have any specific concerns about the costs and complexity of applying the proposed requirements?</p> <p>Question3 Should the proposed new standard exclude non-core assets and short-term leases? Do you believe that there could be difficulties in assessing such assets and leases?</p> <p>Question4 Should subsequent measurement of both the liability and the asset arising from a lease contract be measured using an amortised cost-based approach, or should a fair value basis be used?</p> <p>Question5 Do you think you will find it easier to estimate your incremental borrowing rate than the rate implicit in the lease?</p> <p>Question6 Do you think instead of trying to include in the lease liability the estimate of options to extend lease terms or to buy the asset, the liability should be calculated as the minimum obligations under the lease?</p> |
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This briefing paper contains information in a summary form and is of a general nature. It is not intended to address all of the issues of a specific entity and is not a substitute for detailed research or the exercise of professional judgement.

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