

Straight away

IFRS bulletin from PricewaterhouseCoopers

IASB and FASB propose significant changes to lease accounting

What is the issue?

The IASB and FASB have proposed a new approach to lease accounting that would significantly change the way entities account for leases. Their exposure drafts, both entitled 'Leases', will result in a converged standard that aims to address the weaknesses of existing standards. The key objective is to ensure assets and liabilities arising from lease contracts are recognised in the balance sheet.

Key provisions

Lessee accounting

The proposed model will eliminate off-balance sheet accounting. All assets currently leased under operating leases will be brought onto the balance sheet, removing the distinction between finance and operating leases. The new asset – representing the right to use the leased item for the lease term – and liability – representing the obligation to pay rentals – will be recognised and carried at amortised cost, based on the present value of payments to be made over the term of the lease. The lease term will include optional renewal periods that are 'more likely than not' to be exercised. Lease payments used to measure the initial value of the asset and liability will include 'contingent' amounts, such as rents based on a percentage of a retailer's sales or rent increases linked to variables such as the Consumer Price Index (CPI). The proposed model will require lease renewal and contingent rents to be continually reassessed, and the related estimates to be trued up as facts and circumstances change.

Income statement 'geography' and timing of recognition will change. Straight-line rent expense will be replaced by depreciation, which will be recognised on a basis similar to similar owned assets, and interest expense, which will be recognised on a basis similar to a mortgage.

Lessor accounting

The boards were unable to agree upon a single lessor accounting model and decided that concerns about the application of each of the two approaches in certain fact patterns could only be addressed through a dual model.

- For leases where the lessor retains exposure to significant risks or benefits associated with the leased asset either during the term of the contract or subsequent to the term of the contract, the 'performance obligation' approach would be followed.

The lessor recognises the underlying asset and a lease receivable, representing the right to receive rental payments from the lessee, with a corresponding performance obligation, representing the obligation to permit the lessee to use the leased asset.

- For all other leases, the 'derecognition approach' would be followed. The lessor recognises a receivable, representing the right to receive rental payments from the lessee and records revenue. In addition, a portion of the carrying value of the leased asset is viewed as having transferred to the lessee and is derecognised and recorded as cost of sales.

Similar to lessee accounting, lessors under either approach would also need to estimate the lease term and contingent payments and true-up these estimates as facts and circumstances change.

Disclosures

The proposed model will require more extensive disclosures than are currently required under IFRS and US GAAP. The disclosures focus on qualitative and quantitative information, and on the significant judgements and assumptions made in measuring and recognising lease assets and obligations.

Transition

Pre-existing leases are not expected to be grandfathered. The boards are proposing the new leasing approach to be applied by lessees and lessors by recognising assets and liabilities for all outstanding leases at the date of the earliest period presented using a simplified retrospective approach.

The exposure draft does not propose an effective date. We anticipate the final standard to have an effective date no earlier than 2012.

Am I affected?

Because almost all companies enter into lease arrangements, the model will have a pervasive impact for IFRS and US GAAP preparers. Some entities will be affected more than others, depending on the number and type of leases in existence at the transition date.

The proposal applies to all entities, but certain types of leases are excluded from its scope. The boards propose that the scope of the leasing standard includes leases of property, plant and equipment but does not include leases of intangible assets. The boards also propose to exclude from the scope:

- Leases to explore for or use natural resources (such as minerals, oil, and natural gas);
- Leases of biological assets; and
- Leases of investment property measured at fair value.

What do I need to do?

The comment letter period ends on 15 December 2010; a final standard is expected mid-2011. Given the potential impact of the proposed changes on accounting and operations, management should begin to assess the implications of the proposal on their existing contracts and current business practices. Management should also consider commenting on the exposure draft to ensure their views on the proposed changes are considered.

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