Boards weighing effects of putting leases on the balance sheet

Overview
At their February 2012 meetings, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) explored some potential changes to their previous tentative decisions in their joint leases project.

The Boards did not make any substantive decisions. Instead, they agreed to do more outreach and research before modifying their previous decisions and issuing a second exposure draft (ED) of the proposal.

The Boards’ decision to more fully explore potential changes to their tentative decisions before issuing an ED will likely delay the project. We don’t expect an ED until at least the third quarter of 2012. The Boards had previously intended to issue a new proposal for comment in the second quarter of 2012.

Key changes under consideration
The Boards have tentatively decided that a lessee would recognise a liability to make lease payments and a corresponding right-of-use asset upon lease commencement. The lessee would subsequently recognise interest expense using the interest method and separately amortise the right-of-use asset (generally on a straight-line basis). The overall expense recognition pattern would accelerate lease expense for today’s operating leases.

The Boards also had tentatively decided that lessors would not apply the general lessor accounting approach (i.e., the receivable and residual approach) to leases of investment property. For leases subject to the receivable and residual approach, lessors would recognise a receivable, allocate the carrying value of the underlying asset being leased between the right of use granted to the lessee and the residual asset and recognise profit upon commencement.

The Boards continue to hear concerns from constituents about the income statement effects of these decisions.
Lessee accounting

Many constituents have expressed concerns that the accelerated expense recognition pattern would not reflect the underlying economics of all leases. The Boards are exploring alternative methods of amortising the right-of-use asset that would mitigate some of the front-end loading of lease expense for certain leases.

However, the Boards are not considering changes to the proposed requirement for the lessee to recognise a right-of-use asset and lease liability, the initial measurement of the right-of-use asset and lease liability or the subsequent measurement of the lease liability using the interest method.

The Boards are considering requiring an amortisation method that is unlike any method in use today. The new methods under consideration would not achieve straight-line lease expense under many circumstances. Instead, the lease expense profile would vary depending on certain factors.

Under one of the alternatives being considered, lessees would differentiate between types of leases using principles similar to those used to classify leases as either operating leases or finance leases today. Amortisation expense for certain leases (leases that would likely be considered operating leases today) would be recognised using a method that generally allocates more amortisation expense to later periods under the lease and therefore smoothes out total lease expense over the lease term. Amortisation expense for other leases (leases that would likely be considered finance leases today) would be recognised on a straight-line basis; therefore, total expense would be front-end loaded (similar to finance leases today).

Another alternative under consideration would derive the pattern of amortisation expense from the estimated consumption of the underlying leased asset over the term of the lease. Under this method, lessees would estimate the expected decrease in the fair value of the leased asset that would occur during the lease term. Using this estimate of consumption (i.e., estimate of decrease in value), the lessee would compute the amortisation expense pattern. If the underlying asset is expected to decrease in value by only a small amount during the lease term, a lease would have a higher amortisation expense in the later periods and a lower amortisation expense in earlier periods (smoother total lease expense over the lease term). A lease for which the decrease in the value of the underlying asset is expected to be large would have a more straight-line amortisation expense pattern (total expense would be front-end loaded). Under this method, many real estate property leases would likely have a smoother lease expense recognition pattern than would many equipment leases because there often would be little or no consumption of real estate assets.

The Boards remain committed to putting leases on the balance sheet, but continue to struggle with how to recognise related lease revenue and expense.

How we see it

The alternatives under consideration would introduce additional complexity to the accounting model the Boards are developing for leases. This may prompt questions about whether these potential fixes are worth the cost.

Lessees would be required to perform additional calculations, make more estimates and apply greater judgement, which in the end may not result in straight-line expense recognition.
The Boards are exploring solutions to concerns raised by constituents. These efforts will likely delay the project by at least a few months.

**Lessor accounting**

Constituents have also raised concerns that for some leases the profit recognition pattern for lessors is not appropriate and the approach is not operational. As the Boards assess changes to the accounting by lessees, they are also considering modifying their previous decisions on lessee accounting, including their decision to provide an exclusion for leases of investment properties measured at cost. Most members of the Boards appear to favour developing a lease accounting model that is conceptually consistent for both lessees and lessors.

**What’s next?**

Some members of the Boards raised conceptual questions and operational concerns about the alternatives being explored. Consequently, the Boards decided they needed additional information before making any decisions. The Boards agreed to perform additional outreach and research to address the following concerns:

- Whether the alternatives would be operational (i.e., whether preparers could readily apply the methods and how much it would cost to do so)
- Whether the financial reporting results obtained under the alternative methods would provide decision-useful information and address the needs of users
- Additional consequences of the methods (e.g., whether additional analysis of impairment methods would be required)

**How we see it**

We support the Boards’ decision to more fully explore potential changes and revisions to their tentative decisions before issuing a new ED.
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