IFRS Practical Matters



The Boards have tentatively decided that lessors would have two approaches.

Boards re-examine lessor accounting

While most of the attention of the IASB and FASB's (collectively, the Boards) joint project on leases has been aimed at lessees, the project would also propose new accounting for lessors. The Boards' original joint Exposure Draft (ED) in August 2010 proposed two accounting approaches for lessors, each to be used depending on whether or not the lessor retained exposure to significant risks or benefits of the underlying asset – a determination that could be subjective. Consequently, many respondents to the original ED questioned why two approaches were needed.

Here's where things stand now for lessors:

- ► The Boards decided that lessors would have two approaches, but they differ significantly from those originally proposed
- ► Leases in which an insignificant portion of the economic life or fair value of the leased asset is consumed would follow operating lease accounting
- ► Short-term leases would be permitted to follow operating lease accounting as an accounting policy election
- ► All other leases would follow the receivable and residual approach
- ► For lessors required to apply the receivable and residual approach, the balance sheet and timing and classification of lease-related revenue could change
- Lessors may change their lease structure and strategies depending in part on how lessees would react to the proposed changes

Recently, the Boards completed their re-deliberations and plan to issue a revised ED 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 lessors

The Boards have agreed that lessors would be required to classify leases to determine which of two approaches to apply to the lease.

- For leases in which the lessee acquires or consumes an insignificant portion of the leased asset (hereafter referred to as 'straight-line' leases), lessors would apply operating lease accounting. But, unlike lessees that would be required to recognise a lease liability for straight-line leases, lessors would not recognise a receivable.
- For leases in which the lessee acquires or consumes more than an insignificant portion of the leased asset (hereafter referred to as 'accelerated' leases), lessors would apply the receivable and residual approach.

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 straightline 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, lessors would still be required to evaluate the exception conditions for all leases.

The receivable and residual approach

Under the receivable and residual approach, the lessor essentially 'sells' a portion of the leased asset and records a receivable. The portion of the leased asset that is not deemed 'sold' remains on the books as a residual asset. Lessors would recognise upfront profit or loss only on the portion of the leased asset that is 'sold'. Deferred profit on the residual asset would be part of the carrying value of the residual asset that would be derecognised upon sale or release of the underlying asset.

Here's how the receivable and residual approach would work:

- Lessors would record a receivable for the right to receive lease payments. This would be measured as the sum of the present value of the lease payments to be received over the lease term discounted using the rate the lessor charges the lessee and any initial direct costs.
- ► Lessors would remove a portion of the carrying value of the leased asset from their books. This 'sold' portion would be measured based on a ratio of the present value of lease payments to the fair value of the leased asset at lease commencement.
- ► Lessors would recognise profit or loss, at the lease commencement, for the difference between the present value of the lease payments and the portion of the leased asset 'sold'.
- ► The carrying value allocated to the leased asset not 'sold' would be reclassified as a residual asset consisting of two components: the gross residual and the deferred profit.
- Over the term of the lease, lessors would recognise interest income on the receivable and on the accretion of the gross residual to its estimated fair value at the end of the lease.

Short-term leases

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

Transition

Lessors 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 years of comparative financial statements are presented, leases existing as of 1 January 2015 would fall within the scope of the standard.

To date, the Boards specifically addressed the transition guidance only for leases that would be subject to the receivable and residual approach under the proposal. For such leases, lessors would not be required to remeasure leases currently accounted for as finance leases. For leases currently accounted for as operating leases, lessors would have the option to apply the full retrospective approach or a modified retrospective approach at transition.

Under the full retrospective approach, lessors would apply the final standard from the lease commencement date. In contrast, under the modified retrospective approach, lessors would apply the final standard from the beginning of the earliest comparative period presented (1 January 2015 in the above example). The lease receivable would be measured based on the present value of the lease payments to be received over the remaining lease term discounted using the rate the lessor charges the lessee at lease commencement. The residual asset would be measured using information available at the beginning of the earliest comparative period presented.

The Boards' have not yet specifically addressed lessor transition guidance for leases that would be subject to operating lease accounting under the proposal.



How would the proposal affect you as a lessor?

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, what amounts should be included in lease payments, what is the fair value of the leased asset at lease commencement and the estimated residual value at the end of the lease term. These decisions could affect the determination of whether to apply the receivable and residual approach or operating lease accounting, the measurement of amounts recognised on the balance sheet, as well as the amount and timing of income 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 lessor and lessee 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 generally does not result in significantly different accounting for the arrangements today. Going forward, this could change under the proposal.

Does the lease contain any non-lease components?

Up until now, many lessors may not have focused on separating executory costs such as insurance, maintenance and taxes from their operating lease income because today's accounting treatment for revenue from executory costs is often the same as the treatment for lease revenue. Under the proposal, lessors would be required to separate non-lease components (i.e., services and executory costs) from the lease by identifying the relative standalone selling prices for the lease and non-lease components. This would require judgement.

What is the lease classification?

As previously mentioned, the Boards' recent decisions set forth criteria for lease classification that are different from current lease accounting. For lessors 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, can be treated as leases of property.

To assess the conditions for exceptions that are included in the lease classification practical expedient, lessors 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 may 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, lessors 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 or penalties for cancellation or non-renewal). Lessors may need to establish processes and policies to help maintain consistency in these estimates.

In addition, lessors 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 should be included in lease payments?

Under the proposal, lease payments used to calculate the lease receivable would include fixed payments and variable payments based on an index or rate such as CPI or LIBOR. Termination penalties and purchase option payments would be included. Variable rents based on performance or usage would be excluded from lease payments and recognised when they are earned. Unlike lessees, lessors would not recognise amounts received under residual value guarantees until the end of the lease but would be considered in the impairment test of the residual asset during the lease period. Lessors would also need to reassess variable payments based on an index or rate at each reporting period.

What is the fair value of the leased asset at lease commencement and the estimated residual value at the end of the lease term?

Lessors would need to estimate the fair value of the leased asset at lease commencement as well as the residual value at the end of the lease term. These fair value estimates could have increased significance under the proposal for those leases that were accounted for as operating leases under current accounting, but that would be subject to the receivable and residual approach under the proposal. For such leases, these fair values are used primarily to determine lease classification under current lease accounting. Under the proposal, the fair

value of the leased asset at the beginning of the lease term would not only affect lease classification, but it would also affect the amount of profit (or loss) initially recorded. Additionally, the estimated residual value at the end of the lease term would affect the amount of interest income recognised over the term of the lease. Revised processes for arriving at these estimates may be required due to their increased significance.

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 business operations/sales, legal, IT, and tax. Therefore, a crossfunctional project team may be required to gather the data needed to initially record the lease, 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, fair value, among others) as of the commencement of the lease or as of the beginning of the earliest comparative period presented.

In particular, those companies applying operating lease accounting today that will have to apply the receivable and residual approach going forward, will need to assess the completeness and accuracy of their existing lease data repository. 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 those companies that currently apply operating lease accounting, but would be required to apply the receivable and residual approach, the timing of revenue recognition would change. Rather than rental income and depreciation expense, which are generally recognised on a straight-line basis, companies would recognise an upfront profit (or loss) and interest income, which generally would be accelerated over the lease term. On the balance sheet, the underlying leased asset would be derecognised, and a lease receivable and residual asset would be recognised.

Even for companies that currently apply finance lease accounting, the amount of profit initially recognised could be reduced because no profit would be recognised on the residual asset.

To prepare for these 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.

Lease structuring including market strategy

Lessors who employ leasing as a primary market strategy should understand how the proposal may affect their lessee-customers' behaviour. This would help lessors to negotiate lease arrangements that meet the needs of their customers. For example, certain lessees may desire shorter lease terms in the hope of minimising the financial statement impact. However, shorter leases could result in unpredictable revenue for lessors. In addition, lessees may request that lessors separately price non-lease components to help minimise their financial statement impact. However, lessors may not want to disclose this information. 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. Entities may also consider modifying their offerings in such a way that they do not contain lease components under the revised definition of a lease.

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

Regardless of how companies account for their leases today, changes to systems are likely to be necessary. The receivable and residual approach would significantly change the accounting requirements for accelerated leases that are classified as operating leases today, thereby requiring system changes. Even for companies that apply finance lease accounting today, IT systems would still need to accommodate differences in the calculation of profit initially recognised and financial statement presentation, as well as reassessment requirements.

Companies would need to understand whether existing systems can be modified or if new systems would be required to meet the new accounting, financial statement presentation, and disclosure requirements. 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 system 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 later down the road. Companies also should be mindful that although IT programs can help accumulate data and perform calculations required by the proposal, they are not a magic solution - no program can make the critical estimates or judgements required by the proposal.

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, and tracking book/tax differences. Companies would need to determine necessary changes to tax-related processes and controls required to identify and track tax adjustments.

What about lessees?

The Boards tentatively decided that all leases would be recognised on the balance sheet, with the exception of short-term leases. Similar to lessors, lessees generally would classify leases based on the nature of the leased asset. However, this lease classification would primarily affect the pattern of expense recognition. For straight-line leases, lessees would recognise lease expense on a straight-line basis; and for accelerated leases, lessees would recognise interest and amortisation expense, which results in an accelerated pattern of expense recognition.

For a further discussion of lessee accounting, see our IFRS Practical Matters: New accounting standard for lessees: Are we there yet? (January 2013, EYG no. AU1398)

What can you do now?

Although timing of the final standard is uncertain and the Boards may modify some aspects of their proposal, 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 ED 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 market 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	 Design and help deliver a training session for company personnel Share insights of IASB, FASB, regulator views Provide input into the company's comment letter on the revised ED
Perform a preliminary assessment of the impact of the proposal on the company's financial statements	 Advise and provide input into: 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 Gathering necessary lease information that would be required under the proposal Summarising lease terms Developing a process for managing the significant judgements and estimates that would be necessary to estimate lease term, lease payments, reassessments, the fair value of the leased asset at lease commencement, and the residual value at the end of the lease term Assessing the lease classification, including estimates of the economic life and fair value of the leased asset Calculating the lease receivable and residual asset Calculating the income statement impact of the proposal Assessing the impact on key financial ratios and performance measures Identifying shortfalls in available information that would be required under the proposal
Assess impact of the proposal on strategic business decisions	 Advise and provide input into: The company's decision to change the terms of its lease arrangements to meet the demands of customers-lessees in light of the changes to lessee accounting The impact on strategic business decisions and planned transactions (e.g., mergers, acquisitions and new markets) The impact of changes to financial statement performance and related metrics on existing joint venture agreements, financial covenants or compensation arrangements
Benchmark the company against peers and others in the industry	 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 their financial statements
Assess processes for data collection, internal controls, IT systems	 Provide observations and insights based on leading practices on ways the company could design its business processes, IT systems, and internal controls Assess whether the current enterprise software and IT systems can support the new requirements Identify criteria to consider in selecting IT packages, and advise in the selection process
Assess tax positions relating to the proposal	Advise on analysing tax positions arising from the proposal, reducing tax exposure, and determining tax effects of lease modifications
Plan for ultimate adoption of the final standard	 Advise regarding project management and planning, including timeline, tasks, and resource allocation
Update accounting manuals and accounting policies	Read and provide input into accounting manuals and policies selected by management
Communicate effect of adoption to stakeholders: analysts, regulators, and shareholders	 Advise on developing a communication plan Advise on drafting communications

More information

For a more complete technical discussion about the ED and the latest proposed changes, refer to the following publications available at www.ey.com/IFRS:

Publications that discuss the Boards' re-deliberations since the August 2010 ED

- 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 ED

- ▶ 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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