Accounting change for lessees

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Ernst & Young

Quality In Everything We Do

What is the current state of the proposals for lessees?

The re-exposure of proposals for lease accounting change is expected in early 2012. The original exposure drafts (EDs) issued by the IASB and the FASB (the Boards) in August 2010 led to a record level of feedback from respondents. Many commented that the proposed approach was overly complex, costly and in some cases, might be at odds with how the substance of underlying commercial arrangements are regarded.

The Boards have listened and responded to the feedback. Tentative decisions to date indicate that the revised proposals will be less complex than the original EDs, but all lease arrangements undertaken by lessees that are in scope (except those where the term of the lease is 12 months or less) will still need to be brought 'on balance sheet'. The underlying profile of the expense recorded in the income statement will also change in comparison to current accounting.

Preparing for change

Compliance with the proposals may require companies with lessee arrangements to undertake fundamental change to existing business processes and systems, in addition to managing a range of stakeholder expectations to maintain confidence in reported results. Amongst others, companies will need to consider their approach to the following challenges:

- Education and training of finance and non-finance personnel to succeed in implementing a complex new standard that has significant business implications.
- Data management and new ongoing systems requirements for reporting lease information with possible requirements for dual ledger reporting.
- Stakeholder management and communication of the impacts on KPIs and performance measures.

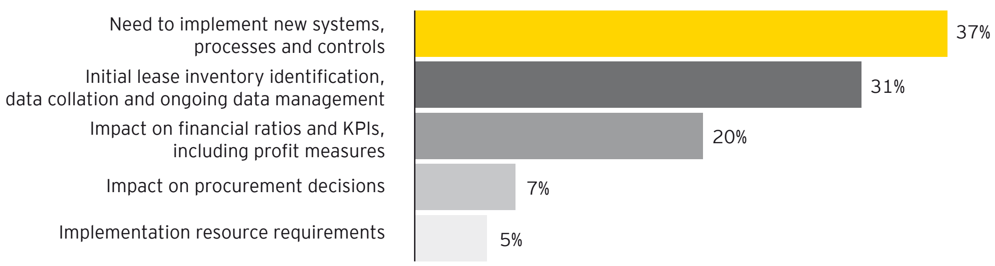
Cross-functional project teams are required to ensure smooth implementation across the business.

This report captures the key themes and opinions from an Ernst & Young Lease Accounting Change workshop for lessees held in London in December 2011 and a series of Technical Update seminars held across the UK and Ireland in the autumn of 2011. It draws on real-time comments and polls taken among participants at these events. Participants at the lessee workshop were from cross-industry sectors including hospitality, retail, banking, manufacturing, telecommunications and extractive industries.

These findings highlight the opinions of finance leaders on the challenges they face in responding to the lease accounting proposals and options to consider for cost effective solution implementation.

Almost 40% of finance professionals polled at our seminars voiced that their biggest concern is the implemention of new systems, processes and controls to calculate and record financial impacts, including possible dual ledger requirements. Another third are most concerned about the challenge of initial lease inventory identification, data collation and ongoing data management. One in five highlight the impact on financial ratios and KPIs, including profit measures in employee bonus schemes and covenant ratios. Others' key concerns are the potential impact on procurement decisions, for example whether to lease or buy, and about the resource requirements of implementation.

What concerns you most about the business impact of the implementation of the lease accounting proposals?



Source: *Technical Update seminars 2011*

Lease definition — a request for additional guidance

The Boards' definition of a lease in the proposals is 'a contract in which the right to use a specified asset is conveyed for a period of time, in exchange for consideration.' Subsequent to the EDs, the Boards tentatively decided that to determine whether a contract contains a lease, entities will need to assess whether, in substance, the contract depends upon the use of a specific asset and conveys the **right to control** the asset.

The assessment of the nature of contracts that fall in scope of the revised standard is key, in particular in light of the divergence in the accounting treatment for service contracts in comparison to lease arrangements. Finance leaders at the Ernst & Young events expressed a need for more clarity on the application of the lease definition and guidance for the determination of a lease versus a service contract arrangement. Without this, the judgement required may result in divergence in practice for similar contracts such as individual outsourcing arrangements. Leasing of virtual storage space was identified as an example of an arrangement that might not be in scope. In general, entities may not have systems and processes to easily identify and monitor service contracts (that may include embedded lease arrangements under the proposals), so the need to identify and build an initial comprehensive inventory of these contracts for a global business is likely to be a challenge.

Finance leaders also expressed concern about the requirement to separately account for lease and the non-lease components of a contract as this will require the identification of additional data points and the need to determine an observable market price perhaps with support from landlords/lessors. Where entities are not able to identify an observable price for non-lease components such as service costs, these will need to be accounted for as part of the lease liability, again perhaps reducing comparability in the accounting for similar contracts. Examples identified of non-lease components included maintenance costs for vehicle leases and insurance costs for leased hotels.

A number of companies raised the need to assess whether a lease contract contains embedded leases to be accounted for in accordance with the revised IFRS requirements.

Impacts for KPIs

Outside of the impacts on KPIs such as EBITDA and net debt ratios, discussions during the Ernst & Young seminars on the impact of the proposed model for performance measures highlighted a number of key concerns including implications for forecasting, covenants for financing, incentive schemes, regulator interpretation of the gross up of the balance sheet through the right-to-use asset, education and communication of results to stakeholders.

Significant concern was expressed about the need to re-configure forecast reporting and models, in particular if businesses run three to five year business plans — an anticipated adoption date of 1 January 2015 clearly falls within this future period. Volatility created due to the requirement to reassess certain aspects of lease accounting at each reporting date is also a concern.

Certain participants anticipated difficult conversations when renegotiating covenants due to uncertainty about volatility in the level of headroom under existing covenants when these changes are implemented. Others are looking to negotiate covenants under a 'frozen GAAP' to exclude the impact of this change but this will require the continued maintenance of dual ledgers or complex calculations to support covenant ratio assessment.

Long term incentive plans can include three year contracts with key employees. Companies should consider whether contracts signed from January 2012 which include a profit or earnings measure should include a 'frozen GAAP' clause to allow the targets to be adjusted for the impact of lease accounting change given the expected impact on profit in the year of implementation in particular.

Banks and companies in regulated sectors expressed significant concern about the impact on capital and regulatory requirements. The proposals will bring large assets and liabilities on to the balance sheets of banks at a time when the industry is still recovering from the financial crisis and dealing with a wide range of new regulation. The Boards have also decided (in July 2011) that it is not necessary to clarify whether the right-of-use asset is a tangible or an intangible asset — this distinction is significant for entities required to comply with certain capital requirements. Some may believe that a bank's capital position has deteriorated as a result of the impacts on the balance sheet whilst in reality there is no economic impact as there should be no change in the bank's credit or market risk. These changes may be on the agenda of relevant regulators such as the FSA, but participants expressed a view that reaching a conclusion on these matters should be given high priority by regulators.

Stakeholders including analysts, audit committees, boards and investors may be aware that change is coming but may have limited idea of the potential impacts on KPIs. Participants envisaged a need for short-term education of internal and external stakeholders, for example through webcasts to analysts/investors plus a requirement for dual presentation of KPIs under 'frozen' versus revised IFRS for an interim period.

Determination of lease term will require judgement

The Boards are proposing a revised definition of 'lease term' in comparison to the original EDs. The change will make the assessment of a lease term simpler but will continue to require judgement. The proposed definition of lease term is '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 the entity to exercise an option to extend the lease or for an entity not to exercise an option to terminate a lease.'

Participants at the Ernst & Young seminars could foresee issues in the interpretation of a 'significant economic incentive' with the need for a clearly defined accounting policy to assist finance teams in making this assessment. Participants identified potential incentives could include lease arrangements where infrastructure investments or technology is included in occupied buildings for banks, or data-warehouses constructed in buildings by telecoms companies.

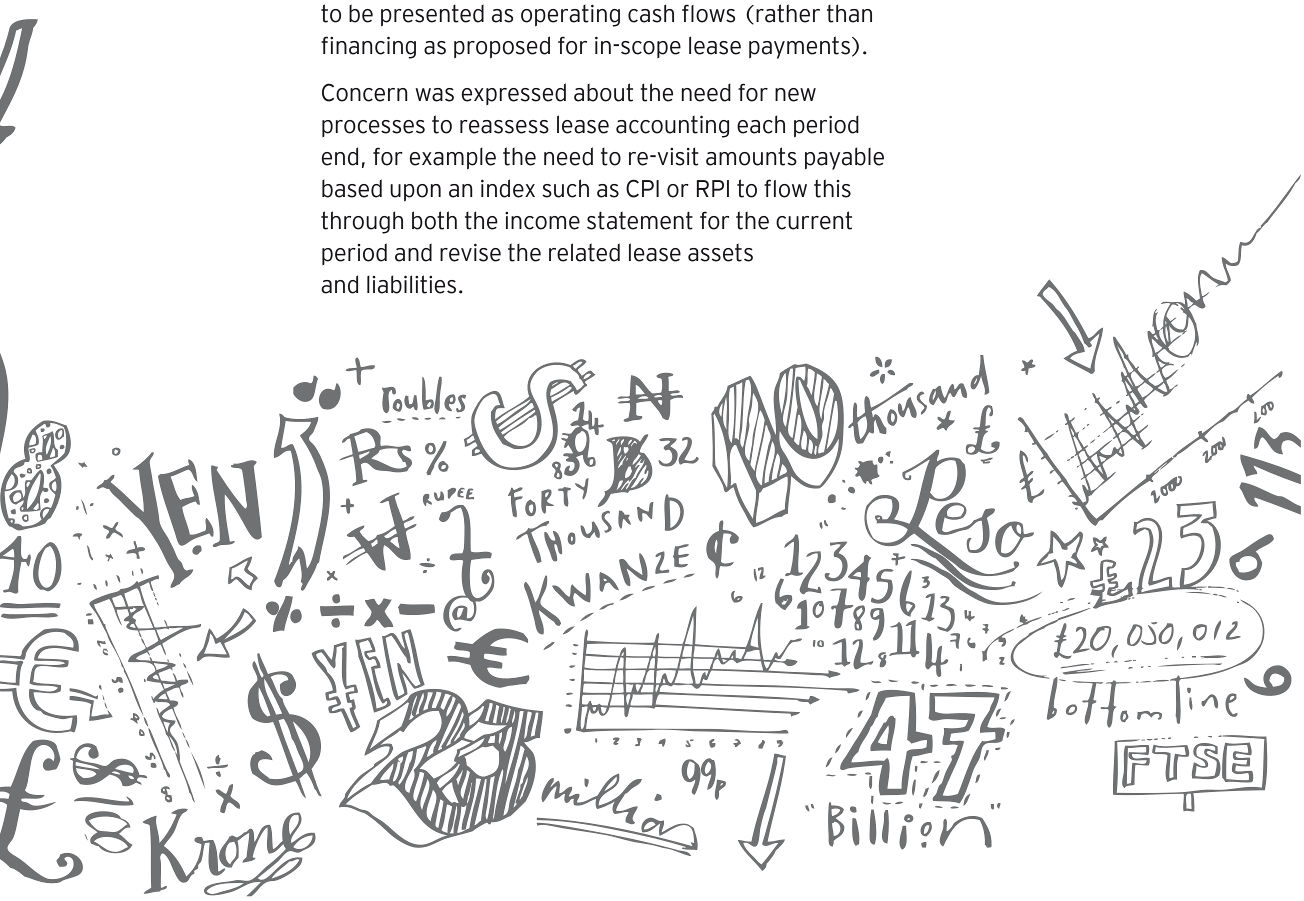
The assessment of the lease term is increasingly important under the proposals as all cash payments made over this period will need to be included in the assessment of the initial lease liability to be brought 'on balance sheet.'

Assessment of lease payments and discount rate will require significant data collation

Proposed lease payments to be included in the calculation of a lease liability will include fixed and contingent payments dependent upon an index or rate (the spot rate at commencement), purchase options, residual value guarantees and termination option penalties (where relevant). Entities will need to identify all relevant data points in contracts to collate this information. The proposals are different from the original EDs which required the inclusion of all contingent rent payments. The amendment to this requirement provides significant relief to retailers and hoteliers, for example, where lease terms often include payments based upon a percentage of turnover or profit. These amounts are expected to be accounted for in a consistent manner with the current requirements (expensed as incurred) with the cash flows paid for variable lease payments of this nature to be presented as operating cash flows (rather than financing as proposed for in-scope lease payments).

Concern was expressed about the need for new processes to reassess lease accounting each period end, for example the need to re-visit amounts payable based upon an index such as CPI or RPI to flow this through both the income statement for the current period and revise the related lease assets and liabilities.

Others foresee issues with the selection of a discount rate to use in the calculation of the lease liability for companies with no borrowings and no benchmark, such as cash-rich private groups. The Boards' proposed requirement is for lessees to use the rate the lessor charges the lessee when that rate is available, otherwise the lessee would use its incremental borrowing rate. For transition it is proposed that entities use a rate for each portfolio of leases with reasonably similar characteristics taking into consideration total leverage. For property leases this could be the yield on the property for example. The Boards plan to provide application guidance for determination of the rate when considering the use of a group rate or a yield on a property, but additional guidance may be required for a wider range of scenarios.



Significant concern over data management, process and IT system change

Upon concluding which arrangements are in scope, companies will need to consider and identify all relevant input data points to collate. This includes the need to identify the timing of payments (monthly, quarterly, annually), nature and currency. Practically where current data exists, this may be incomplete or not be available in a consistent format in current systems or databases. Some participants are in the early stages of data gathering — they communicated difficulties in obtaining contracts across geographies and in different languages where information requirements were incomplete. Others have existing databases of lease information but these were often not centralised, so a process of collation is still required. Also property systems sometimes lack sufficient controls to place reliance upon historical data for financial reporting purposes.

The calculation of the lease liability and the volume of data required is recognised as a huge challenge. Solutions to this may require centralised or devolved ongoing maintenance and management of lease contract data, with new processes required between finance and procurement, property or legal teams responsible for lease negotiation. New lease calculation models will need to be tailored or bespoke IT systems amended to incorporate new lease accounting requirements and generate relevant accounting entries to be recorded in ledgers.

An assessment of conversion options is a new area to consider in light of the IASB's recent communication of the possibility to apply the proposals on a fully retrospective basis. The income statement impact of this may be beneficial for entities given the revised profile of expense recorded over the lease term, but past higher discount rates may limit this advantage.

Dual ledger maintenance is also a key concern. This may be required for tax reporting, as certain tax authorities are proposing not to amend current tax law in the short term. New processes will also be required to calculate additional deferred tax balances as a result of the possible divergence between tax and accounting.

Where to start

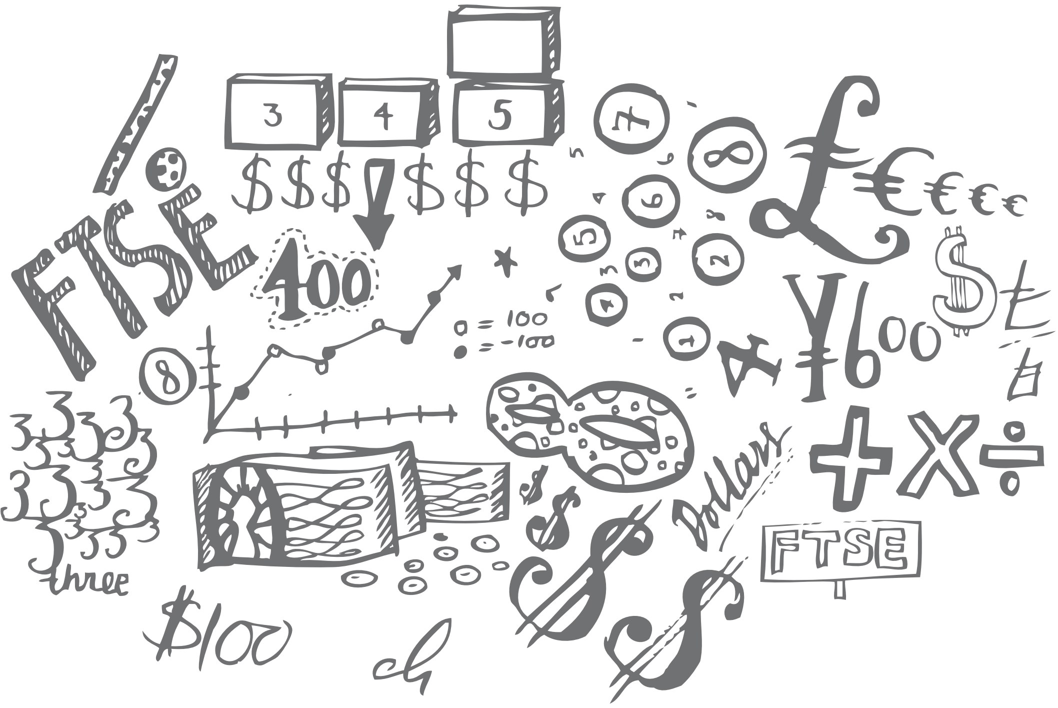
As finance professionals, participants clearly grasped the complexity of the proposed accounting model but some are unclear where to start due to a lack of familiarity with carrying out an impact assessment, the detail of their existing lease arrangements or the intricacies of their IT support systems.

As an initial starting point Ernst & Young would recommend a risk based approach to stratify the lease portfolio and prioritise tasks. This involves all key stakeholders including representatives from central and local finance teams, tax, treasury, IT, legal, HR, property management, procurement and investor relations. A 'current state' assessment of existing lease arrangements, including identification of existing IT systems, location of lease data and an inventory of possible in-scope arrangements, will assist to identify priority action areas and focus the preparation of a project plan.

The three key areas we highlight as priority are the determination of impacts on KPIs, data and IT challenges and stakeholder communication requirements including discussions with landlords/ lessors and IT providers.

We are already working with companies to support both their assessment of the financial impact of the proposals and key activities of focus for their project action plans. Given the possible impacts of the proposals on contracts that will be negotiated in 2012, now is the time to begin to prepare for change.

Should you wish to explore how such a project should be organised we would be happy to share our experiences with you.



How we can help

Ernst & Young can bring its multi-disciplinary teams of accounting, tax, systems, and IT Professionals to your company to assist in assessing what the revised lease proposals means to you. In the chart below, we outline issues and steps you should consider concerning the revised lease proposals, and indicate how Ernst & Young may be able to help you from initial assessment through adoption.

Issues and steps	How Ernst & Young may be able to help
Gain a general understanding of the revised proposals	► Design and help deliver a training session for company personnel ► Share insights of IASB, FASB, SEC views ► Provide input into the company's comment letter on the revised EDs
Perform a preliminary assessment of the impact of the revised proposals on the company's financial statements	► Advise and provide input into: ► Identifying all arrangements that are in the scope of the revised lease proposals, including contracts that would be considered leases but were previously recognised as service contracts ► Gathering necessary lease information to adopt the proposed standard ► Summarising lease terms ► Developing a process for managing the significant judgements and estimates that would be necessary with respect to estimating lease term and lease payments, including reassessments ► Performing a high-level measurement of the right-of-use asset and related liability to make lease payments ► Calculating the high-level income statement impact of adopting the proposed standard ► Assessing the impact on key financial ratios and performance measures ► Identifying shortfalls in available information to adopt the proposed standard
Assess impact of the revised proposals on strategic business decisions	Advise and provide input into: ► The impact on strategic business decisions and planned transactions (e.g., mergers, acquisitions, and new markets) ► The impact on existing loan covenants and borrowing arrangements including the impact to arrangements currently being negotiated
Benchmark the company against peers and others in the industry	► Provide observations of how others are approaching the revised proposals, problems they encountered and solutions developed ► Assist in the evaluation of peers, competitors and industry disclosures and expected impact on the financial statements
Assess processes for data collection, internal controls, IT systems	► Provide observations and insights based on leading practices on ways the company could design its business processes, IT systems, and internal controls ► Assess whether the current enterprise software and IT systems can support the new requirements ► Identify criteria to consider in selecting IT packages, and advise in the selection process ► Develop Excel or Access based models to collate data and assess impact of change
Assess tax positions relating to the revised proposals	► Advise on analysing tax positions arising from adopting the revised proposals reducing tax exposure, and determining tax effects of lease modifications
Plan for ultimate adoption of the proposed standard	► Advise regarding project maintenance and planning, including timeline, tasks, and resource allocation
Update accounting manuals and accounting policies	► Review and provide input into accounting manuals and policies selected by management
Communicate effect of adoption to stakeholders — analysts, regulators, shareholders	► Advise on developing a communication plan ► Advise on drafting communications

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