Straight away
IFRS bulletin from PwC

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IASB/FASB leasing redeliberations – May 2011

What is the issue?

The boards have acknowledged and responded to many of the constituents' concerns in the last six months by proposing revisions to the draft leasing standard that many believed would more fairly portray the substance of the transactions while improving the standard's operationality. However, there was a significant reversal of one of these tentative decisions this week and some discussion of another, which may take these areas back towards where they were in the exposure draft (ED). These reversals and the overall redliberation process to date have left many wondering when and if the standard will be completed, and what credibility it will have with constituents.

Profit and loss recognition pattern – revision of tentative decision

The ED implicitly treated all leases as financing transactions with an accelerated profit and loss recognition pattern. Respondents across a range of industries raised significant concerns about this approach.

Many respondents (including preparers and users) believed the proposed recognition pattern was inconsistent with the economics of many types of lease transactions that are priced in reference to other market transactions (for example, by reference to market rent rates for property leases) rather than priced like financing transactions (for example, a function of applying interest rates to a principal balance). While many users of financial information (such as analysts and rating agencies) make adjustments to the balance sheets of lessees, no adjustments are typically made to their income statements; this is because users are generally satisfied with the current income statement recognition pattern and characterisation of most leases. Concerns were therefore raised during the comment letter process about the usefulness of the income statement or operating cash flow as measures of performance if all leases were reflected as financings.

The boards tentatively decided in earlier meetings that there should be a distinction between those leases that are primarily financing transactions in nature and those that are not – thereby creating a second category of leases, referred to as 'other than finance' leases. However, the boards have now decided to revert to the profit and loss recognition pattern for lessees proposed in the ED. Although they spent several months exploring a dual model, which would have required a straight-line profit and loss recognition pattern for 'other than finance' leases, they have concluded that they cannot support a dual model – in part because of the belief that most leases are paid over time and therefore fundamentally contain a financing element.

The boards also faced the issue of how to apply such a model within their conceptual framework. For example, how could the increasing amortisation expense that would be needed to result in a straight-line total expense comprising amortisation and interest be justified? There was some discussion of recognising a 'plug' amount in other comprehensive income, but ultimately this gained little support among board members.

The decision to revert to the single model for lessees set out in the ED is likely to re-open the issue of front-loading expenses, which many preparers and users criticised in their comment letters. The 'simplified retrospective' transition requirements in the ED would exacerbate the front-loading issue. The boards might address this by allowing a full retrospective approach; however, no decisions on transition have yet been made.

Lessee short-term leases – revision to tentative decision?

The boards had previously tentatively decided that lessees would be allowed (but not required) to account for 'short-term' leases (defined as leases with a maximum lease term of 12 months or less, including all option periods) similar to current operating lease accounting (that is, off-balance sheet on a straight-line basis). This simplification was accepted in response to constituent concerns over the cost versus benefit of recognising and measuring short-term leases. However, there has been a clear indication that the majority of board members are uncomfortable with the earlier decision to allow off-balance sheet accounting and would prefer materiality to be used to determine whether a lease is recognised by a lessee. A decision will be made at a future meeting; however, it could result in substantial cost and effort for preparers if the boards either revert to their original ED proposal (no discounting of the asset and liability), or remove the short-term simplification.

Lessor accounting– no decision reached yet

The boards have discordant views about lessor accounting. The majority of the IASB has voted in straw-polls for a single derecogntion model (one model); the majority of the FASB has voted to retain current lessor guidance, but adjusted to conform with proposed revisions to the definition of a lease, lease term and treatment of variable payments. The FASB has agreed to continue exploring whether a consensus around a single derecognition model is possible.

However, moving to one model could require re-exposure and result in potential delay to the project. In order to issue the standard by the end of 2011, the IASB chairman has encouraged the use of the current lessor guidance, with potentially the FASB moving to an IAS 17 approach to achieve full convergence.

Modifications and changes in circumstances – tentative decisions

The boards tentatively agreed that, where there is a modification to a lease contract, the modified lease should be accounted for as a new lease. Where there is a change in circumstances that would affect the assessment of whether a contract is or contains a lease, both lessee and lessor should perform a reassessment. If this changes the conclusion as to whether a contract does or does not contain a lease, the lease should either be recognised or derecognised accordingly.

The boards tentatively agreed that there should in certain circumstances be re-assessment of whether an extension option should be included in the measurement of the lease term. However, the discount rate should not be reassessed unless there is a change in lease payments due to a change in the assessment of options that affect the lease term. The reassessed rate will be the spot rate at the reassessment date, which will be applied to the outstanding payments due over the revised remaining life of the lease, with a resultant adjustment to the leased asset (up or down).