Straight away
IFRS bulletin from PwC

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IASB/FASB leasing redeliberations – February 2012

What is the issue?

The boards met in February to discuss:

- Lessee accounting – subsequent measurement; and
- Lessor accounting – proposed scope exemption for investment properties.

There was some discussion of lessor accounting and a growing concern about the scope exemption for all investment properties, but most of the meeting dealt with subsequent measurement of the lessee's right-of-use asset.

The boards agree on many aspects of lessee accounting, but there is disagreement on how the right-of-use asset should be amortised. IASB chairman Hans Hoogervorst said that the boards might not be able to agree on this issue and that this outcome would not be desirable, a view shared by the FASB.

The staff will undertake further consultation with users and preparers to better understand the operationality of each of the boards' preferred approaches in an attempt to see if a single converged view can be reached. The plan is to discuss the results of this consultation in the April meeting.

This latest twist has inevitably introduced a further delay to the project, and a revised exposure draft will not be issued before Q3 2012.

Lessee accounting – subsequent measurement

The February discussion focused on the continued objections from constituents to the 2010 exposure draft's proposed 'front-loaded' lessee expense recognition pattern. There was general agreement among board members that something should be done to address this. They confirmed their previous decision that the lease liability, being a financial liability, should be measured at amortised cost using an effective interest rate method, so attention was directed towards measurement of the right-of-use asset. The boards could not however agree on which solution to propose.

IASB's preferred view

The IASB unanimously supported an 'underlying asset' approach. This approach is based on the presumption that lease payments typically cover three components: (a) a payment for the part of the asset the lessee consumes during the lease term; (b) a finance charge on the part of the asset consumed because the lease payments are made over time; and (c) a return on the residual value of the asset – that is, the part of the asset the lessee does not consume, because the residual asset cannot be used by the lessor during the lease period.

The right-of-use asset is amortised with reference to each of these elements, and the amortisation profile varies based on

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the extent to which the value of the underlying asset changes over the lease term – that is, how much of the asset the lessee consumes. If management expects the value of the underlying asset to be the same or greater at the end of the lease compared to the start of the lease (for example, in the case of some property leases), there might be no consumption of the underlying asset by the lessee. As a result, the amortisation expense represents only the lessor's return on the residual asset. When combined with the interest expense on the lease liability, the total expense is recognised straight-line over the lease term.

Conversely, if the value of the underlying asset is expected to be nil at the end of the lease – that is, the lessee consumes all of it – the total expense profile will be similar to that proposed by the boards in the 2010 exposure draft. As the consumption percentage increases from zero, the total expense profile moves from straight-line to front-loading.

The expense profile will also be affected where a lease contains rent-free periods, pre-paid lease balances, stepped rent and other similar features.

The main advantage of the underlying asset approach is that it can be applied to all leases, with no need to distinguish between operating and finance leases, which was one of the boards' original objectives for this project. However, there is a concern that this approach is overly complex and cannot be applied in practice. This view will be tested during the consultation over the coming weeks.

FASB preferred view

The FASB's preferred view is to propose two different amortisation approaches based on lease type. 'Finance leases' will retain the expense profile of the 2010 exposure draft; 'operating leases' will either apply the 'underlying asset' approach favoured by the IASB for all leases or, if this proves impracticable, an 'interest-based' amortisation approach.

An interest-based amortisation approach views right-of-use assets as a unique class of asset. The point of distinction is that when considering the lease contract as a whole, essentially there is no financing effect because the lessee is paying for, and consuming the benefits from, the right-of-use asset in the same period. A lessee would subsequently measure the right-of-use asset at amortised cost at the present value of the remaining economic benefits, discounted using the discount rate used to initially measure the lease liability. For typical leases in which lease payments are made evenly over the lease term, this approach would result in a straight-line total expense profile. However, similar to the underlying asset approach favoured by the IASB, the expense profile will not be straight-lined where a lease contains rent-free periods, pre-paid lease balances, stepped rent and other similar features.

The FASB's preferred view will require criteria for distinguishing between finance and operating leases. The majority of FASB members at the meeting agreed this should be based upon the tentative decision made in 2011 to use IAS 17's risk and rewards indicators as a starting point.