The future of lease accounting

Highlights

- A new lease classification test for lessees and lessors
- A new 'dual' model for lessee expense recognition
- Straight-line income statement recognition for many real estate leases
- Accelerated income statement recognition for many equipment leases

A plug for convergence

At their June 2012 meeting, the Boards returned to decision-making mode after a period of outreach and research on the leases project.

The key issue that had stalled the re-deliberations in 2012 was the front-loaded pattern of expense for lessees that results from the single right-of-use (ROU) model. This has been a cornerstone of the Boards' proposals since the project began. In this meeting, a majority of IASB members initially expressed their continued preference to retain the single ROU model on conceptual grounds. However, IASB members ultimately chose convergence over concepts and agreed to accept the 'dual' model for lessee accounting favoured by FASB members.

The dual model would feature a new lease classification test based on the extent of consumption of the underlying asset over the lease term. On one side of this freshly-drawn line, leases would be accounted for as financing transactions with an accelerated pattern of income/expense recognition; this would be the case for many equipment leases. On the other side of this line, lease income and expense would be recognised on a straight-line basis; this would be the case for many real estate leases.

All leases within the scope of the proposals would be on-balance sheet for lessees, with a new straight-line model for leases that are not considered to have a financing component. The straight-line lessee accounting model is clearly a pragmatic one. Measurement of a lessee's ROU asset under this approach would simply be a plug to achieve the desired straight-line lease expense. In addition, the exemption for short-term leases would be retained, meaning that the dual model actually includes three lessee accounting models.

Lessors would apply the receivable and residual model to leases with a financing component, and an operating lease model similar to that in IAS 17 *Leases* to other leases. Leases of investment property are back in scope for lessors but would often qualify for operating lease accounting.

The lessee and lessor accounting models are not symmetrical. In particular, under the straight-line models, the lessee recognises a financial liability for its obligation to make lease payments but the lessor does not recognise a corresponding financial asset for its right to receive lease payments.

Many compromises were made in this meeting, in the interests of bringing lease liabilities on-balance sheet. The Boards aim to release a new lease exposure draft in the final quarter of 2012.

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The converged solution

In the June meeting, the Boards tentatively decided that lessees and lessors would apply dual lease accounting models. A new lease classification test will be used to determine whether lessees and lessors apply a model resulting in a straight-line pattern of income/expense recognition, or an accelerated pattern of income/expense recognition.

Two lessee models are proposed

Lessees would use the lease classification test to determine whether to apply the accelerated model (based on previous tentative decisions) or a straight-line model.

Under both models, the lessee would recognise a ROU asset and a lease liability for each lease within the scope of the proposals. That is, all leases would be on-balance sheet for lessees. The Boards have not changed their previous decisions on initial measurement. Thus, the lessee would measure the lease liability initially at the present value of the lease payments and measure the ROU asset initially at an amount equal to the lease liability (plus prepaid rentals and initial direct costs).

After initial recognition, a lessee applying the **straight-line model** would:

- measure the lease liability at amortised cost;
- recognise total lease expense on a straight-line basis as a single line item in the income statement; and
- adjust the carrying amount of the ROU asset by the difference between the total lease expense and the interest expense on the lease liability, effectively measuring the ROU asset as a balancing figure.

After initial recognition, a lessee applying the **accelerated model** would:

- measure the lease liability at amortised cost, recognising interest expense in the income statement;
- amortise the ROU asset generally on a straight-line basis, recognising amortisation expense in the income statement; and, thereby
- recognise total lease expense on an accelerated basis.

Two lessor models are proposed

Lessors would use the same lease classification test to determine whether to apply the receivable and residual (R&R) model (based on previous tentative decisions) or the operating lease model (similar to current IAS 17).

Under the **R&R model** the lessor would:

- recognise a lease receivable and a residual asset on lease commencement;
- measure the lease receivable initially at the present value of the lease payments;
- measure the residual asset as an allocation of the carrying amount of the underlying asset; and
- recognise interest income over the lease term, resulting in an accelerated pattern of income recognition.

The **operating lease model** is similar to operating lease accounting under IAS 17. Under this model, the lessor would continue to recognise the underlying asset, would recognise the lease payments on a straight-line basis over the lease term and would not recognise a lease receivable at lease commencement.

Investment property back in scope

In a change to previous tentative decisions, investment property would now be within the scope of the proposals for lessors. However, as explained below, many leases of investment property are likely to qualify for operating lease accounting due to the practical expedient included in the leases classification test.

Short-term leases

These decisions would not apply to short-term lease contracts – i.e. those with a maximum possible term of 12 months or less. Such contracts would remain off-balance sheet for lessees and lessors who elect to apply the short-term lease contract practical expedient.

The new lease classification test

The Boards have tentatively decided to develop a new lease classification test, which will be different to the current lease classification test in IAS 17. The test will be applied to each lease within the scope of the proposals, other than short-term leases, to determine which lease accounting model to apply. Lessees and lessors will use the same lease classification test.

Drawing the line – a practical expedient

At a conceptual level, the new lease classification test will be based on the extent of consumption of the underlying asset – i.e. whether the lessee acquires more than an insignificant portion of the utility of the underlying asset that it then consumes to generate economic benefits over the lease term.

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In practice, it appears likely that lease classification will be dominated by a practical expedient that focuses on the nature of the underlying asset.

Under the practical expedient, **leases of real estate** (land, buildings, part of a building or both) would be accounted for using the straight-line model of income/expense recognition in the income statement unless:

- the lease term is for the major part of the economic life of the underlying asset; or
- the present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

Under the practical expedient, **leases of other assets** would be accounted for using the accelerated model of income/ expense recognition in the income statement unless:

- the lease term is for an insignificant portion of the economic life of the underlying asset; or
- the present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

To determine whether the lease term is for the major part of the economic life of the underlying asset, the lessee and lessor would be required to:

- consider expectations about how the asset will be maintained during the lease term; and
- ignore future market expectations, such as inflation and changes in supply and demand.

At the end of the lease term, if the underlying asset's value is not expected to change significantly from its value at the beginning of the lease term, then the lease term generally would not represent the major part of the underlying asset's economic life. The assessment of the practical expedient tests for leases of real estate may result in different outcomes depending on whether land and buildings are assessed as one unit of account or separately. This was not discussed by the Boards during the meeting.

Comparison with IAS 17

A proposal to retain the current IAS 17 lease classification test was considered but rejected by the Boards. In part, this was because the Boards consider that the new lease classification test will be easier to apply than the current lease classification test. That is, it will be easier to draw the line. In addition, the Boards feel more comfortable with the outcome as to which leases will be accounted for as financing transaction. That is, the line will be in a different place.

The impact of moving the line is likely to be greatest for leases of assets other than real estate. It is likely that many leases of equipment that are currently classified as operating leases under IAS 17 would, under the new lease classification test, be accounted for using the accelerated model of income/ expense recognition in the income statement.

Finalising the classification test

The Boards instructed the staff to write up and refine the classification test to reflect comments expressed by Board members at the meeting. It was not clear whether a further paper will be brought to the July meeting in respect of this lease classification test.

Factors to consider as the classification test is finalised will include consistency with the proposals in the revenue recognition project. In addition, it is not clear whether the Boards intend the classification test to be applied separately to the separate components of a lease of land and buildings, as is currently required under IAS 17.

Applying the latest decisions

The main impacts of the Boards' tentative decisions can be illustrated by considering two simple fact patterns. These examples have been simplified for the purposes of illustration – e.g. they assume that there are no prepaid rentals, initial direct costs, variable lease payments, renewal options or purchase options.

A simple real estate lease

Fact pattern

Consider a simple real estate lease under which:

- a lessee and lessor enter into a lease of retail premises for a 5-year lease period;
- the fair value of the premises is 10,000 at commencement of the lease;
- the remaining useful life of the premises is 40 years at commencement of the lease;
- the fair value of the retail premises is expected to be 10,000 in year 5, ignoring inflation and assuming that real estate market values remain stable;
- the lessee's base rental is 412 per year (paid in arrears); and
- the rate the lessor charges the lessee is 4.12 percent.

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Lease classification

Under the new lease classification test, this lease would be accounted for under the straight-line model by the lessee and under the operating lease model by the lessor.

This is because the asset is real estate, the lease term is for less than the major part of the economic life of the asset, and the present value of the fixed lease payments does not amount to substantially all of the fair value of the asset.

Lessee accounting – straight-line model

The lessee would apply the straight-line model to the simple real estate lease, as follows.

The lessee would measure its lease liability initially at the present value of lease payments, and the ROU asset at the same amount. The lessee would subsequently measure the lease liability at amortised cost using the effective interest rate method and would recognise total lease expense on a straight-line basis in the income statement. The lessee would subsequently measure the ROU asset each period as the balancing figure, calculated by deducting the difference between the straight-line lease expense (which equals the payments in this example), less interest on the lease liability each period, from the beginning ROU balance.

- The ROU asset will be adjusted each period by the difference between the amount of straight-line lease expense less interest arising on the lease liability for the period. In this example for year 1, the calculation of the ROU depreciation would be 412 - 75 = 337. The ROU asset is then adjusted by this amount to calculate the year 1 ROU asset closing balance (1,828 - 337 = 1,491).
- In this simple fact pattern, the ROU asset will equal the lease liability throughout the lease term. If a lease contains variable lease payments that are based on an index or rate, or a significant rent holiday, then the calculation of the depreciation of the ROU asset each period significantly increases in complexity. The result in some cases may be positive ROU asset depreciation, because this is merely a balancing figure.

Lessor accounting – operating lease model

The lessor would apply the operating lease model to the simple real estate lease. Under this model, the lessor would continue to recognise the underlying asset and would recognise the lease income on a straight-line basis. In this example, it is assumed that the lessor is using the IAS 40 *Investment Property* fair value model to account for the underlying asset.

Lessee: Straight line				
Balance sheet			Profit or loss impacts	
Year	Lease liability	ROU asset	Lease expense	Total expense
0	1,828	1,828	-	-
1	1,491	1,491	412	412
2	1,141	1,141	412	412
3	776	776	412	412
4	396	396	412	412
5	0	0	412	412
		Total	2,060	2,060

Lessor: Operating lease model		
Balance sheet		Profit or loss impacts
Year	Underlying asset	Total income
0	10,000	-
1	10,000	412
2	10,000	412
3	10,000	412
4	10,000	412
5	10,000	412
	Total	2,060

Some points to note about this example.

- This model does not view a lease contract as financing the acquisition of an asset. Instead, this model considers the ROU asset to be linked to the lease liability at commencement and throughout the lease term.

Although the lessor accounting for the simple real estate lease 'mirrors' the lessee accounting in the income statement, the approach taken in the statement of financial position is significantly different. In particular, the lessee recognises a financial liability for its obligation to make lease payments, but the lessor does not recognise a financial asset for its right to receive lease payments.

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A simple equipment lease

Fact pattern

Consider a simple equipment lease under which:

- a lessee and lessor enter into a transaction to lease an asset for a 3-year lease term;
- the asset has a useful life of 10 years;
- the lease stipulates that the lessee's base rental is 125 per year (paid in arrears);
- the rate the lessor charges the lessee is 2.5 percent;
- the underlying asset has a carrying amount of 950 in the lessor's financial statements before lease commencement;
- the fair value of the underlying asset at lease commencement is 1,000; and
- the lessor estimates that the carrying amount of the underlying asset at the end of the lease term, if it were subject to depreciation during the lease term, would then be 665.

Lease classification

The new lease classification test would require this lease to be accounted for under the accelerated model by the lessee and under the R&R model by the lessor.

This is because the asset is not real estate, the lease term is for more than an insignificant part of the economic life of the asset, and the present value of the lease payments is not insignificant compared to the fair value of the asset.

Lessee accounting – accelerated model

The lessee would apply the accelerated model to the simple equipment lease, as follows.

The lessee would recognise an ROU asset and a liability for its obligation to make future lease payments. The lessee would measure the lease liability initially at the present value of 125 per year over 3 years discounted at 2.5 percent. Over the lease term, the lessee would recognise amortisation of the ROU asset on a straight-line basis, and finance expense arising on the liability, which would be measured on an amortised cost basis.

The following table summarises the amounts arising in the lessee's statement of financial position and income statement.

Lessee: Accelerated model					
Balance sheet			Profit or loss impacts		
Year	Lease liability	ROU asset	Depreciation charge	Interest expense	Total expense
0	357	357	-	-	-
1	241	238	119	9	128
2	122	119	119	6	125
3	0	0	119	3	122
		Total	956	18	375

The accelerated model treats the lease as a financing transaction. This results in a front-loaded pattern of total lease expense.

Lessor accounting – R&R model

The lessor would apply the R&R model to the simple equipment lease, as follows.

The lessor recognises a receivable for its right to receive lease payments. The lease receivable is measured initially at the present value of the lease payments, discounted at the rate that the lessor charges the lessee; it is subsequently measured using the effective interest rate method.

On initial recognition, the lessor would measure the residual asset as an allocation of the carrying amount of the underlying asset. The initial measurement of the residual asset comprises two amounts:

(a) the gross residual asset, measured at the present value of the estimated residual value at the end of the lease term, discounted using the rate that the lessor charges the lessee; and

(b) the deferred profit, measured as the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset to the residual asset.

Subsequently, the lessor would measure the gross residual asset by accreting it to the estimated residual value at the end of the lease term, using the rate that the lessor charges the lessee. The lessor would not recognise any of the deferred profit in profit or loss until the residual asset is sold or re-leased. The gross residual asset and the deferred profit would be presented together as a net residual asset.

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The following table summarises the amounts arising in the lessor's statement of financial position and income statement under the R&R model.

Lessor: Receivable and residual model									
Balance sheet					Profit or loss impacts				
Year	Lease receivable	Gross residual asset	Deferred profit	Net residual asset	Interest income	Accretion	Upfront profit	Total
0	357	618	(7)	611	-	-	18	18
1	241	633	(7)	626	9	15	0	24
2	122	649	(7)	642	6	16	0	22
3	0	665	(7)	658	3	16	0	19
				Total	143	47	18	83

The R&R model is perhaps the most complex of the models. The figures in the above table are derived as follows.

- The lessor's gross residual asset is measured at the present value of the estimated residual value at the end of the lease term, discounted using the rate that the lessor charges the lessee. In this example, 665 is discounted at 2.5 percent to give a gross residual asset of 618. The lessor then accretes that amount at the rate that it charges the lessee, such that the gross residual asset increases to 665 by the end of the lease term.
- The lessor's net residual asset is an allocation of the carrying amount of the underlying asset. The lessor calculates the opening balance of the net residual asset as:
  - the previous carrying amount of the underlying asset (950); less
  - the amount derecognised for the right of use sold to the lessee (950 x 357/1,000 = 339), being the carrying amount of the asset x (lease receivable/fair value of the asset).

  This gives an opening balance of 611.
- The lessor determines the amount of profit to defer on the residual element, being the difference between the gross residual asset and the net residual asset – in this case, 618 - 611 = 7. As a result, the lessor will always recognise upfront profit and loss when the fair value of the underlying asset is different to its carrying amount. The upfront profit is calculated as:
  - the present value of estimated lease payments; plus
  - the net residual asset; less
  - the carrying amount of the underlying asset.

  In this example, it is (357 + 611) - 950 = 18.
- The lessor would recognise deferred profit when the underlying asset is sold or re-leased at the end of the lease term.

Next steps

The Boards plan to conclude their redeliberations on the leases project at their July meeting. Remaining topics for discussion include:

- remaining lessor accounting matters under the receivable and residual model, including consistency of the lessor accounting model with the Boards joint revenue recognition proposals;
- remaining presentation and disclosure matters for lessees and lessors;
- private company issues and implications for not-for-profit entities (FASB-only); and
- cost/benefit considerations of the proposals as a whole.

If the Boards complete their redeliberations in July as planned, then their staff will move forward with drafting a revised ED. The Boards expect to issue the revised ED in the fourth quarter of 2012. It is expected that the comment period will be 90-120 days (the revised exposure draft on the revenue recognition project had a 120-day comment period).

The Boards hope to issue a final leases standard during 2013.

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For more information

For more information on the project, including our publication on the 2010 ED, *New on the Horizon: Leases*, see our website. A full summary of the Boards' previous tentative decisions on the lessee right-of-use model and the lessor receivable and residual model is included in the December 2011 edition of this newsletter.

The IASB's website and the FASB's website contain summaries of the Boards' meetings, meeting materials, project summaries and status updates.

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