

IFRS practical matters for the C-suite

What do the proposed lease accounting changes mean for you?



The *World Leasing Yearbook 2010* estimates that leasing activity in 2008 amounted to US\$640 billion,¹ with the vast majority of lease obligations not recognised on any balance sheet. On 17 August 2010, the IASB and FASB released a joint exposure draft that would dramatically change lease accounting for both lessees and lessors by requiring balance sheet recognition of all leases. Although the effective date of a final standard is likely several years away, companies should begin to prepare for the resulting impacts on their financial metrics, debt structuring, business processes and information management.

Here's a snapshot of how most lessees would be affected by the proposal:

- ▶ All leases would appear on the balance sheet, eliminating the distinction between operating and finance leases
- ▶ Assets and liabilities would be grossed up
- ▶ Lease liabilities would be re-evaluated at each reporting date when indications of significant changes exist, likely requiring substantial changes to internal controls and information systems
- ▶ Leverage ratios and capital ratios would deteriorate
- ▶ Timing of expense recognition would accelerate and expense would be recharacterised as interest expense and amortisation instead of rent
- ▶ Earnings before interest, taxes, depreciation and amortisation (EBITDA) would be more favourable
- ▶ Cash flows from operating activities, as presented in the statement of cash flows, would be more favourable
- ▶ Tax issues could arise

Why leases?

The IASB and FASB (the Boards) are actively working together on a number of high profile projects with the overall objectives of both improving existing accounting standards and bringing greater convergence between IFRS and US GAAP. The number of projects on the Boards' agendas is unprecedented, signalling that major changes in financial reporting are likely within the next few years. Leasing is one of the more prominent projects and one that may affect a broad range of companies – those that lease large individual assets like real estate and aircraft, as well as those that enter numerous smaller leases for items like office equipment.

Improving lease accounting has been a long-time goal of both the IASB and the FASB. The major criticism of the existing lease standards is that lessees do not recognise all lease obligations on their balance sheets, based on what some consider to be arbitrary distinctions between operating and finance leases. The Boards are addressing this criticism in their leasing project.

¹ International Accounting Standards Board, *Snapshot: Leases*, August 2010



When?

The Boards issued a Discussion Paper, *Leases: Preliminary Views* in March 2009, and issued an Exposure Draft (ED) on 17 August 2010. A final standard is expected in 2011. The Boards are still deliberating the effective date of the lease standard, but it is expected to be 2013 or later.

In view of the multiple projects underway that are all scheduled to be completed in mid to late 2011, the IASB is considering different effective date options. One possibility is a collective 'big bang' effective date for all the new standards on the same date, or possibly staggered effective dates over a period of several years.

Regardless of the effective date ultimately chosen, the Boards have tentatively decided that existing lease arrangements

would not be grandfathered. This means that all existing leases as of the date of initial application would need to be assessed under the new standard, not just those entered into prospectively. The date of initial application is the beginning of the first comparative period presented in the first financial statements in which the proposal would be applied.

The Boards are aware of the large burden on companies and the volume of change presented by so many concurrent new standards; to this end the Boards are seeking comments on the proposed effective dates. The lease standard alone presents more than accounting issues – it presents many systems and business concerns as well. Companies that begin to address these questions early will be in the best position to successfully migrate to the new lease standard.

What is the proposed new lease accounting model for lessees?

The basic elements of the IASB's proposed lessee model are:

- ▶ Lessees would record an intangible asset for the right to use the leased item and a liability for the obligation to make lease payments (lease liability) – under the 'right-of-use model'. The 'risks and rewards' model developed decades ago would be eliminated.
- ▶ The initial lease liability would be measured based on estimates of the lease term, contingent rentals, term option penalties and residual value guarantees, using the lessee's incremental borrowing rate to discount future payments to present value.
- ▶ Lessees would reassess these estimates at each reporting date. Changes to the estimated lease term would adjust the related right-of-use asset and lease liability; changes due to contingent rentals and expected payments under term option penalties and residual value guarantees would be reflected in profit or loss if they relate to past or current periods, and to the right-of-use asset if they relate to future periods, with a corresponding adjustment to the lease liability.
- ▶ The right-of-use asset would be amortised over the shorter of its useful life or the lease term. A lessee may revalue a right-of-use-asset in accordance with IAS 16 *Property, Plant and Equipment*. In addition, the right-of-use asset would be assessed for indicators of impairment at the end of each reporting period.
- ▶ Lease payments would be allocated between interest expense and a reduction of the lease liability using the effective interest method, rather than be recognised as rental expense under the straight-line method.



To illustrate the proposed lessee model, consider the following simple example:

Assumptions		Balance sheet analysis			
Annual lease payment (assumes no contingent rentals, residual value guarantee or term option penalties):	CU6,000	A 'right-of-use asset' of CU15,000 and a corresponding 'lease liability' would be recognised on lease commencement.			
Term of lease:	3 years				
PV of lease payments based on incremental borrowing rate:	CU15,000				
Expense analysis					
	Year 1 CU	Year 2 CU	Year 3 CU	Total CU	
Amortisation of right-of-use asset (PV/3)	5,000	5,000	5,000	15,000	
Interest expense	1,500	900	600	3,000	
Proposed expense	6,500	5,900	5,600	18,000	
Current IFRS expense	6,000	6,000	6,000	18,000	

What about lessors?

The ED excludes from its scope leases of investment property measured at fair value in accordance with IAS 40 *Investment Property*. For lessors recording their investment property at cost, the ED proposes two models, each to be used in different circumstances depending on the terms of the lease and their effect on the lessor.

Performance obligation approach – this approach would be used when the lessor retains exposure to significant risks or benefits associated with the leased asset (the ED provides criteria to consider in making that assessment). This approach provides for essentially symmetrical accounting treatment to that of the lessee. Using the same facts as in the previous example, the lessor would recognise a right to receive lease payments (lease receivable) of CU15,000 and a corresponding lease liability of the same amount on the balance sheet. This lease liability is the lessor's

obligation to permit the lessee to use the underlying asset over the lease term. [Note: This is a simplified example for illustration only. Similar to lessees, lessors would be required to make estimates and apply judgement upon adoption of the proposed standard, and at each reporting period. The lessor's estimates may not be the same as the lessee's in arriving at the amount to recognise].

The lessor would continue to recognise the leased asset and related depreciation expense. In addition, it would amortise its lease liability and amortise revenue over the lease term. Lease payments received would be allocated between interest income and a reduction of the lease receivable using the effective interest method.

In the example above, the total net effect of this accounting may not be substantially different from existing accounting by lessors for operating leases.

Derecognition approach – this approach would be used when the lessor is not exposed to significant risks or benefits associated with the leased asset. Under this approach, the lessor essentially 'sells' a portion of the leased asset and recognises a net profit (or loss) at lease commencement equal to the difference between the present value of the lease payments and the carrying amount of the portion of the leased asset that is derecognised. Over the lease term, the lessor also recognises interest income using the effective interest method.

Under the proposed model, a lessor would record two assets – a financial asset for the lease receivable and a non-financial asset for the residual asset. Under the current approach for accounting for a finance lease, the lessor records one financial asset – the net investment in the lease (lease receivable), which consists of the present value of the lease payments and the unguaranteed residual value of the leased asset.



To illustrate the proposed lessor derecognition model, consider the following simple example in which the lessor has determined that it does not retain exposure to significant risks or benefits associated with the leased asset and should apply the derecognition approach:

Assumptions				
Leased asset carrying amount:	CU12,000			
Annual lease payment (assumes no contingent rentals, residual value guarantee or term option penalties):	CU6,000			
Term of lease:	3 years			
PV of lease payments based on rate lessor is charging the lessee:	CU15,000			
Leased asset fair value:	CU16,500			
The lessor would determine the amount of the leased asset to be derecognised and the initial carrying amount of the residual asset as follows:				
		Fair value of the right to receive lease payments (CU15,000)		
Carrying amount of the leased asset (CU12,000)	X			
		Fair value of the leased asset (CU16,500)		
Net income analysis				
	Year 1 CU	Year 2 CU	Year 3 CU	Total CU
Revenue	15,000	0	0	15,000
Cost of sales	(10,900)	0	0	(10,900)
Interest income	1,500	900	600	3,000
Proposed profit	5,600	900	600	7,100

The amount of the asset to be derecognised would be CU10,900 and the remaining CU1,100 of the carrying amount would be allocated to the residual asset.

Balance sheet analysis

At lease commencement, the lessor would recognise a 'lease receivable' asset of CU15,000 and corresponding 'revenue'. In addition, the lessor would remove the leased asset from its books and recognise 'cost of sales' of CU10,900 and a 'residual asset' of CU1,100. Revenue recognised (CU15,000) in excess of the carrying amount of the portion of the asset derecognised (CU10,900) would be profit (CU4,100) that would be recognised at commencement of the lease.



How would the company's business be affected?

Based on even the short accounting summary outlined above, both lessors and lessees can begin to see the pervasive impact the proposed lease accounting model would have on their operations – effects that go well beyond just accounting. Some of these are discussed below:

Financial statement metrics

The most obvious change to a lessee's financial statements is the growth in the balance sheet that would result from recognising both an asset and a liability for all lease transactions previously accounted for as operating leases. As a result, several key leverage and capital ratios may deteriorate even though cash flow and business activity would not have changed.

In addition, the lessee's income statement would be affected because expense recognition on leases previously accounted for as operating leases would be front-end loaded. More specifically, today's straight-line recognition of rental expense would be replaced by the effective interest method's accelerated recognition of interest expense, together with amortisation of the right-of-use asset.

Interest coverage ratios would suffer, but measures such as EBIT or EBITDA would improve. Due to the need to reassess the lease liability measurement assumptions each reporting period, these metrics also may be more volatile than in the past. Operating cash flows would also improve under the proposed model as cash payments for leases would be classified as financing activities rather than operating activities in the statement of cash flows. Under the current standard, cash payments by a lessee for operating leases are classified as operating activities.

For lessors, income on leases previously accounted for as operating leases would also be front-end loaded under the proposal as compared to existing accounting requirements, and the lessor's balance

sheet would also grow for leases under the performance obligation approach. As a result, lessor ratios and metrics would also change.

For leases accounted for as finance leases under existing accounting requirements, the effect of the proposal on the income statement for both lessees and lessors compared to existing accounting requirements would vary depending on the specific attributes of the lease.

The change to financial metrics could affect loan covenants, financing agreements and regulatory requirements. Companies that base bonuses, share-based payment vesting provisions and other compensation plans on such measures may need to reassess the arrangements and whether they would continue to provide an appropriate performance measure.

The extent of impact on an individual company would of course vary depending on the extent of a company's lease transactions, how the leases were previously accounted for (operating versus finance) and factors such as length of lease term and other specific lease provisions. Performing an impact assessment early on, even at a high level, would enable a company to analyse the potential effects of the proposal so that meaningful communication with stakeholders can take place as needed.

Data gathering

As previously mentioned, the present proposal would require that the new standard be applied to all existing leases as of the date of initial application. This means that if a company was required to first apply the proposed standard in its fiscal year ended 31 December 2013 and three years of comparative financial statements were presented, leases outstanding as of 1 January 2011 would fall within its scope.

To ensure that adoption of the proposal would be complete, a company would need to gather data on all of its leases, and

review key provisions such as lease term (including possible extensions), contingent rentals, guarantees and term option penalties. Under the lessor derecognition model, the fair value of the leased asset would also be required. The resources involved could be substantial, especially considering that many of the leases may have been entered into years ago and at numerous decentralised locations. Beginning to accumulate the necessary data early would help avoid the costly need to retrieve and recreate necessary data at a time when adoption of numerous new standards may be occurring simultaneously. Companies would also be well advised to begin to accumulate, on a real-time basis, the data required by the proposed standard for all newly entered leases.

In addition, although the criteria for determining what is or is not a lease would not change, that determination would take on increased importance for many arrangements. Because the current accounting for operating leases and service contracts is often similar, determining whether a service arrangement contains an operating lease generally does not result in significantly different accounting for the arrangement today. However, that would change under the ED, which would require on-balance sheet accounting for all leases.

Processes and internal controls

For many companies, accounting for most leases may have been relatively straightforward, mainly resulting in the recognition of monthly rental expense for lessees and rental income for lessors. Under the proposal, not only would management estimates be required to initially record the lease, but an ongoing assessment of key measurement assumptions would also be necessary each reporting period. In contrast, under present standards, a company generally need not revisit its original assumptions and estimates after its initial accounting has been determined.



The measurement assumptions under the proposal can be complex and require senior-level judgement beyond just the accounting department.

Because the assumptions call for estimates of expected lease term and future contingent rentals, an in-depth knowledge of the business and the intended use of the leased asset is essential. Accordingly, a company would need to establish accounting policies and design processes and internal controls to make certain that input from operational and financial management is sought, analysed, documented and processed.

Information technology (IT) and systems

Due to the relatively basic accounting requirements that presently exist for operating leases, many companies today are able to use less sophisticated methods such as Excel spreadsheets or simple computer programs to keep track of their leases and associated rental expense or rental income. However, the proposal would add assets and liabilities to the balance sheet, require periodic revaluation and require a different income statement treatment. As a result, many companies would need a more refined system because current methods may not have sufficient depth to capture and manage all of the critical data needed to account for lease transactions under the proposed approach. While some companies may want to design their own IT systems to address the proposed requirements, others may decide to purchase or integrate lease systems that outside vendors will most likely develop as the lease proposal progresses to a final standard.

In any event, companies that are presently designing or upgrading IT financial reporting systems would be well advised to consider the lease proposal's future data requirements as part of their current IT development efforts. Timely assessment of the proposal's impact on IT systems could reduce the risk of costly re-work and redesign later down the road.

Lease structuring and modification

In order to mitigate the effect on balance sheets, the proposed lease model could affect the way companies negotiate and structure their lease arrangements. For instance, shorter lease terms or leases without renewal options would generally result in less of a gross-up of the balance sheet. However, companies would need to weigh the desire for a smaller balance sheet effect against the higher costs of lease renewals that would possibly result. For lessors, shorter lease terms would result in greater renewal risk and higher financing costs. In an effort to lessen the impact of adoption of the proposed rules, companies may also seek to modify existing leases. Still others may reassess their entire lease-versus-buy strategies.

At a minimum, companies entering into new leases today should at least be aware of the potential future impact of the proposal on their balance sheets. While companies should not make economic decisions based on accounting results, they should be aware of the accounting consequences of their decisions.

Tax issues

Lessors and lessees would need to analyse book/tax differences that would result from application of the lease proposal. In addition, as companies potentially modify existing lease arrangements to address the accounting treatment under the proposed new standard, the impact on existing tax treatments would need to be assessed and tax risks going forward would need to be appropriately managed. This would take on greater importance for a company with significant overseas operations involved in leasing activities.

Assessing tax treatments early would help companies reduce tax exposures and develop the most advantageous tax strategies possible.

What should companies do now?

As previously stated, a final standard is not expected to be effective for several years, and additional changes likely will arise between now and then as part of the Boards' normal deliberation process. While no one can predict with certainty the ultimate outcome of an accounting standard, most agree that the basic proposed change – recognising all leases on the balance sheet – is a likely result.

So while it may be too soon to do a 'deep dive' into the proposal, companies with substantial leasing activity – both lessees and lessors – would benefit from an initial assessment of the proposal's effect on their financial statements and operations. At the very least, companies should become knowledgeable of the proposal's requirements and consider them as they enter into any significant new lease transactions. Gaining a better understanding of the proposal will help companies plan for an orderly and efficient transition to the new standard in a way that reduces financial reporting, tax, operational and business risks.

For additional information on the proposal, see Ernst & Young's *Supplement to IFRS outlook Issue 79: Proposed accounting changes for leases*. We will be providing a more in-depth publication in September 2010 to assist entities in better understanding the proposed model.



Ernst & Young can bring its multi-disciplinary team of accounting, tax, systems and IT professionals to your company to assist in assessing what the new lease proposal means to you. In the chart below, we outline issues and steps the company should consider related to the lease proposal, and indicate how Ernst & Young can help you from initial assessment through to adoption.

Issues and steps	How Ernst & Young can help
Gain a general understanding of the proposal	<ul style="list-style-type: none"> ▶ Design and deliver a training session for company personnel ▶ Share insights of IASB, FASB and regulator views ▶ Provide input into the company's comment letter on the ED
Perform a preliminary assessment of the impact of the proposal on the company's financial statements	<p>Advise and provide input into:</p> <ul style="list-style-type: none"> ▶ Gathering necessary lease information to adopt the proposed standard ▶ Summarising lease terms ▶ Performing a high-level measurement of the right-of-use asset and related liability to make lease payments (for lessees)/lease receivable, lease liability, or residual asset (for lessors, depending on the approach followed) ▶ Assisting lessors in determining which accounting model applies to their leases ▶ Calculating the 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
Benchmark the company against peers and others in the industry	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching the proposal, 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 and IT systems	<ul style="list-style-type: none"> ▶ Provide observations and insights based on leading practices on ways the company could design its business processes, IT systems and internal controls ▶ Provide criteria to consider in selecting IT packages and assist in the selection process
Assess tax positions relating to lease proposal	<ul style="list-style-type: none"> ▶ Assist in analysing tax positions arising from adopting the new proposal, reducing tax exposure and determining tax effects of lease modifications
Plan for ultimate adoption of the proposed standard	<ul style="list-style-type: none"> ▶ Advise on project maintenance and planning, including timeline, tasks and resource allocation
Update accounting manuals and accounting policies	<ul style="list-style-type: none"> ▶ Read and provide input into accounting manuals and policies selected by management
Communicate effect of adoption to stakeholders—analysts, regulators and shareholders	<ul style="list-style-type: none"> ▶ Advise on developing a communication plan ▶ Advise on drafting communications

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