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Comment on the Leases Project

1. This paper was prepared by the ASBJ to facilitate the discussions at the September 2014 Accounting Standards Advisory Forum (ASAF) meeting.

Lessee accounting model

Background

2. At the March 2014 joint Board meeting between the IASB and the FASB (hereinafter referred to as "the Boards"), the IASB tentatively decided on a single approach (hereinafter referred to as "the IASB model") for lessee accounting. Paragraphs 5(a) and 13 of Agenda Paper 3A for the March 2014 joint Board meeting describe the IASB model as follows:

> 5(a). …[A] lessee would account for all leases as the purchase of a ROU asset on a financed basis. Accordingly, a lessee would account for all leases as Type A leases (that is, recognizing amortization of the ROU asset separately from interest on the lease liability).
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> 13. …The accounting is substantially equivalent to financing the acquisition of other nonfinancial assets, including other economically similar assets such as the rights to use particular intellectual property (for example, licenses such as franchise rights). The ROU asset is a nonfinancial asset, which [this approach] would account for consistently with other nonfinancial assets. The lease liability is a financial liability, which [this approach] would account for consistently with similar financial liabilities.

3. On the other hand, at the March 2014 joint Board meeting, the FASB tentatively decided on a dual approach (hereinafter referred to as "the FASB model") for lessee accounting. Paragraphs 5(d) and 40 of Agenda Paper 3A for the March 2014 joint Board meeting describe the FASB model as follows:

> 5(d). …[the] lease classification [will be] determined in accordance with the principle in existing lease requirements (that is, determining whether a lease is effectively an installment purchase by the lessee). Under this approach, a lessee would account for the vast majority of existing capital (U.S. GAAP)/finance (IFRS) leases as Type A leases, and the vast majority of existing operating leases as Type B leases.

> 40. [This approach] takes the view that Type B leases (that is, those that are not effectively purchases of the underlying asset) have a specialized role in business that neither reflect the full transfer of a nonfinancial asset (for example, the purchase of a piece of equipment), nor are equivalent to a service contract. As a consequence, a lessee's accounting for a lease does not have to conform to comparable accounting for a purchased asset or a services contract. Type B leases can also differ from other "rights of use," such as licenses of intellectual property, in terms of the rights and obligations they convey.

The ASBJ's analysis on the underlying economics of leases

4. Both the IASB model and the FASB model take similar views on the underlying economics of leases that are currently classified as finance leases under existing standards. That is, both models treat such leases as the acquisition of an underlying asset (or a right-of-use asset) on a financed basis. Accordingly, in the following paragraphs, our analysis will focus on the economics of the leases that are currently classified as operating leases under existing standards.

5. For leases that are currently classified as operating leases under existing standards, the IASB model and the FASB model differ in the sense that a front-loaded lease expense (as a combination of amortisation expense and interest expense) would be recognised under the IASB model, whereas a single lease expense on a straight-line basis would be recognised under the FASB model. On this point, some have argued that the resulting net profit or loss would not be significantly different between the two models.

6. However, even if the resulting net profit or loss does not differ significantly, the IASB model and the FASB model take fundamentally different views on the underlying economics of leases that are currently classified as operating leases under existing standards. This difference would give rise to a fundamental difference in the subsequent measurement of the right-of-use asset and in the recognition of lease expenses.

7. In addition to the IASB model and the FASB model, we think there is another way to look at the underlying economics of lease transactions, that is, to view leases as having characteristics equivalent to service transactions. Among the following three views, Views A and B presume that the lessor's obligation has been performed at the commencement date except for the passive obligation over the lease term, whereas View C does not presume so.

   View A: A lease is viewed as the acquisition of a right-of-use asset on a financed basis. Under this view, consistently with the IASB model, a nonfinancial asset and a financial liability would be recognised at the commencement date.

View B: A lease is viewed as a single unit of account which is composed of the right to use an asset over a specified period and the obligation to make lease payments. Under this view, consistently with the FASB model, a right-to-use asset (which has different characteristics from a nonfinancial asset) and a lease liability (which has different characteristics from a financial liability) would be recognised at the commencement date.

View C: A lease is viewed as a contract equivalent to a service contract. Under this view, the lessor's obligation would be performed over the lease term. Neither an asset nor a liability would be recognised at the commencement date, and a lease expense would be recognised over the lease term.

We acknowledge that some may argue that arrangements classified under View C would not meet the definition of a lease. The definition of a lease is discussed later in this paper.

8. If the Boards reach different conclusions regarding the underlying economics of leases in their joint Leases project, their respective Leases standards are likely to prescribe completely different accounting requirements in many respects, which would lead to entities providing financial information that represent fundamentally different items.

9. Given that the Leases project was initiated in part to avoid creating a major reconciliation difference between IFRS and US GAAP, we believe that it is crucial that the Boards achieve a converged solution. The lessee models in existing Leases standards under IFRSs and under U.S. GAAP are substantially converged in that leases are classified between operating leases and finance/capital leases and that finance/capital leases are recognised on the lessee's balance sheet.

10. Although we understand the need to improve the existing Leases standard that does not require operating leases to be recognised on the balance sheet, we think that, if the Boards were to reach diverged solutions in the Leases project, comparability of financial statements would be reduced among globally operating entities when compared to existing standards. It is questionable whether diverged standards provide benefits to constituents around the world in the long run.[1]

1. On this point, many Japanese preparers have expressed grave concerns that the Boards have tentatively decided to adopt different lessee models in the leases project. Furthermore, these preparers have argued that the benefits of recognising assets and liabilities for leases that are currently classified as operating leases would not outweigh the costs of doing so. In addition, these preparers believe that in order to relieve operational burden, the Boards should consider providing more specific quantitative criteria that help them determine whether lease contracts are considered to be immaterial than those stated in IAS 1 and IAS 8 under IFRSs.

Definition of a lease

Background

11. Regarding the principles supporting the definition of a lease and separating lease components from nonlease components, the Boards have tentatively decided as follows:

(Principles supporting the definition of a lease)

The principles supporting the definition of a lease requires an entity to determine whether a contract contains a lease by assessing whether:

(a) Fulfillment of the contract depends on the use of an identified asset; and

(b) The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration (that is, the customer has the ability both to direct the use of the identified asset and to derive the economic benefits from use of that asset during the period of use).

The final standard should clarify the following regarding whether fulfillment of the contract depends on the use of an identified asset:

(a) Fulfillment depends on the use of an identified asset when the supplier has no practical ability to substitute an alternative asset or the supplier would not benefit from substituting an asset; and

(b) A customer should presume that fulfillment of the contract depends on the use of an identified asset if it is impractical for the customer to determine either (1) whether the supplier has the practical ability to substitute an alternative asset or (2) whether the supplier would benefit from the substitution.

(Separating lease components from nonlease components)

A lessee should separate lease components from nonlease components unless it applies the accounting policy election described below.

(a) A lessee should allocate the consideration in a contract to the lease and nonlease components on a relative standalone price basis. Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract. A lessee also should reallocate the consideration in a contract when (a) there is a reassessment of either the lease term or a lessee's purchase option or (b) there is a contract modification that is not accounted for as a separate, new contract.

(b) A lessee should use observable standalone prices, if available, and otherwise it would use estimates of the standalone price for lease and nonlease components (maximizing the use of observable information).

A lessee is permitted, as an accounting policy election by class of underlying asset, to not separate lease components from nonlease components. Instead, a lessee should account for lease and nonlease components together as a single lease component.

The ASBJ's analysis on the definition of a lease

12. We have the following concerns about the Boards' tentative decisions on how to determine whether a contract is, or contains, a lease.

    (a) Certain contracts provide customers with a combination of a delivery of an asset and the provision of a service from the supplier. As described similarly in paragraphs 21 to 25 of Agenda Paper 1B, which was developed by the staff of the EFRAG Secretariat for the September 2014 ASAF meeting, in cases where such services (for example, the operation of the asset over the contract term) are inseparable from the use of the asset, the customer may not control the right to use the underlying asset without these operating services at the commencement date.

    (b) According to the Boards' tentative decisions, when the customer separates the delivery of an asset (lease component) from the service component (nonlease component), such service component would be recognised together with the lease component as an associated asset and a liability if the customer cannot estimate the standalone price for both the lease component and the nonlease component. While we think that it is important to recognise the lease component as an associated asset and a liability under the right-to-use model, we also think that it is important not to recognise service components, consistently with the existing practice for executory service contracts.

13. We highly appreciate the many years of efforts in the Leases project by the Boards, including the issue of the definition of a lease. However, in order to achieve the objective in the Leases project, one of which is to recognise (only) the right-of-use asset that is controlled by the lessee, the following issues need to be discussed further before finalising the standard.

    (a) Definition of a lease (that is, what is meant by the control of the right to use the asset by the lessee); and

    (b) Separation of lease components from service components (that is, the allocation of the consideration in a contract to the lease component and the service component).