

# Applying IFRS

IASB Exposure Draft *Leases* – redeliberations

**Leases**



**Lessee model comes  
together as leases project  
progresses**

July 2011

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### What you need to know

- ▶ The Boards have made significant revisions to their original proposal, primarily to address constituents' concerns.
- ▶ The revised proposal would significantly change the timing of lease expense recognition and balance sheet metrics and would nearly eliminate off-balance sheet financing through operating leases.
- ▶ Under the revised proposal, certain judgements, including identifying a lease and determining the lease term, would become more important.
- ▶ Many topics are still open, particularly lessor-specific matters. Resolving them and possibly re-exposing the revised proposal will delay the issuance of a final standard until 2012.

## Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) have made significant changes to their proposed leases model to address conceptual and operational concerns constituents raised about their original proposal.<sup>1</sup>

Like the exposure draft, the revised proposal (i.e., exposure draft adjusted for subsequent deliberations) would require most leases to be recognised on the balance sheet. It would also require a number of judgements as well as periodic reassessment. The business implications could be significant, including:

- ▶ Key balance sheet metrics (e.g., leverage ratios, capital ratios) and income statement metrics (e.g., net income, EBITDA) would change.
- ▶ Debt covenants and borrowing capacity may be affected.
- ▶ The lease expense recognition pattern would be accelerated for today's operating leases.
- ▶ Changes may affect decisions to lease versus buy significant assets.

The Boards still need to address lessor accounting and other issues. The IASB recently updated its published project plan indicating that it expects to issue a final standard in the first half of 2012. The FASB's published plan still calls for a final standard to be issued this year, but we think that is unlikely. Both Boards have indicated that before finalising the standard, either a review draft will be made available for review or a second exposure draft will be issued for comment. An effective date has not yet been set.

This publication summarises the revised leases proposal for topics the Boards have redeliberated through June 2011, which are primarily lessee-related, and compares the revised proposal with current accounting. All of the decisions made by the Boards to date are tentative and will not be finalised until the Boards approve a final standard. The Appendix recaps the significant revisions the Boards have made to the exposure draft thus far.

## Background

The Boards are jointly developing a new approach to lease accounting to address criticisms of the current model including:

- ▶ Material assets and obligations arising from operating leases are not recognised.
- ▶ Economically similar lease transactions result in different accounting.
- ▶ Estimates at the inception of a lease are not reassessed.

Last year, the Boards issued an exposure draft that addressed these criticisms, but at the same time, created new concerns. Based on feedback they received, the Boards identified the following key issues for redeliberation:

- ▶ The definition of a lease
- ▶ Lease term
- ▶ Variable lease payments (including contingent rent)
- ▶ Income and expense recognition pattern
- ▶ Lessor accounting model

The Boards have made significant changes to their original proposal to address the concerns raised.

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<sup>1</sup> IASB Exposure Draft, *Leases*. For additional detail about the exposure draft, refer to *Proposed accounting for leases* (November 2010) or *Supplement to IFRS Outlook Issue 79: Proposed accounting changes for leases* (August 2010), both available at [www.ey.com/ifrs](http://www.ey.com/ifrs).

Given the significant accounting implications, companies will have to pay more attention to their contracts to identify any that are, or contain, a lease.

## Scope

The exposure draft proposed using existing guidance to determine the scope of the new leases standard. The definition of a lease and application guidance in the exposure draft was largely carried forward from existing standards. Many respondents raised concerns about applying the existing definition in the new model, particularly given the elimination of operating lease accounting. The following section highlights the scope of the proposed leases standard based on the Boards' tentative decisions to date.

### Definition of a lease

A lease would be defined as a contract in which the right to use an asset is conveyed, for a period of time, in exchange for consideration. To be a lease, an arrangement would have to meet two criteria: (1) fulfilment of the contract would have to depend on a "specified asset"; and (2) the contract would have to convey the "right to control the use" of the specified asset.

Consistent with current standards, a "specified asset" would be an asset that is implicitly or explicitly identifiable. Although a physically distinct portion of a larger asset (e.g., a floor in a multi-storey building) could be a specified asset, a non-physically distinguishable portion of an asset (e.g., 50% of the capacity of a pipeline) would not qualify as a specified asset and would not be the subject of a lease.

Contracts that provide the vendor with substantive substitution rights (i.e., allow the vendor to use any one of a number of different assets to fulfil the contract) would not be considered leases because they would not depend on the use of a specified asset. A substitution right would be considered substantive if substitution of the asset is both practical and economically feasible and the asset could be substituted without the customer's consent.

### Illustration 1 – Substitution rights

Assume that a contract specifies that a service is rendered to a customer and it involves the use of container No. 9, but the vendor can substitute another container for No. 9 without the consent of the customer. The vendor has a lot of identical containers, the containers are maintained in a single, accessible location and the vendor could easily substitute another one for No. 9 at a nominal cost. Fulfilment of this contract would not depend on the use of a specified asset because the substitution right is substantive.

Now assume the same facts except that container No. 9 is customised and located in an isolated area, making vendor substitution impractical and uneconomical. Therefore, the substitution right would not be substantive (i.e., fulfilment of the contract depends on the use of container No. 9).

Contracts that provide vendors with substantive substitution rights would not be within the scope of the proposed leases standard and likely would be accounted for as executory arrangements. The specified asset criterion is generally consistent with current standards.

The "right to control the use" of a specified asset would be conveyed if the customer has the ability to **both** direct the use of the asset and receive the benefit from its use. An arrangement under which a customer obtains all of the benefit from the use of an asset, but does not direct its use, would not be considered a lease.

The ability to direct the use of the asset would be demonstrated by the ability to make decisions about the use of the specified asset (e.g., determining how, when and in what manner the specified asset is used) that significantly affect the benefits received by the customer from the asset. For example, the customer specifying the quantity and timing of the delivery of goods would not, by itself, indicate the customer's ability to direct the use of the asset used to produce or deliver those goods. In contrast, if the vendor operates the asset according to the specific instructions of the customer, the customer has the ability to direct the use of the asset.

The revised right-to-control-the-use criterion is intended to align with control concepts the Boards have developed in their joint revenue recognition project. This means that the customer must meet **both** requirements (direct the use and receive the benefits). Pricing terms would not be considered in evaluating the right-to-control-the-use criterion.

This would be a change from current standards, under which contracts meet the right-to-control-the-use criterion if the customer obtains substantially all of the benefits and the contractual price is neither fixed per unit of output nor equal to the market price per unit of output. Under current standards, the control criterion may be met even if the customer does not have any rights to direct the use of the asset.

Under the revised proposal, certain arrangements (e.g., some take-or-pay arrangements) that are currently accounted for as leases would no longer be considered leases. The Boards are still developing application guidance that would ultimately determine whether a contract meets the definition of a lease.

#### How we see it

- ▶ Companies should carefully scrutinise their contracts to assess whether an arrangement would be considered a lease or would contain a lease. The current accounting for operating leases and service contracts is often similar. Under the revised proposal, lease-related assets and liabilities would have to be recognised for all leases (except for short-term leases). The determination of whether an arrangement is or contains a lease could have significant accounting implications.
- ▶ Many arrangements involve providing or using fixed assets, including those that are used exclusively to provide services and both parties have some rights over the control of the asset. The determination of which party has the right to control the use of the underlying asset would be very subjective in certain arrangements (e.g., time charter arrangements). The Boards plan to provide additional application guidance to help entities determine whether the customer has the right to control the use of an asset.

#### Scope exclusions

The following arrangements would not be in scope:

- ▶ Leases for the right to explore for or use natural resources (such as minerals, oil, natural gas and similar non-regenerative resources)
- ▶ Leases of biological assets
- ▶ Leases of service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*
- ▶ For lessors, leases of investment property measured at fair value
- ▶ For lessees (subsequent to initial measurement), investment property held under a lease and measured at fair value

The proposed definition of a lease would include any asset except for the scope exclusions described above. The Boards also stated that leases of intangible assets would not be required to be

accounted for in accordance with the leases standard. In addition, the Boards directed the staff to perform additional research so that the Boards could determine whether leases of inventory (and for US GAAP, leases of internal-use software in accordance with Subtopic 350-40, *Intangibles-Goodwill and Other Internal-Use Software, of the FASB Accounting Standards Codification*<sup>®</sup>) would be within the scope of the standard. It remains to be seen what, if any, additional exclusions will be established, as well as the effect of not requiring (but presumably allowing as an accounting policy election) leases of intangible assets to be accounted for under the leases standard.

#### Short-term leases

The revised proposal would allow lessees to apply current operating lease accounting to short-term leases. A short-term lease would have a maximum possible lease term, including any options to renew, of 12 months. For example, a nine-month lease with a one-month renewal option (i.e., the maximum possible lease term is 10 months) would qualify as a short-term lease. In contrast, a nine-month lease with four one-month renewal options (i.e., the maximum possible lease term is 13 months) would not.

The determination of whether a lease is a short-term lease would be based solely on the maximum possible lease term in the contract. The entity's intentions, expectations or lease term for accounting purposes would not be considered.

The revised proposal would allow entities to make a policy election to use the simplified accounting. Lessees applying the simplified approach would recognise lease expense on a straight-line basis over the lease term (unless another systematic and rational basis better represents the pattern of use) and would not recognise lease-related assets and lease liabilities.

#### How we see it

- ▶ Companies should carefully evaluate whether short-term lease accounting applies to their arrangements. Evergreen agreements or daily leases with no set termination date would not meet the short-term lease criterion, but the lease-related assets and liabilities recognised for these daily or evergreen agreements may be minimal.
- ▶ The Boards are considering various disclosure options for short-term leases. These include requiring disclosure of the current period's short-term lease expense and a qualitative discussion of short-term lease expense in future periods, or requiring disclosure of committed short-term lease cash flows for the following 12 months. Requiring these types of disclosures would reduce the relief provided to preparers under the short-term lease simplified approach.

Application guidance for determining observable prices is being developed considering the concepts in other projects, such as revenue recognition.

## Separation of lease and non-lease components

For contracts that contain lease and non-lease components, non-lease components, including services and executory costs, would be separated from the lease components, except in limited circumstances. Executory costs have not been defined, but would likely include insurance, maintenance and taxes.

Lessees would allocate payments on a relative purchase price basis (if the purchase price of each component can be observed) or using a residual method (if the purchase price of one or more but not all of the components can be observed). If there are no observable purchase prices, lessees would account for all of the payments required by the contract as a lease (i.e., not separate payments between lease and non-lease components). The Boards agreed to include application guidance in the standard on how a lessee should determine an observable price.

### Illustration 2 – Separating lease and non-lease components

A company enters into a three-year lease of equipment. The contract requires the company to make fixed monthly payments of CU180 to cover the lease, routine maintenance of the equipment and the cost of training the company's employees to use the equipment.

#### Scenario A

The company determines an observable purchase price for each of the components of the contract and calculates the amount allocated to each component as follows:

	Standalone price	% allocation	Payment	Monthly allocation
Equipment lease	CU 160	80%	CU 180	CU 144
Maintenance services	30	15%	CU 180	27
Training	10	5%	CU 180	9
	<b>CU 200</b>	<b>100%</b>		<b>CU 180</b>

For this contract, the company would allocate CU144 of the monthly payments to the equipment lease, CU27 to the maintenance services and CU9 to the training. The company would recognise and measure the assets and liabilities related to the equipment lease using the proposed lease accounting standard. The payments allocated to the maintenance and training would be accounted for like other executory arrangements.

#### Scenario B

Assume that observable prices exist for the equipment lease (CU160) and training (CU10), but not the maintenance services. For instance, the vendor may offer the equipment either with or without a maintenance plan; however, neither the vendor nor others offer a maintenance plan separately. The company would use the residual method as follows:

Monthly payment	CU 180
Equipment lease	(160)
Training	(10)
Maintenance	<b>CU 10</b>

The company would allocate CU160 of the monthly payments to the equipment lease and recognise and measure the assets and liabilities related to the equipment lease using the proposed lease accounting standard. The payments allocated to maintenance (CU10) and training (CU10) would be accounted for like other executory arrangements.

#### Scenario C

If the company has an observable price for the maintenance services (CU30), but cannot obtain observable prices for the equipment lease and training, the training component would be accounted for together with the equipment lease. The company would separately account for the maintenance as an executory arrangement and CU150 of the monthly payments (the amount that cannot be allocated) would be recognised and measured using the proposed lease accounting standard.

#### Scenario D

Assume that the company cannot obtain an observable price for any component. All payments (i.e., the monthly payments of CU180) would be recognised and measured using the proposed lease accounting standard.

#### How we see it

- ▶ The application guidance for determining an observable price will be critical to understanding when non-lease components would be accounted for as part of a lease. It is not yet clear what would constitute an observable price and whether a lessee could use estimation techniques to develop an estimated purchase price.
- ▶ Separating service payments and executory costs from leases may require a change in practice for some companies. Under current lease accounting, these payments are excluded from minimum lease payments, but many entities may not have focused on separating them because the accounting treatment for these payments is often the same as the treatment for operating lease payments. Entities would need to develop processes to identify observable prices for the lease and non-lease components in arrangements that contain a lease. This may involve the use of significant judgement.

The Boards have not yet discussed how to determine the contract value (i.e., payments required by the contract) to allocate initially between the lease and non-lease components or how subsequent changes in contract value would be allocated, but plan to do so at a future meeting.

The determination of lease term when lessee renewal options are present would be subjective because companies must determine if a significant economic incentive exists.

## Lessee accounting

In redeliberations to date, the Boards have made significant revisions to many of the key concepts in their original proposal. The fundamental position that assets and liabilities arising under nearly all lease arrangements will be recognised has not changed. For all leases (other than short-term leases), lessees would recognise a liability to make lease payments and a right-of-use asset that would initially be measured at the present value of lease payments over the lease term. However, many aspects of measuring the amounts recognised have been revised.

The following section illustrates how lessees would apply the revised proposal based on decisions to date.

### Key concepts

#### Lease term

Lease term would be defined as the non-cancellable period, plus any options where there is a significant economic incentive to extend or not terminate the lease. Factors that might create an economic incentive for the lessee include:

- ▶ Renewal rates priced at a bargain
- ▶ Penalty payments for cancellation or non-renewal
- ▶ Economic penalties, such as significant customisation or installation costs (e.g., leasehold improvements)
- ▶ A sublease term that extends beyond the non-cancellable period of the head lease (e.g., the head lease has a non-cancellable term of five years and a five-year renewal option and the sublease term is 10 years)

#### Illustration 3 – Determining lease term

Assume a company enters into a lease for office space that includes a non-cancellable term of two years and two four-year renewal options. If there is no significant economic incentive for the company to exercise the renewal options, the lease term for accounting purposes would be two years.

Now assume the lessee installed a significant amount of leasehold improvements at the beginning of the lease and the leasehold improvements have a useful life of 10 years. The company may determine that a significant economic incentive exists through 10 years. Therefore, it would conclude that the lease term for accounting purposes is 10 years.

#### Purchase options

Accounting for purchase options included in lease arrangements would be consistent with the accounting for options to extend a lease. That is, if the lessee has a significant economic incentive to exercise a purchase option, the exercise price would be included in the lease payments and the right-of-use asset would be amortised over the life of the underlying asset as opposed to the term of the lease.

#### Illustration 4 – Purchase options

A lessee enters into a five-year lease for equipment that includes a purchase option under which the lessee can purchase the equipment for CU1,000 at the end of the contract. The equipment has a seven-year life and the expected fair value of the equipment at the end of five years is CU100,000. The lessee has a significant economic incentive to exercise the purchase option because the lessee can obtain the equipment at a price that is significantly less than the expected fair value at the time of exercise. The present value of the CU1,000 purchase option payment would be included in the initial right-of-use asset and liability to make lease payments. The amortisation period used to determine periodic amortisation expense of the right-of-use asset would be seven years (i.e., the life of the equipment).

Now assume a lessee enters into a five-year lease of the same equipment and that the contract specifies that the lessee can purchase the equipment at the end of the contract for CU100,000. In this scenario, presuming there are no other factors that would indicate otherwise (e.g., other forms of economic compulsion), the lessee would not have a significant economic incentive to exercise the purchase option. Therefore, the purchase option exercise price would be excluded from lease payments and the right-of-use asset would be amortised over five years.

#### How we see it

We believe that the determination of the lease term for accounting purposes and the treatment of purchase options under the Boards' revised proposal would be very similar to current practice. This change from the exposure draft should reduce the burden on preparers, many of whom said that the Boards' original proposal was overly complex.

Assessing whether an economic incentive is significant would be a subjective determination. Including renewal periods in the lease term for accounting purposes could be more impactful under the proposed model than it is today as all leases would be recognised on the balance sheet.

## Usage-based and performance-based contingent rents would not be recognised on the balance sheet.

### Lease payments

Lease payments used to determine the amounts recognised on the balance sheet would include:

- ▶ Fixed lease payments
- ▶ Exercise price of purchase options for which a significant economic incentive to exercise exists
- ▶ Residual value guarantees
- ▶ Termination option penalties
- ▶ Lease payments that depend on an index or rate

Residual value guarantees would be included in the lease-related assets and liabilities at the amounts expected to be payable (e.g., gross guaranteed amount minus the expected value of the underlying asset). For example, the lease agreement includes a guarantee by the lessee that the lessor will realise CU10,000 from selling the asset at the expiration of the lease. At lease commencement (i.e., the date the lessor makes the underlying asset available for use by the lessee), the lessee estimates that the asset will have a value of CU4,000 at the end of the lease. Therefore, the lessee expects to pay the lessor CU6,000 under the residual value guarantee and includes this amount as a lease payment. Amounts payable under guarantees provided by a third party would not be lease payments.

The determination of whether to include termination option penalties would be consistent with the determination of the lease term for accounting purposes. That is, if a lessee would be required to pay a penalty if it does not renew the lease and the lease term for accounting purposes excludes the renewal period, the penalty would be included in the recognised lease payments. For example, assume that a lessee has a lease with a five-year term and an option to terminate after two years if the lessee pays the lessor a termination option payment of CU50,000. If the lessee determined that the lease term for accounting purposes is two years (because the lessee does not have a significant economic incentive not to terminate the lease), the CU50,000 termination payment would be included as a lease payment. In contrast, if the lessee determined that the lease term for accounting purposes is five years, the CU50,000 termination payment would not be considered a lease payment.

Lease payments that depend on an index or a rate would be measured using the prevailing or spot rate. The forward curve would not be considered in determining the lease payments over the lease term. For example, assume a five-year lease requires annual payments beginning at CU10,000 in the first year, increasing each year based on the then current 12-month LIBOR rate. If the 12-month LIBOR rate is 3% at commencement, annual payments of CU10,000 with 3% increases each year (i.e., CU10,000 in year one, CU10,300 in year two, CU10,609 in year three, etc.) would be included in the liability to make lease payments.

Contingent rent based on performance (e.g., a percentage of sales) or usage (e.g., number of miles flown) of the underlying asset would be recognised as an expense when incurred. For example, a contingent rent based on annual sales of a leased store would not be included in the right-of-use asset and liability to make lease payments recognised by the lessee. Instead, these payments would be recognised as an expense as the sales at the store occur.

Many Board members supported the exclusion of performance and usage-based contingent rents from the amounts recognised on the balance sheet as a practicality exception and indicated that robust disclosures of these types of payments would be required. Specific disclosure requirements for contingent rents have not yet been addressed in the redeliberations.

Payments must be truly variable to be excluded from the amounts recognised on the balance sheet. That is, payments that are contractually described as variable, but in substance are fixed, would be treated as fixed lease payments.

### Illustration 5 – In-substance fixed payments

Consider a lease that calls for lease payments to increase each year by the lesser of 2% or 10 times the annual increase in the consumer price index (CPI). Truly variable lease payments that depend on an index, such as CPI, would be included in lease-related assets and liabilities based on the prevailing rate for the index. However, the combination of the multiplier and cap are specifically designed to ensure that the cap is reached and the lease payments are substantively fixed. Therefore, the 2% escalation would be included in the measurement of the lease-related assets and liabilities.

### How we see it

The Boards' decision to exclude performance and usage-based contingent rents from the amounts recognised on the balance sheet reduces the complexity of the proposed accounting for leases. The Boards received feedback from many constituents that the approach included in the exposure draft was complicated and would have been costly to implement. Under the revised proposal, many variable payment features commonly found in leases (e.g., percentage rent, mileage-based fees) would be accounted for in much the same way as they are today.

### **Discount rate**

The discount rate would be determined on a lease-by-lease basis. The discount rate used by the lessee to determine the present value of lease payments would be the rate that the lessor charges the lessee if available; otherwise, the lessee would use its incremental borrowing rate. Practically speaking, lessees will rarely know the rate they are charged by the lessor.

The rate the lessor charges the lessee could be based on the implicit rate of the lease (i.e., the discount rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to be equal to the fair value of the underlying asset), the lessee's incremental borrowing rate or for leases of property, the yield on the property. The lessee's incremental borrowing rate would be the rate of interest that the lessee would have to pay to borrow over a similar term (i.e., the lease term), and with a similar security, the funds necessary to purchase a similar underlying asset.

The Boards agreed to provide application guidance for determining the yield on property and whether to use a rate that reflects a parent's or subsidiary's incremental borrowing rate.

### **Initial recognition and measurement**

For all leases recognised on the balance sheet, lessees would recognise a liability for the obligation to make lease payments (the liability to make lease payments) and an asset representing the right to use the leased item for the lease term (the right-of-use asset). The amounts recognised for leases would initially be measured and recognised as of the commencement date of the lease.

The liability to make lease payments would be measured based on the present value of the lease payments to be made over the lease term. Lessees would use the key concepts described previously to determine the lease term, lease payments and discount rate.

The right-of-use asset would be measured initially at cost and would include the amount of the liability to make lease payments plus any initial direct costs incurred by the lessee. Initial direct costs are direct and incremental to the lease transaction (e.g., commissions, legal fees).

### **Subsequent measurement**

#### **Amortised cost approach**

After the date of commencement of the lease, the lessee would:

- ▶ Amortise the right-of-use asset on a systematic basis that reflects the pattern of consumption of the expected future economic benefits (generally straight-line), if the lessee measures the right-of-use asset at amortised cost
- ▶ Recognise interest expense using the interest method (i.e., a level effective rate throughout the lease term)
- ▶ Reduce the liability for lease payments made

The amortisation period for most right-of-use assets would be the shorter of the lease term or the life of the underlying asset. However, if title transfers at the end of the lease term or the lessee has a significant economic incentive to exercise a purchase option, the amortisation period would be the remaining life of the underlying asset.

The subsequent measurement of the recognised lease-related assets and liabilities would be generally consistent with the subsequent measurement approach for today's finance leases.

While the Boards have not yet redeliberated presentation matters, the exposure draft required that amortisation expense and interest expense be presented separately from other amortisation and interest expense, either in profit or loss or in the notes.

### Illustration 6 – Amortised cost approach

A company enters into a three-year lease of office space and agrees to pay the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. The initial measurement of the right-of-use asset and liability to make lease payments is CU33,000 using a discount rate of approximately 4.25%.

At lease commencement the lessee would recognise the lease-related asset and liability:

Right-of-use asset	CU 33,000	
Liability to make lease payments		CU 33,000
<i>To initially recognise the lease-related asset and liability</i>		

The following journal entries would be recorded in the first year:

Interest expense	CU 1,398	
Liability to make lease payments		CU 1,398
<i>To record interest on the liability to make lease payments using the interest method (CU33,000 X 4.25%)</i>		
Amortisation expense	CU 11,000	
Right-of-use asset		CU 11,000
<i>To record amortisation of the right-of-use asset (CU33,000/3 years)</i>		
Liability to make lease payments	CU 10,000	
Cash		CU 10,000
<i>To recognise cash paid</i>		

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash payments		CU 10,000	CU 12,000	CU 14,000
<b>Lease expense recognised</b>				
Interest expense		CU 1,398	CU 1,033	CU 569
Amortisation expense		11,000	11,000	11,000
Total lease expense		CU 12,398	CU 12,033	CU 11,569
<b>Balance sheet</b>				
Right-of-use asset	CU 33,000	CU 22,000	CU 11,000	–
Liability to make lease payments	CU (33,000)	CU (24,398)	CU (13,431)	–

Because of the consistent interest rate and decreasing liability over the lease term, lessees 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. This expense recognition pattern is consistent with the treatment of finance leases under current lease accounting, but would accelerate lease expense for current operating leases.

Some constituents provided feedback to the Boards that the accelerated recognition of expense does not reflect the underlying economics of many lease contracts and instead recommended a straight-line lease expense pattern. The Boards were unable to develop an approach to achieve straight-line expense recognition that was consistent with other aspects of their proposed model.

## Reassessment represents a significant change from current accounting.

### Revaluation of the right-of-use asset

A lessee may measure a right-of-use asset at its fair value at the date of revaluation less any amortisation and impairment losses arising after the date of revaluation, provided that the lessee's policy is to revalue all owned assets in a class of property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment*. Revaluation gains or losses are recognised in the statement of comprehensive income.

### Reassessment

Lessees would be required to reassess certain key considerations throughout the life of the lease. Reassessment requirements vary. These requirements are summarised in the table below. Once a fact pattern requires a reassessment, the lessee would determine the revised inputs and remeasure the liability to make lease payments as

of the reassessment date. The lessee would adjust the liability to make lease payments to reflect the change in the calculation with the offset to either the right-of-use asset or net income.

Having to reassess key considerations represents a significant change from current standards. Under today's accounting, lessees do not have to actively monitor many of these considerations, and they adjust the accounting for many of these items (e.g., lease term) only when leases are modified. Some respondents to the exposure draft said that the cost of reassessing could exceed the benefit. As part of their redeliberations, the Boards indicated that the changes they made to the lease term used for accounting purposes and the accounting for contingent rents should reduce the cost to reassess.

Consideration	Indicator to reassess	Accounting treatment
Lease term and purchase options	A significant change in factors (except market factors) relevant to determining whether a significant economic incentive exists	Adjust right-of-use asset
Discount rate	Change in lease payments due to a change in lease term	Adjust right-of-use asset
Residual value guarantees	Events or circumstances indicate that there has been a significant change in the amounts expected to be payable	Amounts relating to current or prior periods – net income Amounts relating to future periods – adjust right-of-use asset
Lease payments that depend on an index or rate	Not yet redeliberated	Not yet redeliberated

### Illustration 7 – Reassessment

A lessee enters into a lease that has a five-year non-cancellable initial lease term. The lease includes a five-year renewal option and requires the lessee to make a CU10,000 penalty payment if the renewal option is not exercised. Upon initial measurement (i.e., the lease commencement date), the lessee determines that a significant economic incentive does not exist because the CU10,000 is not significant relative to the overall economics of the transaction and no other factors create an economic incentive. Therefore, the lessee determines that the lease term for accounting purposes is five years, determines the discount rate using a five-year term and includes the CU10,000 penalty payment along with other fixed lease payments in the liability to make lease payment calculation.

At the beginning of year four (i.e., a remaining lease term of two years), the lessee installs significant leasehold improvements that have a useful life of seven years. As part of the reassessment process, the lessee determines there is now a significant economic incentive to exercise the five-year renewal option. To update the liability to make lease payments, the lessee performs the following:

- ▶ Updates the lease term to include the expected exercise of the renewal option (the remaining lease term will now be seven years)
- ▶ Includes as lease payments the fixed lease payments from the remainder of the initial term (i.e., years four and five) and the renewal period (i.e., years six through 10)
- ▶ Removes the CU10,000 penalty payment as a lease payment
- ▶ Reassesses the discount rate (i.e., determines the discount rate at the reassessment date assuming a seven year term)
- ▶ Remeasures the liability to make lease payments using the revised lease payments and discount rate
- ▶ Adjusts the liability to make lease payments to the remeasured amount and recognises the change as an adjustment to the right-of-use asset

Although market factors (e.g., the market rentals, fair value of the underlying asset) would be considered when initially determining whether a significant economic incentive exists, they would not be considered when reassessing the lease term. The Boards made this decision to address concerns that including market factors could make reassessment impractical or onerous (e.g., may require entities to obtain pricing information that may not be readily available). However, it remains to be seen how entities would be able to determine whether a significant economic incentive exists upon reassessment without considering market factors such as current market pricing for similar assets.

#### How we see it

Companies would need to develop processes and related controls to reassess key considerations, including how changes in facts and circumstances affect their assessment of economic incentives and amounts payable under residual value guarantees. We believe this would be a subjective process.

#### Contract changes or changes in circumstances

Substantive contract modifications would be accounted for as new contracts. The standard would include application guidance on assessing whether a change to a contract is substantive. In addition, a change in circumstances other than a modification to the terms of the contract that would affect the assessment of whether a contract is or contains a lease would result in a reassessment of the applicability of the definition of a lease. For example, if a change in circumstances results in a supplier's substitution right no longer being substantive, the customer (i.e., potential lessee) would need to assess if the arrangement would be a lease.

## Other measurement issues

### Impairment

Right-of-use assets would be subject to IAS 36 *Impairment of Assets*. IAS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset and to determine if the recoverable amount is less than the asset's carrying amount to recognise an impairment loss. If it is not possible to estimate the recoverable amount of the individual asset, an entity determines the recoverable amount of the cash-generating unit to which the asset belongs. After an impairment loss is recognised, the adjusted carrying amount of the right-of-use asset would be its new accounting basis.

After an impairment loss is recognised, subsequent reversal of a previously recognised impairment loss is required if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined, after depreciation or amortisation, had there been no impairment.

Lessees currently apply the same impairment analysis to assets held under finance leases. This analysis would be new for leases currently accounted for as operating leases and could significantly affect the timing of expense recognition.

### Foreign exchange

For leases denominated in a foreign currency, lessees would apply IAS 21 *The Effects of Changes in Foreign Exchange Rates* (i.e., remeasure monetary items using the exchange rate at each reporting date). Therefore, any change in the liability to make lease payments due to exchange rate changes would be reflected in net income. The right-of-use asset would be a non-monetary asset measured at historical cost and would not be remeasured to reflect changes in foreign exchange rates.

### Lease incentives

A new lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving

expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party. A lessee would deduct all lease incentives from the initial measurement of the right-of-use asset. However, a lessee would not adjust the lease obligation. This accounting would result in lease incentives being recognised as a reduction in amortisation expense over the term of the lease.

The recognition of lease incentives as a reduction of expense over the term of the lease is consistent with current operating lease accounting. But the balance sheet presentation is different because under the revised proposal the incentive would reduce the right-of-use asset (i.e., it represents a reduction in the cost of the right-of-use asset) instead of being recognised as a liability.

### Illustration 8 – Lease incentives

A company enters into a three-year lease of office space and agrees to pay the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three (the same facts as in illustration 6). The initial measurement of the liability to make lease payments is CU33,000 using a discount rate of approximately 4.25%. The lessor also agrees to reimburse the lessee for up to CU3,000 of moving costs. The company actually incurs CU3,500 of moving costs.

The lessee records the following entries:

Right-of-use asset	CU 33,000	
Liability to make lease payments		CU 33,000
<i>To initially recognise the lease-related asset and liability</i>		
Moving expenses	CU 3,500	
Cash		CU 3,500
<i>To recognise moving costs incurred</i>		
Cash	CU 3,000	
Right-of-use asset		CU 3,000
<i>To recognise reimbursement from lessor (lease incentive)</i>		

Interest expense through the lease term would be the same as in Illustration 6 because the liability to make lease payments did not change. Amortisation expense would be CU1,000 less per year. The summary of the lease contract's accounting including the lease incentive (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash payments		CU 10,000	CU 12,000	CU 14,000
<b>Lease expense recognised</b>				
Interest expense		CU 1,398	CU 1,033	CU 569
Amortisation expense		10,000	10,000	10,000
Rent expense		CU 11,398	CU 11,033	CU 10,569
<b>Balance sheet</b>				
Right-of-use asset	CU 30,000	CU 20,000	CU 10,000	–
Liability to make lease payments	CU (33,000)	CU (24,398)	CU (13,431)	–

Sale-leaseback transactions would no longer provide off-balance sheet financing.

## Other

### Sale and leasebacks

Sale-leaseback transactions would no longer provide off-balance sheet financing as all leases (other than short-term leases) would be recognised on the balance sheet under the revised proposal. The determination of whether sale-leaseback transactions are accounted for as a sale and a lease, or as a financing transaction, would be based on control criteria developed in the joint revenue recognition project. That is, no special criteria would exist for assessing sale-leaseback transactions.

If the consideration exchanged (i.e., sales price for the sale of the asset and rental rate for the lease) is at fair value, the seller-lessee would recognise a gain or loss when the sale occurs on a sale transaction that qualifies as a sale-leaseback. When the consideration is not at fair value, the assets, liabilities, gain or loss would be adjusted to reflect current market rentals. Under current accounting, the seller-lessee may be required to defer and amortise some or all of the profit or loss on a sale based on the specific terms of the particular transaction.

A transaction that does not meet the sale criteria would be accounted for as a financing transaction by the seller-lessee.

#### How we see it

The Boards' decision to use revenue recognition concepts for sale-leaseback transactions represents a change from existing IFRS for sale-leaseback transactions. Currently, IAS 17 focuses on whether the leaseback is an operating or a finance lease, and does not require the seller-lessee to determine whether the sale-leaseback transaction meets the conditions for a sale of the asset. It is not yet clear how features in the lease (e.g., purchase options) would affect the sale evaluation.

### Subleases

In a sublease arrangement one party will act as both the lessor and lessee of the same asset. That is, one party will obtain the right to use the underlying asset under the head lease, and it will act as the lessor in the sublease under which it conveys the right to use the underlying asset to a different party for the same or a shorter term. The head lease and sublease arrangements would be accounted for as separate transactions and unique measurement criteria for subleases would not exist. The lessee accounting model would be applied to the assets and liabilities that arise in the head lease, and the lessor accounting model would be applied to the assets and liabilities that arise in the sublease. Sublease accounting and the financial statement effect of subleases would be affected by whatever decisions the Boards reach on the revised lessor accounting model.

### Lessor accounting

While some of the decisions related to key concepts (e.g., lease term, lease payments) and the definition of a lease would apply to both lessee and lessor accounting, the Boards decided to address key issues other than lessor accounting before dealing with the lessor accounting model.

Under the model proposed in the exposure draft, lessors would be required to recognise an asset representing their right to receive lease payments from the lessee. Depending on the nature of the lease, either a portion of the leased asset would be derecognised or a lease liability (performance obligation) would be recognised.

The Boards have begun redeliberating lessor accounting and have noted that they intend to make significant changes to the model proposed in the exposure draft, but they have not made any formal decisions. After reaching decisions on the overall approach to lessor accounting, the Boards are expected to address other lessor-specific topics, such as accounting by the buyer-lessor in sale-leaseback transactions, accounting for lease incentives and impairment of the right to receive lease payments.

The Boards are expected to make significant changes to the lessor accounting model they proposed in the exposure draft.

## Other matters to be addressed in redeliberations

The Boards still need to address the following items:

- ▶ **Leasehold improvements** – The exposure draft did not address leasehold improvements. Currently, entities must make significant judgements to determine whether leasehold improvements fully or partially funded by the lessor are the lessee's or lessor's fixed asset.
- ▶ **Presentation and disclosure** – Significant aspects of presentation (e.g., statement of cash flows) as well as disclosure matters have yet to be redeliberated.
- ▶ **Transition** – In the exposure draft, the Boards proposed requiring a simplified retrospective approach with no grandfathering provisions. Several transition issues (e.g., sale-leasebacks) were not addressed in the exposure draft.

These topics and other topics are expected to be discussed in the coming months.

## Next steps

- ▶ While the Boards still need to decide whether to re-expose a revised proposal, the Boards have indicated that, at a minimum, they will make an updated draft of the proposed standard available on their websites for constituents to review and provide feedback on.
- ▶ While the Boards' recent decisions eliminate some of the significant changes that would have resulted from the proposals in the exposure draft, a new leases standard would require significant accounting and related process changes for many entities. Entities should carefully review the standard when issued and begin preparing for implementation.

## Appendix: Summary of significant changes since the exposure draft

	Exposure Draft	Redeliberations	Effect
<b>Lease term definition</b>	Longest possible lease term that is more likely than not to occur (i.e., greater than 50% probability)	Non-cancellable period plus any options where there is a significant economic incentive to extend or not terminate the lease	Typically shortens the lease term and reduces amounts recognised on the balance sheet
<b>Contingent rent based on performance or usage</b>	Include contingent rent based on performance or usage in lease-related assets and liabilities using an expected outcome technique	Contingent rent based on performance or usage recognised as expense as incurred	Reduces amounts recognised on the balance sheet; affects timing of expense recognition
<b>Short-term leases – lessees</b>	Recognise on balance sheet without discounting	Accounting policy to apply current operating lease accounting	Reduces amounts recognised on the balance sheet
<b>Right to control the use of a specified asset</b>	Based on meeting any one of three conditions; consistent with current IFRS	Based on ability to direct the use and receive the benefit from use of a specified asset	Changes could scope out certain contracts that are accounted for as leases today
<b>Purchase options</b>	Not included in amounts recognised because: <ul style="list-style-type: none"> <li>▶ Arrangements with bargain purchase options excluded from lease standard</li> <li>▶ Other purchase options accounted for only when exercised</li> </ul>	If the lessee has a significant economic incentive to exercise the option: <ul style="list-style-type: none"> <li>▶ Include exercise price in the measurement of the lease liability or receivable</li> <li>▶ Amortise the right of use asset over the economic life of the underlying asset</li> </ul> Other purchase options accounted for when exercised	Provides for consistent treatment of purchase options and lease renewal options  No change for purchase options that the lessee does not have a significant economic incentive to exercise
<b>Scope</b>	Excluded in-substance purchase/sales from leases scope	No in-substance purchase/sale exclusion	Change aligns with current IFRS
<b>Separation of lease and non-lease components</b>	Separate services, if distinct. If not distinct, lessees and lessors applying the performance obligation approach account for the entire contract as a lease. Accounting treatment for executory costs unclear.	Separate all non-lease components (including services and executory costs) subject to limited circumstances in which the lessee is unable to determine the allocation	More non-lease components would likely be accounted for separately; reduces amounts recognised on the balance sheet

	<b>Exposure Draft</b>	<b>Redeliberations</b>	<b>Effect</b>
<b>Initial measurement date</b>	Date of inception of the lease	Date of commencement of the lease	Discount rate is determined as of the commencement date instead of inception date
<b>Discount rate</b>	Rate can be determined using multiple alternatives	The rate implicit in the lease is used when available	Removed some subjectivity for lessor's rate; lessee frequently will not know the rate the lessor charges the lessee
<b>Sale-leasebacks</b>	Restrictive criteria required to be met to recognise a sale	Sale treatment based on revenue recognition concepts in the joint revenue project	Sale treatment achieved more frequently
<b>Lease incentives</b>	Not addressed	Reduce the right-of-use asset	Clarified accounting treatment



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