SUMMARY

This Position Paper has been developed by the G4+1 group of accounting standard-setters. It reflects an agreed approach to the treatment in financial reporting of leases, which differs in fundamental respects from that which is required by the present standards of members of the G4+1. Each body represented in the G4+1 will consider, in the light of comments received in response to the Position Paper, whether, and if so how, the Paper's proposals should be modified in the development of accounting standards for each jurisdiction.

This summary provides an overview of the most significant proposals made in the Paper. The Paper also considers several less pervasive issues, its recommendations on which are not summarized here.

A G4+1 Special Report on lease accounting, "Accounting for Leases: A New Approach-Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts" (1996), examined the deficiencies in existing national and international accounting standards on leasing and explored a conceptual approach to accounting for leases based on the financial reporting principles adopted by the standard-setting bodies represented in the G4+1 . That report, which focused mainly on lessee accounting, concluded that the distinction between operating leases and finance leases that is required by present standards is arbitrary and unsatisfactory. The main deficiency of these standards noted in the report is that they do not provide for the recognition in lessee's balance sheets of material assets and liabilities arising from operating leases. The report suggested that the comparability (and hence usefulness) of financial statements would be enhanced if the differing treatments of operating leases and finance leases were replaced by an approach that applied the same requirements for all leases.

This Position Paper explores further the principles that should determine the extent of the assets and liabilities that lessees and lessors would recognize under leases, and how they might be applied to account for many of the features that are found in lease contracts.

The recommendations in the 1996 report were criticized by some who believed that if the new approach were applied to leases, it should also be applied to all "executory contracts" – in their view, unfulfilled contracts such as purchase commitments should also result in separate assets and liabilities being recognized by the buyer if the principles being proposed for leasing transactions were applied to transactions generally. The Position Paper addresses this issue (in Part I) and concludes that leases can be distinguished from executory contracts by the fact that leases cease to be executory when the lessor has provided the lessee with access to the leased property for the lease term. The proposals would, therefore, not apply to executory contracts, including take-or-pay contracts or service contracts.

Part II of this Paper discusses accounting by lessees. It proposes that the objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease, fair value is measured by the fair value of the

consideration given by the lessee, including the liabilities incurred, except where the fair value of the asset received is more clearly evident.

The following table provides an overview of the items that would be included in the liabilities of a lessee (and reported as such, with an asset at the beginning of the lease of a corresponding amount) and those that would not.

Items Included in initial assets and liabilities	Items Excluded from initial Assets and Liabilities
Minimum payments required by lease	
Amounts payable in respect of obtaining renewal options.	Rentals relating to optional renewal periods.
Contingent rentals that represent consideration for the fair value of rights conveyed to lessee.	Contingent rentals relating to optional additional usage.
Fair value of residual value guarantees.	Residual values guaranteed where transfer of economic benefits in settlement is not probable.

The Paper notes, and invites comments on, alternative views for certain of the above items.

Leases that are at present characterized as operating leases (and therefore not included on the balance sheet) would give rise to assets and liabilities – but only to the extent of the fair values of the rights and obligations that are conveyed by the lease.

The general effect of the approach proposed is that the amounts recognized as an asset and a liability by a lessee in respect of a lease of a given item would vary in amount depending on the nature of the lease. The financial statements would thus reflect the extent to which different leasing arrangements result in financial obligations and provide financial flexibility.

The Paper also proposes significant changes to lessor accounting practices. These are discussed in Part III. Lessors would report financials assets (representing amounts receivable from the lessee) and residual interests as separate assets. In the Group's view, this would be a marked improvement in lessor accounting, because a lessor's investment in a leased asset has two distinct elements, receivables and residual interests, which are subject to quite different risks.

The amounts reported as financial assets by lessors would, in general be the converse of the amounts reported by lessees as liabilities.

The Paper has been written principally in the context of a system of accounting that is primarily based on historical cost. Members of the G4+1 are contributing to the work of the Financial Instruments Joint Working Group of standard-setters, which is working to develop a comprehensive and internationally harmonized approach to accounting for financial instruments, under which financial instruments would be reported in the balance sheet at fair value. By setting out the proposals primarily in the context of historical cost, it is hoped that the Paper will enable the merits of the proposed approach to lease accounting to be considered independently of the case for reporting financial instruments at fair value. However, in those jurisdictions where investment properties are reported by lessors under existing practices at fair value, the Paper recognizes that the relevance of fair values is widely accepted; consequently, in any revision to accounting standards on leasing, it proposes that requirements for fair value information should be preserved.

Chapter 2
Scope of any revised accounting standards
Introduction

2.1 This Paper advocates an approach that would require the recognition of all assets and liabilities arising under lease contracts. Whilst it would be possible to define the scope of the project as simply being that of leases, and thus exclude other kinds of contracts, such an approach could be criticized as being arbitrary. Some argue that if revised accounting standards were to require assets and liabilities to be recognized for all leases, other contracts should be treated in a similar way. For example, they might argue that forward contracts for the purchase of currency or commodities gave rise to assets and liabilities to receive and pay the contracted amounts, and that an asset and corresponding liability equal to the value of a building would arise even though all that had occurred was the signing of a construction contract.

2.2 This chapter considers issues regarding the scope of any standards on lease accounting that may emerge from the approach advocated in this Paper. The topics considered are:

- Characteristics of leases that give rise to assets and liabilities.
- Why the proposals would not apply to executory contracts.
- Distinguishing leases from take-or-pay contracts.
- Contracts for services.
- Leases of intangible assets and resource exploitation rights.
- Leases of land and buildings.
- Short-term and immaterial leases.

Characteristics of leases that give rise to assets and liabilities.

What are leases?

2.3 For the purposes of this Paper, a lease is any contract between a lessee and a lessor that gives the lessee the right to possess and use a specific item of property for an agreed period of time in return for the lessee making specified payments.

2.4 A feature of a lease that differentiates it from other forms of asset financing is that the lessor retains ownership of the property that is the subject of the lease during the period of the lease. Some lease contracts give the lessee the right to purchase the leased property at the end of the lease term – these are sometimes referred to as “hire purchase contracts”.

Rights and obligations that arise under lease contracts

2.5 Lease contracts typically convey a bundle of rights and obligations to the lessee. The most important right obtained by the lessee is the right to use or exploit the leased property, in accordance with the terms of the contract, for the period of the lease. Unless the contract provides otherwise, once the leased property is delivered or otherwise made available to the lessee, the lessee can expect continued quiet enjoyment for the term of the lease. A lessee’s rights in relation to the use of the property are clearly different from ownership rights, but are valuable rights nonetheless, since they give the lessee rights of access to future economic benefits. In consideration for the rights acquired, the lessee is obliged to pay lease rentals to the lessor and any other amounts required by the lease.

2.6 For the lessor, lease contracts create rights to receive future lease rentals from the lessee and other amounts required by the lease. The lessor usually has a right to the return of the leased property at the end of the lease.

2.7 Some leases, in addition to conveying usage rights, also contain agreements for the lessor to provide asset management and other ancillary services to the lessee such as repairs, maintenance and insurance of the leased item. The treatment of these leases is considered in paragraph 2.41.

When do leases give rise to assets and liabilities?

2.8 The conceptual frameworks adopted by the boards of all the G4+1 members have similar definitions of assets and liabilities for financial reporting. A central feature of the definitions of assets is that past transactions or events have resulted in control over the capacity to obtain future economic benefits. A central feature of the definitions of liabilities is that past transactions or events have resulted in a present obligation to transfer economic benefits. The definitions of assets and liabilities within the frameworks are particularly well suited to cope with leases, since they focus on control of rights acquired and on obligations incurred rather than on “quasi-ownership” that requires polarizing alternatives.

2.9 In accounting for lease contracts, as for any other contracts that give rise to rights and obligations for the contracting parties, it is necessary to examine the nature of those rights and obligations and whether they meet the definitions of assets and liabilities. This requires identification of recognition points, at which changes in assets and liabilities should be reflected in the accounting by the parties to the contract.

2.10 There are various events that might have consequences for the recognition of assets and liabilities in respect of lease contracts. These include:

- Signing a contract to lease.
- Purchase or manufacture by the lessor of the specific item of property that is the subject of the lease.
- Delivery of the property to the lessee
- Rental payments falling due during the lease term.

Delivery by the lessor

2.14 In general, for a lessor, the most substantial act of performance under a lease is passing possession of the leased item to the lessee. This may be done by delivering, or otherwise making available, the item to the lessee. Thereafter, the lessee has rights to "quiet enjoyment" of the leased item during the lease term; once the lessor has done this, there is little doubt that the lessor will continue to allow the lessee access to the leased item for the remainder of the lease term (provided that the lessee does not break the conditions of the lease agreement).

2.15 It is therefore reasonable to conclude that once the lessor has delivered the leased item to the lessee, the lessor's performance under the lease is substantially completed. (Except for any future obligations under agreements to provide asset management or other ancillary services). The lessor now has a right, which may reasonably be viewed as unconditional to collect the lease payments – an assets that can be reported as a debtor; it also has the right to the return of the item at the end of the lease.

2.16 The lessee too has an asset – it has the right to use the leased item in any way permitted by the lease agreement. It also has an obligation, which may be viewed as unconditional, to pay the lease payments -—a liability that may be reported as a creditor.

2.17 Accordingly, the lessor and the lessee should recognize their changed rights and obligations under the lease once possession of the leased item has passed from the lessor to the lessee. At the time, the lessor has substantially performed and the lease contract ceases to be executory. The lessee should recognize the rights to use the item and the obligation to pay rentals over the lease term, and the lessor should recognize the right to receive those rental payments instead of all or part of the leased item. The lessor's substantial performance under the lease contract is an economic event that has changed significantly the nature of the rights and obligations of the parties to the lease contract, which should be reflected in their accounting for the contract.

Initial payment by lessee

2.18 The first act of performance under a lease contract may be the payment of an initial amount by the lessee. Clearly, the lessee does not at this stage have control over the rights to the leased property, and would simply recognize a prepayment, representing its right either to receive the property (on lease) or, alternatively, to have its money refunded.

Distinguishing leases from take-or-pay contracts

2.36 Leases are sometimes compared with take-or-pay contracts. Under such contracts, a buyer is required to pay the contracted amount even if the goods or services are not required. This may appear to give rise to an unconditional obligation to pay, and suggest that a liability to pay should be recognized at the inception of the contract.

2.37 Take-or-pay contracts are, however, essentially executory contracts throughout their term. Each party has the right and obligation to participate in the exchange, or alternatively to compensate or be compensated for the consequences of not doing so. The supplier must be able to continue to supply the goods or services over the life of the contract, whether or not the buyer in fact wishes to take a particular scheduled delivery. Clearly, the supplier has not substantially completed its performance at the inception of the contract, nor has the buyer (unless payment is made in advance). If payment is made in advance, the buyer's performance would give rise to valuable rights – either to receive the goods or services, or to have the payment refunded. Consequently, it is reasonable for the buyer to recognize assets (and corresponding liabilities) only in respect of deliveries that have taken place and payments that have been made.

2.38 Take-or-pay contracts can thus be distinguished from lease contracts, since a lessor substantially completes its performance early in the term of the lease by delivering the leased item to the lessee. All contracts cease to be executory once significant performance has occurred.

Recommendations:

2A Leases can be distinguished from executory contracts by the fact that leases cease to be executory when the leased property is delivered or otherwise made available to the lessee. The proposals would therefore not apply to executory contracts (including take-or-pay contracts, which are considered to be executory throughout their term).

2B. Where a lease contains a contract for services the two elements should be accounted for separately.

2C Where contracts for services in substance incorporate leases of the service provider's property, these should be accounted for as leases.

2D Leases of intangible assets (including agreements to explore for or use natural resources) should not in principle be excluded from the scope of revised standards.

2E No specific exemption should be proposed for short leases; reliance should instead be placed on the principle of materiality.

Part II
Leases in the Financial Statements of Lessees

Chapter III
Assets and Liabilities of Lessees – General Principles

Introduction

3.1 Leases typically convey a bundle of rights and obligations to the lessee. The approach to lessee accounting that is proposed in the Paper focuses on accounting for those rights and obligations. The main issues to consider in developing such a framework for recognizing assets and liabilities relating to lease contracts are:

- What rights does the lessee acquire under the lease contract and when do they meet the definition of an asset?
- What obligations does the lessee incur under the lease contract and do they meet the definition of a liability?
- If assets and liabilities are created by the lease, how should they be measured?

Rights and assets that arise for lessees

3.2 As discussed in Chapter 2, the Group takes the view that most leases provide the lessee with rights or access to future economic benefits that it controls and obligations that it must meet, which respectively satisfy the definitions of assets and liabilities for financial reporting.

3.3 The lessee's rights will comprise the rights to use the leased property for a specified period and sometimes also options, for example to extend the lease in exchange for further payments or to purchase additional usage of the property. In the interest of clarity, this chapter considers only straightforward leases; leases with such optional features are discussed in Chapter 4.

3.4 A lease asset that is recognized in a lessee's balance sheet represents property rights or control over future economic benefits rather than ownership of the underlying physical property. Under a lease contract, the lessee generally obtains access to the use of the leased item, and therefore gains control over its future economic benefits for the term of the lease, once it is delivered to the lessee or otherwise made available fort the lessee's use.

3.5 Under some leases the lessor also agrees to provide ancillary services such as repairs and maintenance of the leased item. In such cases the right to use the item and the provision of services are distinct elements – as discussed in Chapter 2, contracts for services do not result in separate assets and liabilities because performance of the service has not yet occurred.

3.6 In accordance with the normal principles of asset recognition, (these recognition principles are derived from the conceptual frameworks for financial reporting of the members of the G4+1) a lease asset is recognized if:

(a) it is probable that future economic benefits associated with the item will flow to the entity; and
(b) it has a value that can be measured reliably.

3.7 Where it is determined that a lease conveys rights to the lessee that meet the definition of an asset, it would be highly unlikely for the above recognition criteria not to be met. In entering into leases, lessees will normally expect to derive future economic benefits from the use of the leased items. In addition, the initial value attributable to the assets that arise can normally be determined or estimated by reference to the obligations the lessee assumes under the terms of the lease agreements.

3.8 The rights conveyed to the lessee and the obligations assumed in relation to lease contracts are linked; therefore the assets and liabilities need to be considered together to determine how they should be recognized. In many respects, the accounting treatment of a lease under this approach reflects the purchase by the lessee of an economic interest in the leased item, which the consideration being payable in installments to the lessor. Conversely, from the lessor's perspective, the accounting treatment of a lease reflects the sale by the lessor of an economic interest in the leased item, with the consideration being receivable in installments from the lessee.

Initial measurement of assets and liabilities that arise.

3.13 Assuming arm's length parties, the cost of an acquired asset is normally measured by the fair value of the consideration given, except where the fair value of the asset received is more clearly evident.

3.14 In the Group's view, the same principle should apply to assets recognized in respect of leases. Consequently, the objective should be to record, at the beginning of the lease term, (Hereafter, for ease of reference, the term "the beginning of the lease term" has been used to denote the point at which lease assets and liabilities may arise – ie when the lessor substantially performs by making the leased item available for the lessee's use under the terms of the lease contract – rather than necessarily the signing of the lease contract) the fair value

of rights and obligations that are conveyed by the lease. This reflects the bargained fair value of the use of the item and any other rights conveyed by the lease contract, normally measured by the liabilities incurred and any other consideration payable.

3.15 Determining the liability incurred by the lessee in order to measure the fair value of the asset is therefore simply the application of the normal principle of recognizing assets and liabilities arising from a transaction at their fair values at the transaction date. The fair value of the rights obtained by the lessee cannot be less than the present value of the minimum payments required by the lease (assuming that the lease is negotiated on arm's length terms), and in many straightforward leases the present value of the minimum payments will represent the bargained fair value of the property rights conveyed by the lease.

3.16 Consider a simple example where a lessee agrees to hire equipment for three years at an annual rental of 5,000. At the end of the lease term the lessee returns the equipment to the lessor. The lessee's rights and obligations can be analyzed thus:

(a) the right to use the equipment for three years;
(b) the obligation to pay 5,000 per year for three years, and
(c) the obligation to return the equipment to the lessor at the end of three years.

3.17 Under the principles discussed above, when the equipment is delivered to the lessee, the lessee should recognize an asset and a liability and measure them at the present value of the three annual payments. The liability is the present obligation incurred under the lease contract. The asset represents the fair value of the right to use the equipment for three years only – the lessee controls the usage rights for that period and does not have any rights relating to the equipment beyond the end of the lease term.

Leases with optional features

3.18 The discussion of the previous example has assumed that the term of the lease and the minimum payments required by the lease are unambiguously stated in the lease contract. However, this is not always the case. Many leases give the lessee options to renew or cancel the lease, where the lessee has a choice whether to continue with a lease beyond a certain date, or to cancel the lease, perhaps with an additional payment. In some leases the rentals are not fixed amounts but are contingent on future events such as the actual usage of the leased item by the lessee, the amount of revenue generated by the leased item in the lessee's business, or changes in prices, such as interest rates or measures of price inflation. The application of the proposed principles to the recognition and measurement of the assets and liabilities arising from leases that contain such features is discussed in Chapter 4.

Residual values

3.19 One of the issues that has been addressed by the Group is that the lessee's rights and objections could be analyzed in different ways, even when it has been determined what present obligations exist. At the core of the issue is the fact that different amounts would be recognized in respect of the lessee's separate assets and liabilities depending on the view taken of their nature – although there would not necessarily be a difference in the net amounts recognized. These different views generally revolve around the treatment of the leased item's residual value. An alternative view of the above example is that the lessee should include in the asset and liability amounts respectively the full value of the equipment and the obligation to return it at the end of the lease. Advocates of this approach would argue that the lessee has control of the (whole of the) equipment for the term of the lease and has an obligation to return it. They would also argue that the inclusion of "gross" asset and liability amounts would make the financial statements of entities that lease their assets more comparable with those that own them (the difference being that the latter do not have obligations to return the property to another entity).

3.20 The Group has rejected this view of how the lessee's assets and liabilities should be characterized. First, in the Group's view, the lessee's rights relate to only part of the equipment's economic life, not the whole of it, and so the recognized asset should be characterized as such. Second, the obligation to return the equipment at the end of the lease is not in the Group's view an obligation to transfer economic benefits for the value of the equipment that is being returned, since the economic benefits relating to the equipment beyond the end of the lease were not transferred to the lessee in the first place. The Group also believes that in this example, leasing is not similar to ownership – and the accounting treatment should not make transactions that are not alike appear to be alike. Indeed, an important effect of the Group's recommendations is that the accounting treatment of leases would generally reflect differences between leasing and ownership.

3.21 Whereas the example in paragraph 3.16 is relatively straightforward to analyze, many leases are more complex and convey to the lessee an economic interest in and/or an obligation relating to the equipment's residual value. The issue then is how the rights and obligations relating to the residual value are characterized in the balance sheet. The recognition and measurement issues relating to residual values and residual value guarantees are discussed in Chapter 5.

Recommendations:

3A Assets and liabilities should be recognized by a lessee in relation to the rights and obligations conveyed by a lease when the lessor has substantially performed its obligation to provide the lessee with access to the leased property for the lease

term – generally this is when the leased property is delivered or otherwise made available to the lessee.

3B Until the above recognition point is reached, a lessee should account for a lease contract in a similar way to any contract to purchase property that has not yet been delivered.

3C The objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease. Fair value is measured by the fair value of the consideration given, except where the fair value of the asset received is more clearly evident.

3D The fair value of the rights obtained by a lessee cannot be less than the present value of the minimum payments required by the lease (assuming that the lease is negotiated on an arm's length basis).

Chapter 4
Leases with optional features

Introduction

Renewal, cancellation and purchase options

4.1 Many leases provide the lessee with the right either to end the lease at some point, to extend the lease for a further period, or to purchase the leased property at some point? For example, consider a lease that requires the lessee to hire equipment for three years at an annual rental of 5,000 and gives the lessee the right to hire the equipment for a further two years at the same rent. The issue is whether the lessee should recognize an asset and a liability for the present value of three years' rentals or five years' rentals.

4.2 The issue arises, in a slightly different form, under existing standards on lease accounting, where the interpretation of clauses containing renewal or break options for the purpose of classifying leases as finance leases or operating leases can be difficult. Existing standards generally define the lease term to include any periods covered by renewal options that are regarded as "reasonably certain" of being exercised, and the factors to be considered are sometimes specified. It may be that if the lease is viewed as a five-year lease it is a finance lease, whereas if the lease term is viewed as three years it is an operating lease. If, on the other hand, the classification of the lease is the same under either scenario, the accounting under present requirements is either not affected (if an operating lease) or is less severely affected (if a finance lease) by the view that is taken of the option. But the treatment of options in leases is more generally relevant under the approach advocated in the Paper because they potentially affect the amount of assets and liabilities that are recognized for all leases in which they occur.

Contingent Rentals

4.3 Although leases normally specify minimum rentals that must be paid over the lease term, some leases require the lessee to pay additional amounts that are not fixed in advance. Instead, the actual amounts that the lessee will be required to pay are contingent on the outcome of uncertain future events. Such rentals are commonly referred to as contingent rentals. Common examples are motor vehicle leases containing clauses where rentals are increased to reflect the actual mileage driven above an initially agreed mileage; property leases in the retail industry where rentals are related to the turnover in the lessee's business; and property leases where rents are periodically reset to current market values to take account of inflation. Arrangements involving leases of intangible assets, (as noted in Chapter 2, the Group takes the view that leases of intangible assets should not in principle be excluded from the scope of revised accounting standards) such as licenses of trade marks, patents or other intellectual property, also commonly require payments that are linked to the licensee's exploitation of the rights acquired (such as royalties on sales derived from the use of the property). Three kinds of contingent rentals can be distinguished:

- Rentals that vary with usage (for example, a charge for additional miles that a leased care is driven above a defined threshold).
- Rentals that are a proportion of the lessee's revenues or profits derived from the use of the leased property (for example, a share of sales made from a retail outlet).
- Rentals that vary in line with prices (for example, the UK 'institutional' property lease where rentals are revised to reflect increases to market levels at specified intervals during the lease).

4.4 Under present standards contingent rentals are not included in the minimum lease payments for the purpose of determining whether a lease is a finance lease or an operating lease. Nor are they included in the minimum lease payments that are recognized as assets and liabilities in the event that the lease is treated as a finance lease. The treatment of contingent rentals is important under the approach advocated in this Paper because it directly affects the amount of assets and liabilities that would be recognized for many leases.

Similarities between contingent rentals and options

4.5 Leases that contain renewal and purchase options give rise to similar issues to leases that contain contingent rentals, especially those that vary with usage. The similarity is that both kinds of leases give the lessee the option to 'purchase more' of the asset; the difference is simply whether the lessee purchases more time or more usage. In view of this similarity, the same principles ought to apply to both circumstances. However, some contingent rentals, especially those that vary in line with prices, may be viewed as giving the lessee an obligation to pay an uncertain amount for the asset rather than an option to purchase more of the asset.

Proposed general principles

4.6 As noted in Chapter 3, the Group believes that the objective should be to record, at the beginning of the lease term the fair value of the rights and obligations that are conveyed by the lease. Fair value is measured by the fair value of the other consideration given (comprising the liabilities incurred and any other consideration such as cash paid in advance), except where the fair value of the asset received is more clearly evident. The application of this objective results in the following general principles.

4.7 The rights that are reflected in the lease asset that is recorded by the lessee will comprise the rights to use the property and also options, for example to extend the lease, to purchase additional usage of the property in exchange for usage-related rentals, or to purchase the property itself.

4.8 On the assumption that the lease is negotiated on an arm's length basis, the value of the rights obtained by the lessee under a lease cannot be less than the present value of the minimum payments required by the lease.

4.9 When accounting for options conveyed to the lessee, the exercise of renewal or purchase options should not generally be anticipated: the fair value of the options themselves acquired at the beginning of the lease term will be reflected in the minimum payments required by the lease.

4.10 A renewal or purchase option may itself have a significant value at the beginning of the lease term (when the price payable on exercise is significantly less than the fair value of the rights acquired: for example, a bargain renewal or bargain purchase option). Expressed in option terms, the option acquired by the lessee is significantly 'in the money' at the beginning of the lease term. Where this is the case (and assuming its value can be ascertained with sufficient reliability), the option should be accounted for separately from the rights to use the property for the non-cancelable period of the lease, and a portion of the minimum lease payments would be deemed to relate to the purchase of the option. One way in which the value of such options might be determined is by comparison of the rentals required by a lease including options with those that are specified in a lease that contains no such options.

4.11 Under the historical cost model that is developed in this Paper, the carrying amount in respect of a renewal or purchase option would be reviewed for impairment during the period up to the exercise date and, if the option is exercised, the carrying amount at the exercise date would be amortized subsequently as appropriate. Some members believe that this treatment would be inappropriate if such options were considered to be financial instruments. In their view, the accounting treatment for renewal or purchase options should be consistent with accounting standards on financial instruments.

4.12 An option may have a value that is small (when the price payable on exercise is approximately the same as the value of the rights acquired at that time), or it may not be possible to ascertain the value of an option with sufficient reliability. If the value of the option is immaterial to the lessee's financial statements, or it cannot be measured reliably, the option would not be accounted for separately; as a result, the whole of the minimum lease payments would be deemed to relate to the usage of the asset.

4.13 Some leases contain multiple options. For example, the lessee may have the choice of either purchasing the asset at the end of the initial term or renewing the lease for a further term. The lessee's assets and liabilities at the beginning of the lease term would generally be determined as those arising from the least cost option.

4.14 The exercise of options will give rise to additional assets and liabilities, reflecting the fair value of the additional rights and obligations obtained and assumed by the lessee as a result of the exercise.

4.15 If the minimum payments required by the lease (such as the minimum payments specified in leases with contingent rentals) are clearly unrepresentative of the value of the property rights conveyed by the lease, an amount reflecting the fair value of such rights should be recognized as assets and liabilities. The fair value of the property rights conveyed by a lease might be determined by having regard to the payments required by a similar lease that had no provision for contingent rentals.

4.16 Contingent rentals (in excess of the minimum payments, or greater amount, recognized at the beginning of the lease term) should be recognized when the contingency criteria are met.

4.17 The application of the principles set out above is discussed in the remainder of this chapter.

The role of 'probability' in determining the assets and liabilities that arise from lease contracts.

Proposed approach to recognition and measurement of assets and liabilities

4.18 In the framework that has been outlined in the previous paragraphs, the identification and measurement of lease assets do not as a matter of principle depend on assessing the probable outcome of options to purchase more time or usage. Until an option is exercised, the recognized assets and liabilities will reflect the consideration given for the option, not the consideration that becomes payable when the option is exercised.

4.19 An option gives the lessee a right, but not an obligation, to purchase more time or usage. The lessee has no liability in respect of the exercise of the option because no present obligation to make further payments relating to optional renewal periods, etc arises until the lessee takes action to create one by exercising the option. This approach is consistent with normal accounting for the purchase of options in most other circumstances.

4.20 Under the proposed approach the probability of the lessee's exercising an option is implicitly reflected in the assets and liabilities recognized at the beginning of the lease term.

The lease term – cancellation and renewal options

4.27 The example introduced at the start of this chapter is considered below:

Example 1
A company enters into a lease of equipment with a term of three years at an annual rental of 5,000. In addition the lease gives the lessee the right to renew the lease for a further two years at the same annual rental.

4.28 The lease in this example could be described in either of two ways:
- As a *three-year* lease, with an option to *renew* for a further two years.
- As a *five-year* lease, with an option to *cancel* after three years.

Irrespective of which of the above two formulations is used in the lease contract, the economic effect is the same, and the accounting treatment should also be the same, ie the assets and liabilities recognized at the beginning of the lease term should reflect the minimum payments required by the lease, unless this amount is clearly unrepresentative of the value of the property rights conveyed by the lease.

Part III
Leases in the Financial Statements of Lessors

Chapter 8
Assets of lessors – general principles

8.1 the approach to lessor accounting that is proposed in this Paper focuses on accounting for the rights that are conveyed to lessors by the lease contract and on other rights relating to the leased property. The approach corresponds with that advocated for lessee accounting.

Treatment under present accounting standards

8.2 Under present accounting standards, entirely different methods are used to characterize leased assets in balance sheets and to recognize income from leased assets in performance statements, depending on whether the lease is classified as a finance lease or an operating lease. Those differences mirror the different treatments for lessees. A finance lease is treated similarly to a financing or sale on deferred terms to the lessee of the whole of the leased property. An operating lease is deemed not to include the transfer to the lessee of any economic interest in the leased property.

8.3 For leases classified as finance leases, the whole of the lessors' investment is shown as a receivable (a financial asset). The lessor's financial asset is measured as the present value of the amounts recoverable from the lease; the amounts recoverable comprise the remaining rental payments under the lease and any residual value (guaranteed or unguaranteed) that accrues to the lessor. At the inception of the lease, the amount reported as a financial asset is usually equivalent to the cost of the leased item to the lessor. However, in certain circumstances a gain (or, in rare cases, a loss) may be recognized that is equivalent to the profit that would have resulted from an outright sale. In some jurisdictions that accounting is limited to lessors that are considered to be manufacturers of, or dealers in, the leased property. Interest methods are generally used to account for subsequent changes in the lessor's financial asset; thus rental payments and other amounts recoverable are allocated between a capital element (treated as repayment of the principal amount of the outstanding receivable) and a finance income element (treated as interest on the lessor's outstanding investment).

8.4 For leases classified as operating leases, the leased property is treated as an asset of the lessor in its entirety. Consequently, the whole of the lessors' investment is shown as an item of property, plant or equipment (a non-financial asset). This asset is subject to accounting standards dealing with depreciation and impairment of assets. Rental payments are normally recognized as income on a straight-line or other appropriate basis over the lease term.

Assets that arise for lessors

Receivables and residual interests

8.5 The approach taken in this Paper, as discussed earlier in the context of lessee accounting, is that leases convey rights and obligations to the parties concerned that, conceptually, may give rise to assets for both the lessor and the lessee. Their respective assets would represent different economic interests in the leased property, the lessee's asset reflecting the right to use the leased item for their term of the lease.

8.6 Chapter 2 proposes that leases can be distinguished from executory contracts by the fact that leases cease to be executory when the leased property is delivered or

otherwise made available to the lessee. Delivery is an act of performance by the lessor that changes significantly the nature of the rights and obligations of the parties to the lease contract, which should be reflected in their accounting for the contract. At that point, the lessor has transferred to the lessee rights to some or all of the future economic benefits that derive from the item of property. In exchange, the lessor has obtained rights to receive payments. The lessor also has rights relating to the service potential of the leased property at the end of the lease term (the residual interest). The nature of the lessor's asset has, therefore, changed as a result of its performance under the lease contract.

8.7 The rights and obligations that arise for the lessee and the lessor may be summarized thus:

- The lessee has obtained rights to use the leased item in any way permitted by the lease agreement, and has incurred an obligation to pay rentals over the lease term.
- The lessor has obtained a right to collect the lease payments; it also may have a right to the return of the leased item at the end of the lease.

8.8 The lease has converted some or all of the lessor's existing asset (the item of property) into a financial asset. Thus some or all of the lessor's exiting property asset should be derecognized and reported as a financial asset – a receivable.

A financial asset is defined in IAS 39 'Financial Instruments: Recognition and Measurement' as follows:
(a) cash;
(b) a contractual right to receive cash or another financial asset from another enterprise;
(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favorable; or
(d) an equity instrument of another enterprise.

Thus, some or all of the lessor's existing property asset should be derecognized and reported as a financial asset – a receivable.

8.9 A consequence of this approach, therefore, is that a lessor may report two separate assets in respect of a lease:
(a) a receivable in respect of payments required by the lease; and
(b) an interest in the residual value of the property.

The amount of each kind of asset would vary depending on the nature of the lease: if the lease term is short in relation to the economic life of the leased asset, the receivable would be small (perhaps even immaterial) and, conversely, if the lease term is long, the lessor's asset would almost all be represented by the amount receivable.

8.10 The above characterization of the lessor's assets reflects straightforward leases; leases with optional features are discussed in Chapter II.

Measurement of the lessor's assets

Initial measurement of receivable at fair value

8.13 It is to be expected that if a lease gives rise to a financial liability for the lessee, it should in principle give rise to a corresponding financial asset for the lessor. The Group's proposed objective in accounting for assets and liabilities recognized by lessees is to record, at the beginning of the lease term, the fair value of rights and obligations that are conveyed by the lease. From the perspective of the lessor, the amounts receivable from the lessee should as a matter of principle also be recorded initially at fair value (representing the fair value of the consideration that the lessee has agreed to pay for the right to use the leased property).

8.14 The fair value of the rights conveyed by the lease cannot be less than the present value of the minimum payments required by the lease (assuming that the lease is negotiated on arm's length terms).

Recognition of gains at the beginning of the lease term

8.15 As a general principle, it is the Group's view that a gain should be recognized at the beginning of the lease term if (a) there is evidence that the value of the lessor's assets (less its liabilities) has increased as a result of its performance in entering into the lease contract, and (b) the increase can be measured reliably. This principle is reflected in the UK's standards FRS 5 'Reporting the Substance of Transactions'. Where an item is transferred for only part of its life, FRS 5 would allow a gain to be recognized if it can be measured reliably. Where measurement is difficult, with the result that the amount of any gain or loss is uncertain, FRS 5 delays the recognition of any gain, to the extent that it is in doubt. Evidence would be required of the fair value of the property being leased (if greater than its previous carrying value), and the receivable and residual interest assets resulting from the lease contract would also need to be capable of being measured reliably. Under the historical cost model that has been developed hitherto in the Paper, any gain recognized at the beginning of the lease term would be restricted to the proportion of the original asset that was transferred under the lease .

8.16 Where the conditions for recognition of an initial gain were not satisfied, it would be reasonable for the leasing activities to be treated essentially as financial activities (together with the provision of any ancillary services). Hence, the whole of the lessor's earnings would reasonably be accounted for as finance income arising during the lease term, together with revenue from providing any ancillary services.

8.17 It is normally reasonable to assume that (as with the majority of exchange transactions) the fair value of the consideration given is equal to the fair value of the consideration received. In the context of a lease, this implies that the aggregate of the fair value of the receivable in respect of payments required by the lease and the fair value of the lessor's interest in the residual value of the property is equal to the fair value of the property held before the lease.

8.18 The Group therefore proposes that there should be a presumption that no gain or loss arises at the beginning of the lease term unless there is evidence that the carrying amount of the property immediately before the beginning of the lease was less than its fair value. The circumstances in which this is likely to arise are:

(a) where the lessor is in the business of regularly trading in the kind of property in question (ie is a manufacturer or dealer lessor). In such a business the property would be recorded at manufacturing cost or purchase price; however, the existence of transactions other than leases, especially sales, provides strong evidence that the fair value of the lease receivable and the retained interest in the property may well be a higher amount, or;

(b) where the amount at which the property is carried in the lessor's books immediately before the beginning of the lease is based on a historical cost (or revalued amount) that was established long before the lease was granted. In these circumstances, the carrying amount of the property is unlikely to approximate its fair value.

8.19 Enterprises that manufacture or deal in the property that they lease may view their leasing activities as an alternative method of marketing their products. A dealer might be defined as an entity that buys in one market (wholesale) and sells in another (retail). Such lessors differ from other lessors insofar as the cost at which the lessor acquires the property for lease is either the cost of manufacture or the wholesale price, which is usually lower than the normal selling price.

8.20 In terms of the accounting treatment for a lease by a manufacture or dealer lessor, the following activities may be identified:

- A sale, as if the lessor had sold an economic interest in the property at a normal selling price
- The provision of finance over the lease term relating to the economic interest that has been transferred to the lessee
- The provision of ancillary services (if any)
- Retention of the rights to the second-hand property at the end of the lease, which may be recovered by sale or reletting.

The activities noted in the last three points above are similar to those of any finance lease. With respect to the first point, the Group takes the view that a manufacturer or dealer lessor should in principle be permitted to recognize a gain (equivalent to a 'selling profit' in relation to the rights that have been transferred to the lessee) at the beginning of the

least term if it could be demonstrated that the lessor was able to obtain the leased property at a price that was less than what the lessee would normally pay. Part of this demonstration would involve provision of evidence that the attributed fair value (or 'retail" selling price) was a price at which actual sales could be expected to take place, and was not simply a list price at which no sales were ever made. Also there should be evidence that the payments expected under the lease and the residual value are reliably measurable.

8.21 Accounting standards could allow a gain to be recognized at the beginning of a lease where the principle set out in paragraph 8.15 is met, ie including all circumstances where it can be demonstrated that entering into a lease increases the value of the lessor's assets. Alternatively, recognition of a gain could be restricted to the two circumstances listed in paragraph 8.18. The Group supports the latter approach.

Restriction of gains to reflect the proportion of the asset transferred

8.22 When it is appropriate to recognize a gain at the beginning of the lease, the gain should reflect the extent to which the equipment has genuinely been sold, rather than retained. A practicable method of ensuring this is to restrict the amount of selling profit that should be recognized to the proportion of the normal selling price of the equipment that is represented by a receivable, rather than by the lessor's interest in the residual value. Thus, if the lessor had no interest in the residual value, a profit of up to the amount that would be made on a normal cash sale would be recognized, and this would be proportionately reduced to reflect the extent to which the lessor retained a residual interest.

8.23 The following example illustrates the proposed treatment.

Example

A manufacturer leases equipment that cost 100 to produce, and has a normal selling price of 120. The present values of the lease payments and the estimated residual value, calculated by discounting the expected cash flows to the selling price of 120, are determined as 70 and 50 respectively.

The manufacturer-lessor would recognize a receivable of 70 and reduce the carrying amount of its asset by 70 / 120 of 100, ie 58. This would leave its interest in the residual value stated at 42 (100 – 58). The manufacturer-lessor's total assets would be 112 (70 + 42), resulting in a recognized profit of 12 (ie 70 / 120 of 20, the profit arising on a normal scale).

8.24 Issues concerning the initial measurement of a lessor's receivable and residual interest assets, and how they should be accounted for during the lease term, are addressed in Chapters 10 and 12.

Recommendations:

8A Two elements – a receivable in respect of payments required by the lease and an interest in the residual value of the property – should be presented separately by lessors in the balance sheet, reflecting the different property rights arising under the lease.

8B The amounts receivable from the lessee should be recorded initially at fair value (representing the fair value of the consideration that the lessee has agreed to pay for the right to use the leased property).

8C The fair value of the rights conveyed by the lease cannot be less than the present value of the minimum payments required by the lease (assuming that the lease is negotiated on arm's length terms).

8D A gain should be recognized at the beginning of the lease term if (a) there is evidence that the value of the lessor's assets (less its liabilities) has increased as a result of its performance in entering into the lease contract, and (b) the increase can be measured reliably.

8E Accounting standards should prescribe that a lease should fall within the scope of 8D above only if:

(a) the lessor also manufactures or deals in the property that it leases; or

(b) in other situations, the carrying amount of the property that is the subject of the lease is demonstrably lower than its fair value.

8F Any gain recognized at the beginning of the lease term should be restricted to reflect the proportion of the original asset that was transferred under the lease to the lessee.