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IFRS Developments

Boards issue revised proposal to put most leases on the balance sheet

What you need to know

- The IASB and FASB proposed that lessees be required to recognise assets and liabilities arising from their involvement in most leases.
- All entities would classify leases to determine how to recognise lease-related revenue and expense. Classification would also affect what lessors record on the balance sheet.
- Classification would be based on the portion of the economic benefits of the underlying asset expected to be consumed by the lessee over the lease term.
- The IASB and FASB are expected to devote significant outreach efforts on this project. Comments on the exposure draft are due by 13 September 2013.

Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) issued exposure drafts on 16 May 2013 proposing a right-of-use model for leases that would require lessees to recognise most leases on their balance sheets. Lessor accounting would also be affected.

The Boards are expected to devote significant effort to additional outreach. Although the IASB overwhelmingly voted in favour of issuing the proposal for comment, three of the FASB's seven members voted against it. In addition, FASB chair, Leslie Seidman, who voted to issue it, will leave the FASB when her term ends at the end of June 2013.

Key considerations

The scope would be different from today's standard. A lease would be defined as a contract that conveys the right to use an asset for a period of time in exchange for consideration. The contract must: (1) depend on the use of an explicitly or implicitly identified asset, which could be a physically distinct portion of an asset, such as a floor of a building; and (2) convey the right to control its use.

A contract would convey the right to control the use of an identified asset if, throughout the contract term, the customer has the ability to: (1) direct the use of the asset; and (2) derive benefit from its use. This concept is intended to align with the control concept in the Boards' joint revenue recognition project.

How we see it

The identified asset criterion is generally consistent with the specified asset concept in current lease accounting. The 'right to control the use' of the asset criterion would differ from today's 'right to use' concept. Consequently, some arrangements that are currently accounted for as leases would no longer be considered leases under the exposure draft.

Lease and non-lease components (e.g., services) of a contract would generally be accounted for separately. Lessees would be required to obtain observable stand-alone prices for each component, if possible, and allocate any remaining consideration to components without observable prices. If there are no observable stand-alone prices for any components, lessees would account for all of the components in the contract as a single lease component (i.e., not separate payments between lease and non-lease components).

Lessors would be required to account for all components separately because the Boards believe they have the information to do so.

Lessees and lessors could make an accounting policy election, by class of asset, to apply a method similar to current operating lease accounting to leases with a maximum possible lease term, including any options to renew, of 12 months or less.

Lessees and lessors would use the same principle to classify leases.

Lease classification

Lease classification would determine how lease-related revenue and expense are recognised. For lessors, it would also affect what is recorded on the balance sheet. Lessees and lessors would use the same principle to classify leases as either Type A or Type B. Classification would be based on the portion of the economic benefits of the asset expected to be consumed by the lessee over the lease term.

To reduce complexity, the Boards proposed basing classification on the nature of the asset being leased so that:

- Leases of property (i.e., land and/or a building or an identified portion of a building) would be classified as Type B leases, unless either of the following conditions exists:
  - The lease term is for the major part of the asset's remaining economic life
  - The present value of the lease payments accounts for substantially all of the asset's fair value
- Leases of assets that are not property (e.g., equipment) would be classified as Type A leases, unless either of the following conditions exists:
  - The lease term is for an insignificant part of the asset's total economic life
  - The present value of the lease payments is insignificant compared with the asset's fair value

The proposal states that a lease component that contains both property and non-property elements (e.g., a storage tank on land) would be classified based on the nature of the primary asset within the lease component.

How we see it

IASB and FASB members have mixed views on lease classification, suggesting that they may revisit this topic in re-deliberations.

Lessees and lessors would recognise performance or usage-based variable rents when they are incurred or earned, respectively.

Lessee accounting

Initial measurement

Lessees would initially recognise a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term.

The lease liability would be the present value of the in-substance fixed lease payments (less lease incentives receivable from the lessor), plus:

- Variable payments that depend on an index or rate
- Amounts expected to be payable under residual value guarantees
- Exercise price of certain purchase options
- Certain lease termination penalties

Variable rents based on performance or usage would be excluded from the calculation of the lease liability and would be recognised in the income statement as incurred.

The right-of-use asset would be measured at cost, based on the amount of the lease liability plus lease prepayments (less any lease incentives received) and the lessee's initial direct costs (e.g., commissions and legal fees).

Subsequent measurement

For both Type A and Type B leases, lessees would accrete the lease liability using the effective interest method and lease payments would reduce the liability.

Subsequent measurement of the right-of-use assets would differ by lease type. For Type A leases, the right-of-use assets would be amortised on a straight-line basis unless another systematic basis better represents the pattern in which the lessee expects to consume it. The aggregate of interest expense on the lease liability and amortisation of the right-of-use asset would generally result in higher total periodic expense in the earlier periods of the lease.

For Type B leases, the change to the asset would be the difference between the periodic straight-line expense (similar to straight-line expense for current operating leases) and the interest incurred on the lease liability.

Right-of-use-assets would be subject to impairment testing under IAS 36 *Impairment of Assets*.

Presentation

Right-of-use assets and lease liabilities for each type of lease would be presented separately from each other and from other assets and liabilities, either on the balance sheet or in the notes. Amortisation expense and interest expense for Type A leases would be presented separately on the income statement, and the periodic expense for Type B leases would be presented as a single line item of lease or rent expense.

For Type B leases, lessors would not record a lease receivable, even though lessees would record a payable for such leases.

Lessor accounting

Lessors would treat Type B leases similar to today's operating leases. This means that lessors would continue to recognise the underlying asset and would recognise lease income either on a straight-line basis or another systematic basis that better represents the pattern in which it is earned.

Initial measurement — Type A leases

Lessors would apply an approach similar to today's finance leases. Upon lease commencement, a lessor would derecognise the asset and recognise:

- A lease receivable for the right to receive lease payments (similar to how a lessee recognises a lease liability)
- A residual asset representing the lessor's right to the underlying asset
- A profit (if any) for the portion of the underlying asset leased

Subsequent measurement — Type A leases

Lessors would recognise interest income for the accretion of the lease receivable and the residual asset (using the effective interest method) and reduce the lease receivable for payments received. Lease receivables and residual assets would be subject to the impairment requirements in IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9 *Financial Instruments*, and IAS 36, respectively.

Presentation — Type A leases

Lessors would present lease receivables and residual assets separately on the face of the balance sheet or in the notes. Lease-related income statement items would be presented in the notes or shown separately on the income statement.

Sale and leaseback transactions

The accounting for these transactions would be based on the control criteria in the Boards' joint revenue recognition project. If control passes to the buyer-lessor, the transaction would generally be accounted for as a sale and a lease. However, if the seller-lessee retains control of the asset (e.g., the lease term is for the major part of the asset's remaining economic life or the present value of the lease payments accounts for substantially all of the asset's fair value), this would be accounted for as a financing transaction.

Transition

The Boards proposed allowing full retrospective or modified retrospective transition. Under both approaches, entities would recognise lease-related assets and liabilities as of the beginning of the earliest comparative period presented. The modified retrospective approach would allow entities to use certain shortcut calculations to initially measure lease-related assets and liabilities and hindsight to determine the lease term or whether a lease exists at all. No leases would be grandfathered under either transition approach. The Boards have not yet proposed an effective date.

Next steps

Comments are due by 13 September 2013.

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