ey.com/IFRS

Issue 75 / March 2014

IFRS Developments

Boards back away from some key aspects of leases proposal

What you need to know

- The IASB supported a single on-balance sheet model for lessee accounting while the FASB supported a dual on-balance sheet model. Despite this fundamental difference, the Boards reiterated their commitment to seek a converged solution.
- The Boards also indicated that they do not intend to significantly change lessor accounting. Instead, they supported retaining a dual classification model.
- The Boards reached certain tentative decisions on lease term, a short-term lease exception and other ways to simplify their May 2013 exposure draft.

The Boards remain committed to putting most leases on the balance sheets of lessees.

Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) are looking for ways to simplify their 2013 proposal on leases in response to feedback from constituents that the accounting would have been too complex and costly to apply.

The Boards reiterated their commitment to putting most leases on the balance sheets of lessees and to reaching a converged solution. But the discussions at their March 2014 meetings on how to simplify lessee accounting highlighted differences between the Boards that may be difficult to resolve.

At the March 2014 meetings, the Boards reached certain tentative decisions on the lease term, a short-term lease exception and other ways to simplify their May 2013 exposure draft (the 2013 ED).[1]

[1] See the Exposure Draft: *Leases*, on the IASB's website and our *Applying IFRS: How the lease accounting proposal might affect your company* (August 2013) EYG no. AU1746.

Building a better working world

Lessee accounting model

The Boards discussed the following two approaches for lessees to subsequently measure the lease asset and obligation:

- A single model that would require lessees to account for all leases (except certain leases excluded from the scope of the standard) as Type A leases (i.e., a financing). Therefore, lessees would reflect the acquisition of a right-of-use asset and a corresponding liability on the balance sheet, and interest and amortisation expense would be recognised separately in the income statement.
- A dual model that would classify leases as Type A (i.e., a financing) or Type B (leases with a generally straight-line lease expense pattern) using the classification principles in IAS 17 *Leases*. Both Type A and Type B leases would be on the balance sheet, but the expense recognition and presentation would be different.

The IASB overwhelmingly supported the single-model approach. However, the FASB expressed similar support for the dual-model approach.

The IASB members that supported the single model believe it is the most conceptually sound approach because all leases contain a financing element. They also believe the single model would be beneficial for users of the financial statements because it would provide separate interest and amortisation expense information for most leases.

The FASB members that supported the dual-model approach believe the primary objective of the project is to put leases on the balance sheets of lessees without significant disruption to preparers and users. Therefore, because the dual model would use today's lease classification principles, it would be less costly for preparers to apply (e.g., transition, ongoing compliance). In addition, users would benefit from more useful balance sheet information about leases based on classification principles that they are familiar with.

How we see it

The Boards' decisions raise the possibility that there could be differences in lessee accounting in any final standards. The Boards appear to recognise that risk and said they will continue to work to resolve their differences.

Lessor accounting model

The Boards discussed two possible approaches for the lessor accounting model.

In comment letters and other feedback, a majority of constituents (including users) expressed support for retaining today's dual model for lessor accounting. In response, the Boards considered two approaches that would use today's IAS 17 dual classification approach, which is similar, but not identical, to the FASB's Accounting Standards Codification (ASC) 840, *Leases*. Leases that transfer substantially all of the risks and rewards of ownership would be classified as Type A (similar to today's finance leases). All other leases would be classified as Type B (similar to today's operating leases).

The difference between the two approaches relates to the recognition of selling profit on certain Type A leases (i.e., when the underlying asset's fair value is greater than its carrying value). The IASB indicated a preference for evaluating the transfer of substantially all of the risks and rewards from the lessor's perspective. That is, lessors would consider all risks and rewards transferred to other parties when making the "substantially all" evaluation. This would include risks and rewards transferred to parties other than the lessee (e.g., a residual value guarantee provided to a lessor by a third-party insurer).

The FASB, however, indicated a preference for evaluating the transfer of substantially all of the risks and rewards only from the lessee's perspective. That is, risks and rewards transferred to third parties other than the lessee would not be considered.

How we see it

Both lessor alternatives would result in significantly fewer changes to lessor accounting than the Boards' 2013 proposal.

The Boards' decisions on the portfolio approach and short-term leases are intended to provide relief to preparers.

Other tentative decisions

The Boards reached tentative decisions on the lease term (initial lease term and reassessment), the use of the portfolio approach, certain relief for small-ticket leases for lessees and a short-term lease exception. These changes were made in response to constituents' concerns that the cost of applying the 2013 proposal would have outweighed the benefits.

Lease term – lease renewal and termination options

The Boards confirmed that a high threshold should be used to determine the lease term for leases with options to extend or terminate the lease (as well as an option to purchase a leased asset). However, they decided to change the term used to describe the threshold to "reasonably certain," which is used in IAS 17. The Boards also said that "reasonably certain" means the same thing as "reasonably assured" in ASC 840. In doing so, the Boards agreed not to use the new term they had proposed (i.e., significant economic incentive) to avoid implying that practice should change.

The Boards also decided that lessees would be required to reassess the lease term upon the occurrence of significant events or changes in circumstances that are within the lessee's control (i.e., market-based factors would be excluded). The Boards expect that such events would occur infrequently. Finally, the Boards decided that lessors would determine the lease term at the commencement date in the same manner as lessees but, unlike lessees, would not reassess the lease term.

Portfolio approach

Many constituents had expressed concerns that the cost of applying the 2013 ED would exceed the benefits for leases that are high in volume, small in value and generally have similar characteristics (e.g., leases of a fleet of similar cars). The Boards decided that lessees and lessors would be able to apply a final standard using a portfolio approach (rather than a lease-by-lease approach). Entities would be able to use a portfolio approach when they reasonably expect that doing so would not result in a material difference from accounting for the leases on an individual basis. It is not clear how the Boards would define "reasonably expect" and "material" for these purposes. The ED did not address the portfolio approach, which led many constituents to infer that it would not be permitted. The IASB decided to include the portfolio guidance in the application guidance of a final standard while the FASB decided it would include it in the Basis for Conclusions.

Other relief for small-ticket leases (lessees only)

The Boards considered, but rejected, relief for lessees with small-ticket leases based on specified materiality thresholds. The Boards also discussed a scope exception for leases of "small-ticket" assets (e.g., leases of office furniture), which IASB members decided to provide. However, the FASB members generally opposed it. The Boards will revisit this topic in a future meeting after the staffs research the types of assets that would qualify and how such an exception could affect the financial data of entities across various industries.

How we see it

The use of a small-ticket exception appears to be a more important issue to those supporting a single on-balance sheet model.

Short-term leases

The ED proposed that lessees could make an accounting policy election (by class of asset) to exclude leases with a maximum possible contractual lease term (including all optional periods) of 12 months or less from the recognition and measurement provisions of the ED. The Boards confirmed that the threshold for short-term leases should be 12 months or less.

However, the Boards agreed to align the definition of "short-term lease" with that of "lease term." Specifically, the revised short-term lease definition would only consider lease renewal or termination options that a lessee is reasonably certain to exercise. This change would broaden the population of leases that might qualify for the exception. Certain quantitative and qualitative disclosures would be required for short-term leases if an entity makes such a policy election.

What's next

The Boards will continue to redeliberate lessee accounting, lessor accounting, leases of "small-ticket" assets and other issues (e.g., lease scope, definition) at future meetings. We expect redeliberations to continue through much of 2014.

EYG No. AU2269

ED None