

## IFRS Practical Matters

Reintroducing lease classification would require lessee judgements that could affect the pattern of expense recognition.

# New accounting standard for lessees: Are we there yet?

The IASB and FASB (collectively, the Boards) have been working on their joint lease project for over six years, and recently completed their re-deliberations. While the Boards have taken numerous twists and turns on the road to completing the project, their intended destination has always remained the same – they are committed to putting leases on the balance sheet.

Early on, the Boards decided to eliminate the distinction between operating and finance leases. However, a June 2012 decision would reintroduce lease classification, but following new guidance.

Here's where things stand now for **lessees**:

- ▶ All leases would be recognised on the balance sheet except for short-term leases
- ▶ Leases generally would be classified based on an assessment of how much of the leased asset is consumed
- ▶ Lease classification would affect the pattern of expense recognition
- ▶ The proposal would change how lessees account for their leases resulting in likely changes to business operations, systems, processes and controls
- ▶ Substantial effort may be needed to gather the data required under the proposal

The Boards plan to issue a revised exposure draft for comment during the first quarter of 2013. Although the effective date is uncertain, we do not expect it to be before 1 January 2016.

## Summary of the proposal for lessees

The Boards have agreed on a 'right-of-use' model that would apply to all leases. Under this model, lessees would record a right-of-use asset and a lease liability on the balance sheet for each lease. The lease liability would be measured based on the present value of lease payments over the lease term using the discount rate at lease commencement. Lessees would then be required to assess how to classify each lease to determine the pattern for expense recognition.

- ▶ For leases in which the lessee acquires or consumes an insignificant portion of the leased asset (hereafter referred to as 'straight-line' leases), lessees would recognise lease expense on a straight-line basis.
- ▶ For leases in which the lessee acquires or consumes more than an insignificant portion of the leased asset (hereafter referred to as 'accelerated' leases), lessees would recognise interest and amortisation expense. Because interest expense would generally decrease over time, total expense would be front-loaded. This pattern is consistent with the treatment of finance leases under current lease accounting.

To simplify the assessment of lease classification, the Boards have proposed using a practical expedient based on the nature of the underlying asset. Under the practical expedient, property leases (i.e., land, a building, or part of a building) would be classified as straight-line leases unless the lease term is for a major part of the economic life of the underlying asset **or** the present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset. Leases of assets other than property (e.g., equipment) would

be classified as accelerated leases unless the lease term is an insignificant portion of the economic life of the underlying asset **or** the present value of fixed lease payments is insignificant relative to the fair value of the underlying asset.

While the Boards believe that most leases would be classified based on the nature of the underlying asset, lessees would still be required to evaluate the exception conditions for all leases.

### Short-term leases

For leases with a maximum possible term of 12 months or less (including any options to renew), lessees would be able to elect to apply current operating lease accounting.

### Transition

Lessees would be required to apply the final standard to all leases existing at the beginning of the earliest comparative period presented. For example, if the final standard is effective as of 1 January 2016 and two comparative financial statements are presented, leases existing as of 1 January 2015 would fall within the scope of the standard. However, lessees would not be required to remeasure existing finance leases.

Lessees would have the option to apply the full retrospective approach or a modified retrospective approach at transition. Under the full retrospective approach, lessees would apply the final standard from the lease commencement date.

In contrast, under the modified retrospective approach, lessees would apply the final standard from the beginning of the earliest comparative period presented (1 January 2015 in the above example) based on the lease payments over the remaining lease term using the discount rate as of the effective date of the standard.

## How would the proposal affect you as a lessee?

The proposal would result in fundamental challenges that go well beyond just accounting. Some of these are discussed below:

### Management judgements and estimates

The proposal would require companies to inventory and evaluate their arrangements to determine which ones are leases, whether there are non-lease components embedded in the lease, how the lease should be classified, what periods should be included in the lease term and what amounts should be included in lease payments. All of these decisions would directly impact the size of the lease-related asset and liability that would appear on the balance sheet as well as the amount, timing, and classification of expense recognised. Therefore, it is key for companies to consider the following issues:

### Which arrangements are leases?

Under the proposal, the definition of a lease (a contract in which the right to use a specified asset is conveyed for a period of time, in exchange for consideration) generally would be consistent with current lease accounting. However, the Boards have clarified that the right to use a specified asset is conveyed only if the customer has the ability to **both** direct the use of the asset and receive the benefit from its use. In many lease arrangements, both the lessee and lessor have some rights over the underlying asset. For example, an arrangement in which the customer specifies the quantity and timing of the delivery of goods but the vendor controls when and how the specified asset is used to produce or deliver those goods would not meet the definition of a lease under the proposal. Determining which party has the right to control the use of the underlying asset and receive the benefits from its use could be subjective.

In addition, because the current accounting for operating leases and service contracts is similar, determining whether an arrangement is a lease or a service contract has not been a focus for many companies. Going forward, this would change in light of the on-balance sheet treatment for lease arrangements.

***Does the lease contain any non-lease components?***

Up until now, many lessees may not have focused on separating non-lease components (i.e., services and executory costs such as insurance, maintenance, and taxes) from their operating leases because today's accounting treatment for such payments is often the same as the treatment for lease payments. Under the proposal, lessees would separate non-lease components from the lease when purchase prices for one or more of the components are observable. If non-lease components are not separated (i.e., because there are no observable purchase prices), they would be included in the calculation of the lease-related assets and liabilities. Separation of non-lease components would require judgement. Lessees may need support from lessors and may need to develop processes to identify observable purchase prices for the lease and non-lease components.

***What is the lease classification?***

As mentioned above, the Boards' recent decisions set forth criteria for lease classification that are different from current lease accounting. For lessees currently following US GAAP, bright-line tests would be eliminated. In practice, current IFRS is interpreted using similar thresholds to the bright-line tests in US GAAP.

While the Boards have provided a practical expedient to help simplify the determination of lease classification, the classification of some lease arrangements may not be straightforward. For example, it is not clear whether leases of certain assets, such as telecommunication towers or pipelines, could be treated as leases of property.

To assess the exception conditions included in the lease classification practical expedient, lessees would need to estimate the economic life and the fair value of the leased asset. This would be necessary to evaluate the degree of consumption. However, even after making these estimates, the determination of lease classification would not necessarily be straightforward for some leases. In a July 2012 webcast, the IASB and FASB staffs gave examples of a 30-year lease of commercial property for which the economic life was 40 years, and a 5-year lease of a time charter vessel for which the economic life was also 40 years. In both cases, the IASB and FASB staffs indicated the classification of the leases may not be clear. The Boards have not provided specific guidance on the exception conditions (i.e., the meaning of 'insignificant', 'major part' and 'substantially all'). These assessments could require considerable judgement, as well as processes and controls to make sure that arrangements are evaluated consistently.

***What periods should be included in the lease term?***

Under the proposal, the lease term would include the non-cancellable period plus optional periods for which there is a significant economic incentive for the lessee to extend (or not terminate) the lease. The proposed definition of lease term closely aligns with current lease accounting rather than that proposed in the August 2010 ED. Assessing whether a significant economic incentive exists would continue to require judgement and analysis.

In making their initial assessment, lessees would consider both market factors (such as market rental rates and fair value of the leased asset) and other factors (such as the existence and useful life of significant leasehold improvements, penalties for cancellation or non-renewal, or a sublease term that extends beyond the lease term of the head lease). Lessees may need to establish processes and policies to help maintain consistency in these estimates.

In addition, lessees would need to reassess the lease term on an ongoing basis (e.g., when there is a significant change in the 'economic incentive' evaluation). This is not required under current lease accounting. Because the proposal indicates that changes in market factors would not be considered when reassessing the lease term, this requirement could be particularly subjective.

***What amounts should be included in lease payments?***

Under the proposal, lease payments used to calculate the lease liability would include fixed payments, variable payments based on an index or rate such as CPI or LIBOR, and amounts expected to be payable under residual value guarantees. Termination penalties and purchase option payments may also have to be included. Variable rents based on performance or usage would be excluded from lease payments and recognised when they are incurred. Lessees would also need to reassess variable payments based on an index or rate at each reporting period.

### **Data collection and ongoing data management**

The judgements and estimates required to account for leases under the proposal would demand in-depth knowledge from accounting personnel, as well as people outside the accounting department including treasury, corporate real estate, business operations, legal, IT, and tax. Therefore, a cross-functional project team may be required to gather the data needed to initially record the lease, to perform the required periodic reassessments and assess the impact of lease modifications.

Companies would need to decide whether the full retrospective approach or the modified retrospective approach is preferable in their circumstances. The approach selected would determine whether companies would have to gather historical lease data (e.g., lease payments, amounts of non-lease components, discount rates, among others) as of the commencement of the lease or as of the beginning of the earliest comparative period presented.

Companies also would need to evaluate their existing lease processes to determine where lease information is maintained. Some companies may find that their existing lease data repository, if any, does not have all of the information required to facilitate the calculations and judgements required under the proposal. Transition could involve substantial effort, particularly for companies with complex leases, large portfolios of leases at decentralised locations, and leases in different languages.

### **Financial statements and metrics**

For most lease arrangements, the proposal would result in a gross-up of the balance sheet. This would cause a deterioration of debt ratios and return on assets as compared with current accounting. Certain regulatory ratios also may be impacted. Because the timing of expense recognition would accelerate and expense would be re-characterised as interest and amortisation expense for accelerated leases, financial metrics such as EBITDA and interest coverage ratios would be affected.

To prepare for the proposed changes, a company should assess the potential impact on its financial statements and metrics and evaluate how this may affect the way stakeholders view the company's financial performance. Some companies envisage a need to educate internal and external stakeholders on the financial statement repercussions of the proposal. Others plan to communicate key performance indicators under both current lease accounting and the final standard during the transition period.

In addition, companies should identify whether compensation and debt arrangements would need to be revised in light of the proposal. However, renegotiating these arrangements may not be simple. For instance, companies may need to negotiate with their creditors whether to revise debt agreements to allow for more headroom in the covenants, or to allow for the continued use of current lease accounting in the covenant calculations. While continued use of current lease accounting may seem like a good idea, it would require the continued maintenance of dual ledgers or complex calculations to support covenant ratio assessment.

To the extent lease and financial information is available from public sources, companies also may want to understand how their peers' financial metrics would be impacted.

### **Lease procurement and structuring**

Once lessees understand the potential impact of the proposal, they may want to consider the impact on their financial metrics as they negotiate new leases. This may drive some lessees to consider shorter lease terms or a higher proportion of variable rents. However, such terms will often expose the lessee to greater renewal risk and cost as lessors seek to be compensated by increasing lease payments or reducing lease incentives. To help separate non-lease components from lease payments, lessees may consider requesting lessors to separately price non-lease components as part of the lease negotiation process. A contractually stated price or a list price for a component may be, but is not presumed to be, the standalone price of that component.

Furthermore, because the proposed lease accounting model would differ significantly from current accounting, some lessees may reassess their entire 'lease versus buy' strategy, and consider whether buying the asset would be more advantageous.

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

### **IT systems, processes and controls**

For many companies today, lease arrangements are managed through a variety of spreadsheets. Some companies may use a lease management programme for their property leases. While these spreadsheets and programmes may have some of the data necessary to comply with the proposal, companies would need to evaluate the completeness and accuracy of the data, and would likely need additional information that is not required for current lease accounting. In addition, existing spreadsheets and programs would not be sufficient to handle the accounting requirements going forward.

Companies would need to understand whether existing systems can be modified or if new systems would be required to initially record their leases and to account for them moving forward. As part of implementing any IT system, it would be important to develop processes and controls for maintaining documentation of management's judgements and estimates.

Upon initial application, companies would be required to restate prior comparative reporting periods. Furthermore, companies may need to keep separate books for external reporting and tax purposes. This would increase IT requirements and may further complicate processes and controls.

Identifying, developing and implementing changes to IT systems are not easy, and the amount of time necessary would depend on the legacy systems in place. Companies that are currently designing or upgrading IT financial reporting systems should consider the proposal as part of their current IT development efforts. This could reduce the risk of costly re-work and re-design further down the road. Companies also should be mindful that although IT programs are useful in accumulating data and performing calculations required by the proposal, they are not a magic solution - no program can make the critical estimates or judgements required.

### **Tax considerations**

Adoption of the proposal would result in additional tax-related considerations. These include understanding the impact of the lease accounting changes on existing tax positions, initial adjustments to deferred taxes for leases recognised on the balance sheet, and tracking book/tax differences related to amortisation expense, rent deductions and interest deductions. The deferred tax accounting requirements would be significant. Companies would need to determine necessary changes to tax-related processes and controls required to identify and track tax adjustments.

### **What about lessors?**

The Boards tentatively decided that lessors would use the same classification criteria as lessees whereby lessors would apply a receivable and residual approach to accelerated leases and operating lease accounting to straight-line leases. In addition, lessors may make an accounting policy election to apply operating lease accounting to short-term leases.

For a further discussion of lessor accounting, see our *IFRS Practical Matters: Boards re-examine lessor accounting* (January 2013, EYG no. AU1397).



## So are we there yet?

Although timing of the final standard is uncertain, the basic principle of putting leases on the balance sheet is unlikely to change. So while we have not yet arrived at the final destination, we are getting close.

Preparing to adopt a new accounting standard of this magnitude presents a daunting challenge. We continue to believe that starting early is the best way to reduce the overall cost of implementation, and to avoid unwanted surprises and costly missteps. In that light, here are some actions you should begin to consider now:

- ▶ Review the revised exposure draft when published, submit a comment letter and monitor the Boards' deliberations
- ▶ Establish a project team to help identify when to begin and the level of effort necessary for transition to the final standard
- ▶ Determine training requirements for individuals responsible for lease accounting and related judgements
- ▶ Determine the population of lease arrangements that would be in scope
- ▶ Identify lease data to be accumulated based on the requirements of the proposal
- ▶ Establish a process for gathering and analysing lease data
- ▶ Understand the magnitude of the changes to your company's financial statements and leasing strategy as you negotiate new lease arrangements, or make changes to existing ones, and evaluate how this may affect the way stakeholders view your company's financial performance
- ▶ Consider requirements for maintaining multiple sets of lease data for comparative periods between current lease accounting and the proposal, as well as book/tax differences upon adoption
- ▶ Understand IT financial reporting system options - whether current vendors would provide upgrades to existing lease accounting software or whether new IT systems would be required

Ernst & Young can bring its multi-disciplinary teams of accounting, tax, and IT professionals to your company to assist in assessing what the proposal means to you. In the chart below, we outline issues and steps you should consider concerning the proposal, 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 proposal	<ul style="list-style-type: none"> <li>▶ Design and help deliver a training session for company personnel</li> <li>▶ Share insights of IASB, FASB, regulator views</li> <li>▶ Provide input into the company's comment letter on the revised exposure draft</li> </ul>
Perform a preliminary assessment of the impact of the proposal on the company's financial statements	<ul style="list-style-type: none"> <li>▶ Advise and provide input into:               <ul style="list-style-type: none"> <li>▶ Identifying all arrangements that would be in the scope of the proposal, including contracts that would be considered leases but are currently recognised as service contracts or vice versa</li> <li>▶ Gathering necessary lease information that would be required under the proposal</li> <li>▶ Summarising lease terms</li> <li>▶ Developing a process for managing the significant judgements and estimates that would be necessary to estimate lease term and lease payments, including reassessments</li> <li>▶ Assessing the lease classification, including estimates of the economic life and fair value of the leased asset</li> <li>▶ Calculating the right-of-use asset and related liability to make lease payments</li> <li>▶ Calculating the income statement impact of the proposal</li> <li>▶ Assessing the impact on key financial ratios and performance measures</li> <li>▶ Identifying shortfalls in available information that would be required under the proposal</li> </ul> </li> </ul>
Assess impact of the proposal on strategic business decisions	<ul style="list-style-type: none"> <li>▶ Advise and provide input into:               <ul style="list-style-type: none"> <li>▶ The impact on strategic business decisions and planned transactions (e.g., mergers, acquisitions, and new markets)</li> <li>▶ The impact on existing loan covenants and borrowing arrangements including the impact to arrangements currently being negotiated</li> <li>▶ The company's analysis of whether to continue to lease versus buy</li> <li>▶ The impact of changes to financial statement performance and related metrics on existing joint venture agreements, financial covenants, and compensation arrangements</li> </ul> </li> </ul>
Benchmark the company against peers and others in the industry	<ul style="list-style-type: none"> <li>▶ Provide observations of how others are approaching the proposal, problems they encountered and solutions developed</li> <li>▶ Assist in the evaluation of peers, competitors and industry disclosures and expected impact on their financial statements</li> </ul>
Assess processes for data collection, internal controls, IT systems	<ul style="list-style-type: none"> <li>▶ Provide observations and insights based on leading practices on ways the company could design its business processes, IT systems, and internal controls</li> <li>▶ Assess whether the current enterprise software and IT systems can support the new requirements</li> <li>▶ Identify criteria to consider in selecting IT packages, and advise in the selection process</li> </ul>
Assess tax positions relating to the proposal	<ul style="list-style-type: none"> <li>▶ Advise on analysing tax positions arising from the proposal, reducing tax exposure, and determining tax effects of lease modifications</li> </ul>
Plan for ultimate adoption of the final standard	<ul style="list-style-type: none"> <li>▶ Advise regarding project management and planning, including timeline, tasks, and resource allocation</li> </ul>
Update accounting manuals and accounting policies	<ul style="list-style-type: none"> <li>▶ Read and provide input into accounting manuals and policies selected by management</li> </ul>
Communicate effect of adoption to stakeholders: analysts, regulators and shareholders	<ul style="list-style-type: none"> <li>▶ Advise on developing a communication plan</li> <li>▶ Advise on drafting communications</li> </ul>

## More information

For a more complete technical discussion about the exposure draft and the latest proposed changes, refer to the following publications available at [www.ey.com/IFRS](http://www.ey.com/IFRS):

### [Publications that discuss the Boards' re-deliberations since the August 2010 exposure draft](#)

- ▶ *Applying IFRS: Leases project on the brink of re-exposure* (September 2012, EYG no. AU1267)
- ▶ *IFRS Practical Matters: Lease accounting proposals: simplified, but not simple* (August 2011, EYG no. AU0930)

### [Publications that discuss the Boards' August 2010 exposure draft](#)

- ▶ *Proposed accounting for leases* (November 2010, EYG no. AU0689)
- ▶ *IFRS Practical Matters: What do the proposed lease accounting changes mean for you?* (August 2010, EYG no. AU0610)

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## Ernst & Young

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