IFRS industry insights

The Leases Project – An update for the consumer business industry

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In August 2010, the IASB and FASB (the "Boards") took a major step towards overhauling the existing lease accounting rules by issuing a set of proposals in the form of an exposure draft (ED). The proposals would significantly affect the accounting for lease contracts for both lessees and lessors across all industries. Since issuing the ED, the Boards have conducted extensive outreach. The comment period on the ED, which ended 15 December 2010, produced over 750 letters, and afterwards the Boards hosted roundtable sessions that included participants from all constituencies, including preparers, users, and auditors, from a wide cross section of industries. Three of the more contentious issues highlighted by the consumer business industry during the Boards' outreach were around lease term, variable lease payments and the pattern of expense recognition. The Boards recently discussed those three issues and made a number of tentative decisions which differ from the proposals in the ED. The Boards will reach out to constituents over the next several weeks to gather feedback on these tentative decisions.

Lease term

The ED defines the lease term as the "longest possible term that is more likely than not to occur." The comment letters overwhelmingly disagreed with this proposal because many entities thought that a renewal option does not represent a liability until the lessee has actually exercised the option and estimating the lease term would be burdensome and costly to implement and could result in unreliable estimates for leases with multiple renewal options.

In February 2011, the Boards tentatively decided that "lease term" should be defined for the lessee and lessor as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a "significant economic incentive" for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. Factors such as the existence of a bargain renewal option and a penalty for not renewing the lease would be considered in determining the lease term but past practice and management intent would not. The lease term would be reassessed only when there is a significant change in facts and circumstances.

The tentative decision to include renewal options in the lease term when there is a "significant economic incentive" to exercise the option represents a change from the ED because it raises the threshold for when renewal options would be included in the lease term. Judgement will be required, but the tentative decision is more closely aligned with IAS 17 *Leases* that uses a "reasonably certain" threshold. However, the requirement to reassess the lease term would represent a change from the current guidance.

Variable lease payments

The ED would require the use of a probability-weighted expected outcome approach to estimate lease payments including contingent rentals, term option penalties and residual value guarantees. Many respondents to the ED objected to this proposal, noting that the approach would be costly to implement and could result in unreliable estimates for long-term leases.

In February 2011, the Boards tentatively decided that all variable lease payments that are "reasonably certain" of being paid should be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable and that estimate should be reassessed when there is a change in facts and circumstances. Variable lease payments that depend on an index or rate or that lack "commercial substance" would also be included in the lessee's liability and lessor's receivable.

Although this decision represents a change from the proposal in the ED because of the inclusion of a high threshold, entities would still be required to estimate the amount of "reasonably certain" variable lease payments throughout the lease term and reassess that estimate in the future. Entities may not be able to ignore contingent rentals because there could be some level of contingent rentals, even far into the future, that will be reasonably certain of being paid by the lessee. Estimating contingent rentals would be particularly burdensome and costly for entities that have a large number of longer term leases that include contingent rental terms. The change to the definition of "lease term" noted above may provide some relief to entities that enter into leases that include renewal options and contingent rentals because the lease term may be shorter than it would have been under the ED.

Expense recognition pattern for lessees

The ED proposed that rental expense would be replaced with amortisation expense and interest expense, with total expense being recognised earlier in the lease term.

Many respondents to the ED did not agree with the proposal because it would result in:

- higher expenses in earlier periods of the lease; and
- further divergence from the cash payments made in lease contracts.

In addition, for leases previously accounted for as operating leases, some financial statement users indicated they would prefer to see lease payments treated as rental expense in profit or loss.

In February 2011, the Boards tentatively decided that there should be two types of leases – finance and other-than-finance – and the profit or loss recognition pattern for finance leases would be front-loaded which is consistent with the proposal in the ED and would be straight-line for other-than-finance leases.
The determination of the type of lease would be based on a number of factors which are still being developed by the Boards. This tentative decision does not affect the proposal in the ED that would require a lessee to recognise an asset and liability under the right-of-use model.

The tentative decision to have two types of leases may help to resolve the issue around the expense recognition pattern for lessees. The factors that would be used for determining the type of lease are still being developed, so it is unclear whether the split between a finance and other-than-finance leases will be similar to today's split between finance and operating leases.
It is also uncertain how the straight-line expense amount would be calculated and presented in profit or loss. The calculation and presentation of the expense amount will be discussed at a future meeting.

The Boards still have a number of issues to discuss before finalising the project and issuing a final standard. We will provide you periodic updates as significant decisions are made by the Boards.

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