Overview
The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) tentatively agreed to change the expense recognition pattern and related income statement presentation for some leases. No other aspect of the lessee model was changed. The nature of the underlying asset generally would be used to determine which leases have an accelerated recognition pattern and which have a straight-line recognition pattern.

Lessors would use the same classification criteria as lessees, but the balance sheet treatment of leases by lessors and lessees could differ.

The Boards made these changes to the model they are developing in response to concerns raised by constituents that their previous decisions, which would have resulted in the front-loading of lease expense for most leases, did not reflect the underlying economics of some leases.

The Boards’ staffs believe that all substantive issues have been redeliberated. In the coming months, the Boards will address any remaining issues, including how these decisions affect previous decisions (e.g., transition and disclosure). The Boards also may reconsider aspects of lessor accounting as part of their redeliberations of the proposed revenue recognition standard. The Boards expect to issue a new leases exposure draft for comment during the fourth quarter of 2012.

The Boards’ latest decisions would change the way leases are classified and require straight-line expense recognition for some leases.

Key decisions
The Boards decided to distinguish between two types of leases, which we refer to as straight-line leases and accelerated leases. Both lessees and lessors would use the same criteria to classify leases. The two types of leases would have different lease income and expense recognition patterns.
Lease classification

The Boards developed a principle for classifying leases based on whether the lessee acquires and consumes more than an insignificant portion of the underlying asset over the lease term. The Boards decided that lease income and expense for leases that convey a relatively small percentage (i.e., an insignificant portion) of the life or value of the leased asset should be recognised evenly over the lease term.

However, the Boards simplified the classification assessment by adding a rebuttable presumption that leases would be classified based on the nature of the underlying asset being leased. Based on the Boards’ latest decisions, leases would be classified as follows:

- Leases of property (i.e., land, building or part of a building) would be classified as straight-line leases unless either of the following conditions is met:
  - The lease term is for the major part of the economic life of the underlying asset.
  - The present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.

- Leases of assets other than property (e.g., equipment) would be classified as accelerated leases unless either of the following conditions is met:
  - The lease term is an insignificant portion of the economic life of the underlying asset.
  - The present value of the fixed lease payments is insignificant to the fair value of the underlying asset.

The principle behind the classification assessment focuses on whether the lessee is paying to finance the acquisition of the portion of the underlying asset that it consumes or simply paying to use the asset. The presumption is that in most property leases, lessees do not consume more than an insignificant portion of the underlying asset during the lease term, while in most other leases, they do consume more than an insignificant portion of the underlying asset during the lease term. This presumption may be overcome if the conditions noted above are met.

How we see it

The income and expense recognition pattern for many property leases would be consistent with current accounting. However, many equipment leases that are accounted for as operating leases today (e.g., an equipment lease for which the lease term is only 25% of the economic life) would be classified as accelerated leases and would have different lease income and expense recognition patterns than they do under current accounting.

Under the current leases standard, it may not be important to distinguish between property and assets other than property for lease classification purposes. This is different from the proposed standard, which would require an entity to apply additional judgement to assess whether the leased asset is a property.

Lessee accounting

Similarities between the types of leases

All leases (other than short-term leases) would be recognised on the balance sheet and the initial measurement of the lessee’s right-of-use asset and liability to make lease payments would be the present value of the lease payments over the lease term for both types of leases.

The subsequent measurement of the liability to make lease payments would also be the same for both types of leases. Accretion of the liability would be calculated using the interest method (i.e., using a constant interest rate) and lease payments made would reduce the liability.
Differences between the types of leases
Subsequent measurement of the right-of-use asset and the corresponding lease expense recognition pattern would differ for the two types of leases.

For accelerated leases, lessees would separately amortise the right-of-use asset (generally on a straight-line basis) and recognise interest expense for the accretion of the liability. Because interest expense generally decreases over time, lessees would recognise total lease expense on an accelerated basis. This pattern is consistent with the treatment of finance leases under current lease accounting and similar to financed purchases of non-financial assets. It is also consistent with the expense recognition approach in the Boards’ 2010 exposure draft. Amortisation expense and interest expense would be presented either separately or with other amortisation and interest expense, respectively, on the income statement.

For straight-line leases, lessees would calculate both the periodic straight-line expense — similar to determining straight-line expense for operating leases under current accounting — and the accretion of the liability (using the interest method). Lessees would then determine the change in the right-of-use asset by subtracting the period’s accretion of the liability from the periodic straight-line expense amount. Total expense for straight-line leases would be presented as a single line item (e.g., lease or rent expense) on the income statement.

Illustration: Comparing the two types of leases for lessees
Assume a lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. The initial measurement of the right-of-use asset and liability to make lease payments is CU33,000 using a discount rate of approximately 4.24%.

If the asset being leased is a car, the lease would likely be an accelerated lease. If the asset being leased is space in an office building, the lease would likely be a straight-line lease. This table illustrates the difference in accounting:

<table>
<thead>
<tr>
<th>Both lease types</th>
<th>Accelerated lease</th>
<th>Straight-line lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time</td>
<td>Lease liability</td>
<td>Interest expense</td>
</tr>
<tr>
<td>Initial</td>
<td>CU 33,000</td>
<td></td>
</tr>
<tr>
<td>Year 1</td>
<td>CU 24,398</td>
<td>CU 1,398</td>
</tr>
<tr>
<td>Year 2</td>
<td>CU 13,431</td>
<td>CU 1,033</td>
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<tr>
<td>Year 3</td>
<td>CU</td>
<td>CU 569</td>
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<sup>A</sup> The annual straight-line amount is $12,000/year \([(10,000+12,000+14,000)/3]\).

<sup>B</sup> Calculated by subtracting the accretion of the lease liability (i.e., interest expense calculated for the accelerated lease) from the calculated annual lease expense (i.e., the calculated straight-line amount).

<sup>C</sup> Subsequent measurement of the ROU asset calculated by subtracting the change in the ROU asset from the prior period’s ending balance.

How we see it
While straight-line expense recognition would be achieved for some leases, the approach would not relieve, and may even add to, the record-keeping burden for lessees due to the accounting and reporting requirements for each type of lease.
Investment property lessors would use the same classification criteria as lessees.

**Lessor accounting**

Lessors would apply operating lease accounting to straight-line leases and the receivable and residual approach\(^1\) to accelerated leases. Lessors following operating lease accounting would neither recognise a lease receivable nor derecognise a portion of the underlying asset even though the lessee would recognise a liability to make lease payments and a corresponding right-of-use asset.

No special provisions would be included for lessors of investment property.

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\(^1\) Lessors applying the receivable and residual approach 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 recognised profit on the right of use granted to the lessee at lease commencement. For more details on the receivable and residual approach, please refer to our IFRS Developments Issue 17: Operating lease accounting survives for some real estate lessors, which is available at www.ey.com/ifrs.