Straight away

IFRS bulletin from PwC

16 May 2013

IASB/FASB publish revised exposure draft on leases

What is the issue?

On 16 May 2013, after more than two years of deliberations, the IASB and FASB issued a revised exposure draft (ED) of a standard for leases.

This ED attempts to address many of the criticisms of the 2010 ED. At a high level, the proposed model appears simpler to apply than the previous proposals. But this might underestimate the impact of having to identify and recognise assets and liabilities in respect of all leases, as well as the need to re-think which accounting model to apply to different types of lease.

Key proposals

Lessee accounting

Consistent with the 2010 proposals, the ED eliminates off balance sheet accounting for lessees. The balance sheet distinction between operating and finance leases is removed, and a new asset (representing the right to use the leased item for the lease term) and liability (representing the obligation to pay rentals) are recognised for all leases (except short-term leases – see below).

The definitions of 'lease term' and 'lease payment' have changed since the 2010 ED. The lease term will include optional extension periods only where there is a significant economic incentive to extend. Lease payments used to measure the asset and liability will exclude contingent rents that vary on the basis of usage or performance (such as sales from a retail store or distance flown by an aircraft). These bases of measurement will result in lower carrying values for lease assets and liabilities than those under the 2010 proposals, and are not significantly different from current accounting for finance leases under IAS 17.

Probably the most significant change since the 2010 ED (although it represents less of a change from current requirements) is that the boards are now proposing two different expense recognition patterns for different types of lease: some (termed 'type A' leases) will apply the approach proposed in 2010, similar to current finance lease accounting with its resultant expense front-loading; and others ('type B' leases) will apply a straight-line expense recognition pattern, similar to current operating lease accounting. The approach to be applied will depend on whether the lessee acquires or consumes more than an insignificant portion of the underlying asset. Where this is the case, the lease will be treated as a type A lease; otherwise, it will be treated as type B.

Acknowledging the practical difficulties inherent in this approach, the boards have proposed a series of presumptions depending on the nature of the underlying asset. Leases of property should be treated as type B, unless the lease term is for the major part of the property's remaining economic life, or the present value of the lease payments accounts for substantially all of its fair value. Leases of assets other than property (such as vehicles or equipment) should be treated as type A, unless the lease term represents an insignificant portion of the underlying asset's total economic life, or the present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

Lessor accounting

The proposals for lessor accounting have also changed since the 2010 ED. Consistent with lessee accounting, lessors will identify leases as either type A or type B, using the same criteria. For type B leases, the lessor will follow accounting that is similar to current operating lease accounting. For type A leases, the lessor will derecognise the underlying asset and replace it with a lease receivable (measured at the present value of the lease payments) and a residual asset (measured at the present value of the estimated residual value at the end of the lease term plus the present value of any expected variable lease payments). Any profit relating to the receivable component is recognised immediately, whereas profit relating to the residual component is deferred until the underlying asset is re-leased or sold by the lessor. Interest income on both the receivable and the residual asset is recognised over the lease term.

Distinguishing between a lease and a service

The ED includes new guidance on assessing whether a contract contains a lease or a service, or both. This guidance is different from the current IFRIC 4 analysis and might result in some contracts being treated differently.

Disclosures

The proposed model will require more extensive disclosures – both qualitative and quantitative – than under current standards.

Transition

Pre-existing leases will not be grandfathered. All leases will need to be reassessed, and the new model will be applied using either a fully retrospective approach or a simplified retrospective approach.

The ED does not propose an effective date. We anticipate that the final standard will be effective no earlier than 2017.

Am I affected?

Almost all companies enter into lease arrangements, so the proposals will have a pervasive impact. But certain types of leases are excluded from its scope, namely:

- leases of intangible assets;
- leases to explore for or use natural resources;
- leases of biological assets; and
- service concession arrangements within the scope of IFRIC 12.

In addition, both lessees and lessors can elect, by class of underlying asset, to account for leases with a maximum term of up to 12 months in a similar way to current operating lease accounting.

What do I need to do?

The comment period ends on 13 September 2013. Given the potential impact of the proposed changes on accounting and operations, management should begin to assess the implications of the proposals on existing contracts and current business practices. Management should also consider commenting on the ED to ensure that their views on the proposed changes are considered.