



Focus on >

## A New Approach to Accounting for Leases

Rachel Knubley, IASB staff, describes the recently published discussion paper on lease accounting



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### Background

In March the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published a joint discussion paper *Leases – Preliminary Views* that proposes significant changes to lease accounting. The discussion paper is the result of intensive research by the boards. It analyses current issues in lease accounting and presents the boards' initial views on how those issues could be addressed in a new standard.

**By publishing the discussion paper the boards hope to receive input from all those affected by a new standard. The responses will have an important effect on how the project will be carried forward.**

Under the proposals in the discussion paper, lessees will no longer classify their leases as finance leases or operating leases. Instead, a lessee will recognise as an asset its right to use the leased item and an obligation to pay rentals.

The discussion paper is a response to concerns raised by investors regarding the treatment of leases under existing standards. In particular, investors complain that the existing standards fail to depict clearly the financial effects of operating leases.

### Approach to lessee accounting

In developing their proposals, the boards analysed a broad range of lease contracts. They concluded that, whether classified as operating leases or finance leases, leases always create rights and obligations that meet their definitions of assets and liabilities. Leasing a machine, for example, gives the lessee the right to use the machine and an obligation to pay rentals whether or not the lease is classified as a finance lease.

On the basis of this analysis, the boards propose to remove the requirement to classify leases as finance leases or operating leases and develop a new accounting model for all lease contracts. Under this new model a lessee would recognise:

- an asset for its right to use the lease item (the right-of-use asset)
- a liability for its obligation to pay rentals.

### Measurement

The discussion paper proposes that the lessee's obligation to pay rentals should be measured initially at the present value of the lease payments discounted using the lessee's incremental borrowing rate. Subsequent measurement would be on an amortised cost basis.

Initial measurement of the right-of-use asset would be on a cost basis. Cost would equal the present value of the lease payments discounted using the lessee's incremental borrowing rate. Consequently, at initial recognition the obligation to pay rentals will equal the right-of-use asset. Subsequently, the right-of-use asset would be amortised over the shorter of the lease term and the economic life of the leased asset.

### Leases with options

Lease contracts often include options to renew the lease or terminate the lease early. The boards initially explored recognising and measuring these options separately from the right-of-use asset. However, following discussions with

both lessees and lessors they decided that this approach would be impracticable.

The discussion paper therefore proposes that at the start of the lease the lessee must determine what it believes is the most likely lease term. For example, in a 10-year lease with an option to renew for an additional five years, the lessee must decide the most likely outcome. If renewal of the lease is the most likely outcome, the lessee would recognise a right to use the leased item for 15 years and an obligation to pay 15 years of rentals. The most likely outcome would be reassessed at each reporting date. Changes to the obligation to pay rentals arising from reassessment would be recognised as an adjustment to the right-of-use asset.

Continued on next page >

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## BVRLA Joins Leaseurope

Leaseurope has welcomed the British Vehicle Rental and Leasing Association (BVRLA) as a member. The Federation now comprises 46 member associations in 34 European countries, all sharing one voice in Brussels.

"As we continue to lobby the relevant EU authorities on issues including security, cross border rental and fleet renewal, we need to make sure our industry and its concerns are taken into account. With its high profile and expertise in vehicle rental and leasing, the BVRLA's active participation is very positive news for Leaseurope" commented Leaseurope Director General, Tanguy van de Werve.



























