

A U-turn on straight-line lease expense

What you need to know

- ▶ The IASB and FASB reversed their earlier decision to continue straight-line expense recognition for most operating leases.
- ▶ As a result, the expense recognition pattern for many leases would be accelerated.
- ▶ The Boards plan to revisit their earlier decision to allow lessees to keep short-term leases off of the balance sheet.
- ▶ The Boards began redeliberating lessor accounting, but did not make any decisions.

Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) did a U-turn on their tentative decision to introduce lease classification into their new accounting model for lessees.

The Boards have essentially decided to go back to their original approach of requiring lessees to recognise lease expense on a basis consistent with today's finance leases. These latest decisions, like all decisions to date, are tentative and will not be finalised until the Boards approve a final standard.

This publication updates our discussion of the Boards' earlier decisions included in our *Supplement to IFRS Outlook, Straightening out lease expense and other issues* (Issue 100, April 2011).

Lessees would apply the same approach to all leases recognised on the balance sheet and would front-load lease expense.

Pattern of expense recognition

Last month, the Boards agreed to introduce a distinction between two types of leases for lessees using criteria similar to those used to classify leases today.

Both types of leases would have been recognised on the balance sheet, but expense recognition would have differed. That tentative decision was made in response to feedback from constituents that the recognition of expense under their original finance lease approach did not reflect the underlying economics of many lease contracts.

Under last month's proposal, a lessee in a finance type of lease (roughly equivalent to today's finance leases) would recognise higher total periodic expense (i.e., total interest and amortisation expense) in the earlier periods of a lease and lower total periodic expense in later periods. Total expense related to leases not considered finance leases (i.e., generally leases classified as operating leases today) would have been recognised on a straight-line basis.

However, the Boards were unable to develop an approach to achieve straight-line expense recognition that was consistent with other aspects of their proposed model and the conceptual framework. The Boards have now agreed to reverse their earlier decision.

Based on their latest deliberations, the Boards decided that lessees should apply the finance lease approach to all leases recognised on the balance sheet (i.e., only one type of lease exists for lessees). The lessee would recognise interest expense using the interest method and separately amortise the right-of-use asset (generally on a straight-line basis). This expense recognition pattern is consistent with the treatment of finance leases under current lease accounting and the exposure draft proposal.

The Boards also discussed, but did not make any decisions on, the proposed approach to lessor accounting, including determining whether lessors would apply a consistent approach to all leases or differentiate between two different types of leases.

The Boards may also revise their earlier decisions on accounting for short-term leases.

The Boards had previously agreed that entities could make an accounting policy election (on an asset-class basis) to keep leases with a maximum possible term of 12 months off the balance sheet and recognise lease expense on a straight-line basis. The Boards now plan to revisit this tentative decision. Possible approaches include eliminating the policy election to allow off-balance sheet accounting or extending the maximum possible term that would qualify as a short-term lease.

How we see it

The Boards continue to make significant adjustments to their proposal to account for leases under the right-of-use model. We expect that the model will evolve further over the coming months and that the final product may be very different from that which is currently proposed.

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EYG no. AU0858

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