



## Boards to Debate Where to Draw (Straight) Line on Lessee Accounting

At their May 24 meeting, the FASB and IASB (the Boards) discussed feedback received in response to the outreach by their staff on alternative lessee income statement measurement approaches the Boards are considering as part of their lease accounting project.<sup>1</sup> The alternative approaches would affect the amortization method that lessees would be required to apply to right-of-use (ROU) assets after initial recognition, and whether the resulting pattern of total lease expense is accelerated (i.e., front-loaded) or generally straight line over the lease term. This edition of *Defining Issues* summarizes constituent feedback, the Boards' reaction to the feedback, and the alternatives that they will discuss at their June meeting.<sup>2</sup>

The Boards' outreach was undertaken in response to ongoing concerns by some of their constituents about the lessee expense recognition pattern proposed in the Boards' 2010 exposure draft (ED) on lease accounting that they previously tentatively reaffirmed during their redeliberations.<sup>3</sup> Under the Boards' 2010 ED and previous tentative decisions, the pattern of expense recognition by lessees would be accelerated (i.e., front-loaded) in relation to the generally straight-line pattern of lease expense for operating leases under current GAAP. The outreach solicited constituent feedback on the operationality and usefulness to financial statement users of three alternative ROU amortization approaches in addition to the accelerated approach in the Boards' 2010 ED: the interest-based approach, the underlying asset approach, and the whole contract approach.

### Alternative Amortization Approaches for ROU Assets

During their February meeting, the Boards discussed the merits of the accelerated approach, the interest-based approach, and the underlying asset approach. The whole contract approach was developed by the staff at the Boards' direction in preparation for the outreach to constituents. Because constituents broadly preferred the whole contract approach over the interest-based amortization and underlying asset approaches, they are not discussed in this newsletter.<sup>4</sup>

**Accelerated Approach (Previous Tentative Decision).** Under the Boards' previous tentative decision, lessees would be required to amortize all ROU assets in the same manner as property, plant, and equipment or intangible assets (i.e., generally on a straight-line basis over the estimated lease term). Lessees would recognize a front-loaded pattern of expense for leases other than short-term leases (i.e., those with a

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<sup>1</sup> FASB ASC Topic 840, Leases, and the summary of the joint project of the FASB and IASB - Leases, both available at [www.fasb.org](http://www.fasb.org). Also see KPMG's Defining Issues publications on the joint leases project, all available at [www.kpmginstitutes.com/financial-reporting-network](http://www.kpmginstitutes.com/financial-reporting-network).

<sup>2</sup> The meeting is scheduled to take place in London on June 12-14, 2012.

<sup>3</sup> FASB Proposed Accounting Standards Update, Leases, August 17, 2010, available at [www.fasb.org](http://www.fasb.org), and Exposure Draft ED/2010/9, Leases, August 2010, available at [www.ifrs.org](http://www.ifrs.org).

<sup>4</sup> Refer to KPMG's Defining Issues No. 12-7, FASB and IASB Reconsider Views on Lessee Accounting, available at [www.kpmginstitutes.com/financial-reporting-network](http://www.kpmginstitutes.com/financial-reporting-network), for a description of the interest-based and underlying asset approaches.

maximum possible term of 12 months) due to the combined effect of interest expense on the lease liability (determined using the effective-interest method) and generally straight-line amortization of the ROU asset.

**Whole Contract Approach.** The whole contract approach would consider the ROU asset and the lease liability to be inextricably linked and treat the lease contract as a single unit of account for subsequent measurement purposes. Under this approach, the lease would not be considered a financing transaction. Therefore, the lessee would recognize the total lease payments generally on a straight-line basis over the lease term. This would be accomplished by adjusting the ROU asset by the difference between the total expense amount (i.e., generally straight line) and the amount of interest on the liability. However, interest expense and amortization expense would be combined in the income statement as a single amount called lease expense. This approach would produce a result in the income statement that is the same as lessee accounting for operating leases under current GAAP.

### Constituent Feedback

The staff held meetings with lessees, lessors, financial statement users, and auditors during their recent outreach efforts. Lessees were asked to provide feedback on the costs to apply each of the alternative ROU asset amortization approaches, and which approach best reflected the economics of their lease transactions. Lessors generally were asked whether they believed there should be symmetry between the lessee and lessor accounting approaches and whether they would be willing and able to provide lessees with the information necessary to apply the approaches. Financial statement users were principally asked for their views on which approach would give them the most useful information. The staff solicited auditors' feedback on their ability to audit the alternative approaches and the related costs.

Lessees provided the following principal feedback:

- Those who view their leases as financing transactions generally supported the accelerated approach, while those who do not generally supported the whole contract approach.
- The accelerated and whole contract approaches were broadly considered less complex and less costly to apply than the interest-based and underlying asset approaches. Lessees expressed significant cost-benefit concerns with respect to both the interest-based and underlying asset approaches.
- Lessees were split on whether the accelerated approach or the whole contract approach would be less costly to apply.
- All of the proposed approaches would require information system changes to account for the lease liability, which would produce the majority of the costs of applying the new requirements.

Some lessors indicated they would be willing and able to provide lessees with information to apply each of the alternative ROU amortization approaches (e.g., information on useful lives, residual values, and fair values of underlying assets). However, other lessors indicated they could not or would not provide lessees with the requisite information because of competitive or contractual reasons (e.g., non-disclosure provisions).

The staff noted that it was clear that no one approach or solution would satisfy all financial statement users' needs because they do not perform the same analysis and the information used differs among users. However, they provided the following feedback:

- Including lease assets and liabilities on lessees' balance sheets would be a significant improvement to financial reporting;
- A single lessee model that is consistent, easy to understand, and results in transparent information would be preferable to multiple models; and
- Most find information on a financing component to be useful; however, many also would like to obtain straight-line total lease expense information because they use it as a proxy for a lessee's cash payments.

Auditors generally indicated that:

- The accelerated approach was the most conceptually sound; and
- The underlying asset approach would be the most costly to audit due to the complexity of the calculations, as well as the estimates and judgments involved in that approach.

In addition, some constituents believe there are different types of leases that should be accounted for differently, which might result in applying the accelerated approach to some leases and the whole contract approach to others.

### **Alternatives for Discussion at June Meeting**

The Boards discussed their initial views on how to move forward in response to the constituent feedback. A majority of the FASB members expressed the view that some leases should be accounted for under the accelerated approach while others should be accounted for under the whole contract approach. A majority of the IASB members expressed a preference for applying the accelerated approach to all leases other than short-term leases, but indicated that they could support applying the whole contract approach to some leases. The Boards directed their staff to prepare three lessee accounting alternatives for consideration at their June meeting. These include:

- Application of the accelerated approach to all leases other than short-term leases (consistent with 2010 ED);
- Application of the whole contract approach to all leases other than short-term leases; and
- A two-model alternative for all leases other than short-term leases under which the accelerated approach would apply to some leases and the whole contract approach would apply to others.

Based on the discussions at the May 24 meeting, it appears that a majority of both Boards may support the two-model alternative. Consequently, the Boards' focus in June may be on establishing the classification test that would be used to determine whether the ROU asset would be amortized using the accelerated approach or the whole contract approach. A number of potential classification tests were suggested by various Board members during the meeting including:

- A test similar to the classification test in IAS 17;<sup>5</sup>
- A test that would be the inverse of the IAS 17 classification test where a lessee would apply the accelerated approach for leases that convey more than a minor portion of the risks and rewards incidental to ownership of the underlying asset to the lessee and would apply the whole contract approach to all other leases;
- A test based on type of leased asset (e.g., apply the accelerated approach for equipment leases and the whole contract approach for real estate leases); and
- A test that would be a hybrid of the previous test (e.g., also apply the whole contract approach to equipment leases with substantial service elements and also apply the accelerated approach to real estate leases that are more similar to purchasing the underlying real estate).

Several Board members asked the staff to consider developing a potential classification test that would take into consideration the expected consumption of the underlying asset during the lease term, while others wanted them to develop a test that would consider the significance of the financing in the lease.

## Next Steps

Other topics that the Boards plan to discuss in future meetings in addition to the lessee accounting matters described above include:

- Lease classification for lessors (i.e., which leases, if any, would qualify for operating lease accounting);
- Remaining lessor accounting matters under the receivable and residual model;
- Private company issues and implications for not-for-profit entities; and
- Overall cost and benefit of the proposals.

After the Boards complete their redeliberations on the leases project, the staff will draft a revised ED for comment. The Boards continue to target issuance of a revised ED in the second half of 2012 followed by a final standard in 2013.

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<sup>5</sup> IAS 17, Leases.

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