Straight away

IFRS bulletin from PwC

25 July 2011

IASB/FASB leasing redeliberations – July 2011

What is the issue?

The boards have voted to re-expose their proposals for lease accounting in view of the changes they already intend to make to the model proposed in last year's exposure draft. The technical discussions will not conclude until September 2011 at the earliest, but there is already sufficient evidence to support the need for re-exposure. A revised exposure draft for public comment is expected in the final quarter of this year.

Other issues tackled in this month's board meeting include:

- lessor accounting;
- presentation and disclosure;
- embedded derivatives; and
- accounting for variable lease payments based on a rate or index.

Re-exposure

The decision to re-expose the proposals will provide interested parties with an opportunity to comment on them, including all the changes the boards have made since the publication of their exposure draft in August 2010.

The boards have not completed all of their deliberations, but the decisions taken to date have been sufficiently different from those published in the exposure draft to warrant re-exposure. The boards intend to complete their deliberations, including consideration of the comment period, during the third quarter of this year with a view to publishing a revised exposure draft shortly afterwards.

Lessor accounting – tentative decision

The boards tentatively agreed that all lessors should account for leases using a 'receivable and residual' approach (previously known as the 'derecognition approach'). A lessor would derecognise the underlying asset and replace it with a lease receivable and residual asset. If profit on the right-of-use asset transferred to the lessee is reasonably assured, the lessor recognises that profit at lease commencement. The residual asset is measured on an allocated cost basis (that is, based on the proportion of the underlying asset's fair value that is subject to the lease relative to the portion that is not).

For example, a lessor leases an asset to a lessee for approximately half of its useful life. At the commencement of the lease, the asset is carried at C100 but has a fair value of C120. The present value of the lease receivable is measured at C72, which is equivalent to 60% of the fair value of the asset. The residual asset is therefore measured initially at C40, being 40% of the carrying value. Profit of C12 is recognised, being the difference between the lease receivable of C72 and the derecognised portion of the asset of C60. The residual asset is accreted over the term of the lease using the rate charged in the lease.

Where profit is not reasonably assured, any profit is recognised over the lease term. In that case, the residual asset is measured at lease commencement as the difference between the receivable and the previous carrying amount of the leased asset. If the lease receivable is greater than the carrying amount of the leased asset, the difference between those two amounts is recognised as profit immediately. Using the same facts as the example above, the residual asset is recognised initially at C28, being the difference between the lease receivable and the previous carrying amount of the leased asset. The residual asset is accreted over the term of the lease to an amount equivalent to its carrying amount if it had been depreciated.

The boards agreed to retain the exposure draft proposal to allow lessors a simplified accounting approach for leases with a maximum lease term of 12 months or less. Such short-term leases can be accounted for similar to current operating lease accounting.

The boards also agreed to retain the scope exemption for investment property measured at fair value in accordance with IAS 40, 'Investment property'.

However, the boards did not agree with the staff's recommendation to allow current operating lease accounting by lessors where it is impractical to determine the carrying amount of the leased portion of an asset, such as a multi-tenant property where the entire asset is measured at cost. This may be a significant and complex issue for lessors that are not accounting for such assets at fair value under IAS 40.

Variable lease payments (based on a rate or index) – tentative decision

The boards revisited the accounting for variable lease payments based on a rate or index. They tentatively agreed that such payments would initially be measured at the rate that exists at lease commencement. In practice, this means that, for example, leases with payments based on LIBOR would use a current spot rate; leases with payments based on a CPI index would use the absolute index at lease commencement and not the expected rate of change in that index. So a lease with fixed rental increases of 2% per annum as a surrogate for inflation will not be measured in the same way as a lease with rental increases based on changes to CPI, even if that index is predicted to increase at the same rate of 2% per annum.

In addition, management would need to reassess such variable lease payments, as these rates/indices change at each reporting period. The recognition of such changes would be in accordance with the proposals in the exposure draft. For lessees, this is in profit or loss when they relate to a past or current accounting period; and there would be an adjustment to the right-of-use asset where they relate to a future period. For lessors, all such changes will be recognised in profit or loss. The staff has been asked to bring back a number of worked examples to a future meeting.

The boards will continue their discussion of this topic in September, including how the profit and loss recognition patterns are applied by a lessor where profit is not reasonably assured.

Embedded derivatives – tentative decision

The boards agreed that a lessee or lessor will be required to assess whether the lease contract contains embedded derivatives, which would need to be accounted for in accordance with IAS 39 'Financial instruments: Recognition and measurement'.

Presentation and disclosure – tentative decision

The boards discussed and tentatively agreed upon a presentation and disclosure package that attempts to balance user needs with the cost of providing such disclosure.