

IFRS Practical Matters



Lease accounting proposals – simplified, but not simple

While the Boards continue to consider all feedback from constituents and make changes to their original proposals, companies are beginning to prepare for change now.

Here's where things stand now for lessees:

- ▶ The IASB and FASB are responding to feedback that their original proposals on lease accounting were overly complex and costly to implement
- ▶ As a result, the Boards have proposed several simplifications
- ▶ The fundamental requirement of the original proposals – to recognise all leases on the balance sheet – would not change for leases with a maximum possible term greater than 12 months
- ▶ The revised proposals would still require significant judgements and estimates, and periodic revision of those estimates
- ▶ While some aspects of the original proposals have been simplified, others have been made more complex
- ▶ The changes to lease accounting would be substantial and may significantly affect a company's financial statements, business operations, processes, and controls
- ▶ The Boards will re-expose the revised proposals

What is changing from the Exposure Draft?

Many respondents to the August 2010 Exposure Draft (ED) commented that the proposed approach was overly complex, costly, and in some cases, inconsistent with the economics of the underlying transactions.

In response, the Boards made a number of significant changes to their original proposals for lessee accounting:

- ▶ Lease terms would typically be shortened – optional periods are included only if there is a significant economic incentive to extend
- ▶ Contingent rents based on performance and usage are excluded from lease payments. Purchase option payments are included only when there is a significant economic incentive to exercise (i.e., when determined to be a bargain)
- ▶ More non-lease costs would be separated from the lease, reducing amounts recognised on the balance sheet
- ▶ Lessees would have the option to apply current operating lease accounting to all short-term leases
- ▶ Arrangements with bargain purchase options or ownership transfer would be considered leases, not purchases

Definition of a lease

The ED defined a lease as a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration. Although this is very similar to the definition of a lease in today's accounting standards, the fact that leases would be recognised on the balance sheet sparked increased scrutiny of what is considered a "specified asset" and how to determine whether the "right to use a specified asset is conveyed". As a result, the Boards sought to clarify these two key concepts underlying the definition of a lease.

Consistent with current accounting, the Boards agreed that a "specified asset" is a unique, identifiable asset, which may include a physically distinct portion of a larger asset (e.g., a floor in a multi-story building). A non-physically distinguishable portion of an asset (e.g., 50% of the capacity of a pipeline) would not qualify as a specified asset.

In a change from current accounting, the Boards also agreed that the "right to use a specified asset is conveyed" if the customer has the ability to both direct the use of the asset and receive the benefit from its use. Certain contracts under which customers receive the benefits of an asset, but cannot direct its use, would no longer be considered leases. For example, an agreement under which a customer purchases all of the electricity produced by a specific generator, but does not make any decisions on how, when, and in what manner the generator is used, would not be a lease. These determinations can be highly subjective, leading to increased complexity.

What is in scope?

The ED would have required lessees to separate non-lease components, including services, from the lease only if specific criteria were met. If the criteria were not met, the entire contract would be recognised on the balance sheet. Many respondents to the ED believed that the criteria were too stringent, and that many non-lease components (including services and executory costs such as insurance, maintenance and taxes) would end up on the balance sheet. In response, the Boards relaxed the criteria, which would result in the separation of more non-lease components from the lease when purchase prices of the various components are observable.

Under the ED, contracts that are purchases or sales (i.e., leases with a bargain purchase option or transfer of ownership) were not considered leases, and were outside the scope of the original proposals. The Boards have now decided not to make that distinction. As a result, the proposed lease standard would be similar to current accounting, and leases with a bargain purchase option or transfer of ownership would be in scope.

Lease term

The Boards agreed to revise their proposed definition of the lease term and align it more closely with current practice. As revised, the lease term would include only optional periods for which there is a significant economic incentive for the lessee to extend (or not terminate) the lease. In making their initial assessment, lessees would consider both market factors (such as market rentals and the fair value of the asset) and other factors (such as the existence and useful life of significant leasehold improvements). For many leases, this revised definition would result in shorter lease terms for accounting

purposes than under the Boards' original proposals (which defined the lease term as the longest possible lease term that is more likely than not to occur).

Reassessment of the lease term would be required only when there is a significant change relevant to determining if the lessee has a significant economic incentive to extend (or not terminate) the lease. This judgemental reassessment is not part of today's lease accounting. Adding further complexity, when the lease term is reassessed, market factors would not be considered in determining whether a significant economic incentive exists. When a reassessment is required, the lessee would determine the revised inputs and remeasure the lease-related liability as of the reassessment date.

Lease payments

The Boards initially proposed that contingent rents based on performance and usage would be included in lease payments using a probability-weighted expected outcome approach. But many respondents commented that the proposed approach was overly complex. As a result, the Boards agreed to revise the approach for contingent rent payments to ease the burden on preparers.

Contingent rents based on performance or usage would be excluded from lease payments and recognised when they are incurred. For example, a contingent rent based on annual sales would not be included as part of the lease-related asset and liability. Instead, these payments would be recognised as the sales occur (i.e., recognise expenses as incurred). Contingent rents based on an index or rate, such as CPI¹ or LIBOR,² would continue to be included in lease payments and would be measured at the rate that exists as of the measurement date (commencement of the lease or the end of each reporting period).

¹ Consumer Price Index (CPI)

² London Interbank Offered Rate (LIBOR)

The current proposals would still require significant estimates and management judgement

These proposed changes to contingent lease payments would result in lower lease-related assets and liabilities than the original proposals, and the measurement concepts used for performance and usage-based contingent rents would be more consistent with current accounting.

The Boards also agreed that the amounts expected to be payable under residual value guarantees would be included in lease payments. If events or circumstances indicate that there has been a significant change in the amounts expected to be payable, a lessee would need to reassess the amount of the residual value guarantee included in lease payments. Termination penalties would be included if they are due based on the assessment of the lease term.

The accounting for purchase options included in lease arrangements would be consistent with the treatment for renewal options. That is, if the lessee has a significant economic incentive to exercise the purchase option, the exercise price would be included in the lease payments and the lease-related asset would be amortised over the economic life of the underlying asset, consistent with current accounting for a lease with a bargain purchase option.

Expense recognition pattern for lessees

Some respondents criticised the ED stating that the proposed accelerated recognition of expense did not reflect the underlying economics of many lease contracts. In response to this criticism, in April 2011, the Boards tentatively agreed to introduce a distinction between two types of leases – “finance” leases and “other-than-finance” leases. This distinction would have been used to determine the pattern of expense recognition of a lease – permitting straight-line expense recognition for other-than-finance leases.

However, the Boards ultimately were unable to develop an approach to achieve straight-line expense recognition that was consistent with other aspects of their proposed model.

As a result, the Boards reversed their April 2011 tentative decision and decided that only one type of lease should exist for lessees. A lessee would recognise interest expense using the interest method and would separately amortise the right-of-use asset (generally on a straight-line basis). This accelerated expense recognition pattern is consistent with the treatment of finance leases under current lease accounting and the ED.

Short-term leases

The Boards decided to allow lessees to apply current operating lease accounting to leases with a maximum possible term of 12 months or less. Evergreen agreements or daily leases with no set termination date would not meet the short-term lease criterion. The ED originally provided this exception only for lessors; lessees would have been required to recognise lease-related assets and liabilities for short-term leases on the balance sheet.

What about lessors?

In the ED, the Boards proposed two approaches for lessors – the performance obligation approach and the derecognition approach, each to be used in different circumstances depending on the terms and conditions of the lease and their effect on the lessor. The Boards have tentatively agreed that lessors should apply a single approach, the “receivable and residual” approach, to all leases.

Under this approach, lease receivables would be recognised for all leases (except short-term leases).

A portion of the carrying amount of the underlying leased asset would be re-characterised as a residual asset, and the remainder would be derecognised. The timing and pattern of lessor profit recognition would depend on whether the profit in the lease is “reasonably assured”. This new approach to lessor accounting is significantly different from current accounting and the ED.

The Boards still need to discuss other lessor-specific issues, including the interaction with the financial instruments project, changes in lease agreements, residual value guarantees, impairment, financial statement presentation, disclosure and transition. A more detailed discussion of lessor accounting will be addressed in a future edition of *IFRS Practical Matters* once the Boards progress further on their redeliberations.

What about timing?

The Boards originally planned to issue the final standard during the second quarter of 2011; however, the timing is now delayed. The Boards now expect to issue a second exposure draft early in the fourth quarter of 2011, giving constituents an opportunity to provide further feedback on the revised proposals. A final standard is likely to come in 2012.

Neither of the Boards has decided on effective dates, but given the significance of the proposed changes, both have indicated that they would provide ample time for companies to apply the new requirements.



What do the revised proposals mean for your company now?

As described previously, the Boards' recent decisions have reduced the burden of some provisions of the ED. However, in other areas, the Boards' decisions have introduced greater complexity. Despite the overall changes, a significant amount of effort would still be required to adopt the revised proposals, as discussed below.

Management judgement

Even though some aspects of the ED have been simplified, the revised proposals would still require significant estimates and management judgement, many of which would directly impact the size of the lease-related asset and liability that would appear on the balance sheet and the degree of expense acceleration.

In addition, the revised proposals will require management to disclose the basis for its judgements and estimates. Here are some of the key questions management would need to answer:

Which arrangements are leases?

Companies would still need to identify and evaluate all arrangements to determine whether they contain a lease under the clarified definition. Does the asset qualify as a "specified asset" and has the right to use the specified asset been conveyed?

In many lease arrangements, both parties have some rights over the underlying asset or they have been contractually agreed to in advance. The determination of which party has the right to control the use of the underlying asset could be very subjective. Certain arrangements that are currently accounted for as leases may no longer be considered leases.

Furthermore, 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 revised proposals, which would require on-balance sheet accounting for nearly all leases.

Does the lease contain any non-lease components?

For all leases identified, companies would need to distinguish any non-lease components that need to be excluded from the lease. Up until now, many entities may not have focused on separating non-lease components from their operating leases because today's accounting treatment for such payments is often the same as the treatment for lease payments. Entities would need to develop processes to identify observable purchase prices for lease and non-lease components. This may involve the use of significant judgement.

What should be included in the lease term and payments?

Although the revised approaches to determining the lease term and lease payments more closely align with current accounting, assessing whether an economic incentive is significant would require judgement. These judgements may take on increased significance for certain leases (e.g., leases that are clearly operating leases today) because they would directly affect the amount of lease-related assets and liabilities recognised on the balance sheet.

In addition, companies would need to reassess the lease term and lease payments on an ongoing basis - which is not required under today's accounting. Because the revised proposals would not allow market factors to be considered, reassessing the lease term could be particularly subjective.

Companies would also need to determine the rate the lessor charges the lessee or the incremental borrowing rate related to a lease. Lessees may not focus on these rates today for leases that are not anywhere close to meeting the finance lease classification.

What information would be needed upon transition?

While the Boards have not yet re-deliberated the transition provisions, the ED proposed that existing lease arrangements would not be grandfathered. If transition is left unchanged from the ED, this means that all existing leases as of the date of initial application, not just those entered into prospectively, would need to be assessed under the new standard. The date of initial application would be the beginning of the first comparative period presented in the first financial statements in which the new standard would be applied. For example, if a company is required to apply the new standard for its 31 December 2015 year-end and two years of comparative financial statements are presented, leases outstanding as of 1 January 2014 would fall within the scope of the new standard.

Under the "simplified retrospective" approach proposed in the ED, a company would not go back and retrospectively apply the proposals as of the original inception date of its leases. Instead, it would begin accounting for leases outstanding as of the beginning of the first comparative period presented, based on the remaining lease term and lease payments as of that date.

Companies would also need to consider any leases initially entered into subsequent to the beginning of the first comparative period presented. Because of the effort involved, some companies will likely need to begin now to gather the information necessary to comply with the revised lease proposals. This exercise could involve substantial effort, particularly for companies with large portfolios of leases at decentralised locations.



Financial metrics

For most companies, the changes to the ED would still result in gross-up of the balance sheet and a deterioration of the debt-to-equity ratio and return on assets compared with current accounting. The timing of expense recognition would accelerate and expense would be re-characterised as interest and amortisation expense instead of rent for today's operating leases. This would improve financial metrics such as EBITDA.

To prepare, companies should assess the potential impact on their financial metrics and evaluate how this may affect the way stakeholders view the company's financial performance. To the extent that such information is available from public sources, companies also would want to understand how their peers' financial metrics would be impacted. Addressing these questions early will allow companies to manage the implementation of the proposed standard in a manner that has the least negative impact.

Lease structuring including strategic and market strategy

To minimise the impact on their financial metrics, lessees may desire shorter lease terms. However, if shorter lease terms are more desirable for lessees, lessors may increase lease payments or reduce lease incentives to recover their investment. Moreover, because the new lease accounting model would change so significantly from current requirements, some lessees may reassess their entire lease-versus-buy strategy.

Companies would be well advised to consider these possibilities as they prepare for change.

Infrastructure, process and controls

The judgement and estimates required under the revised proposals would demand in-depth knowledge of the business and an understanding of the intended use of the leased asset. Therefore, substantial involvement from people outside of the accounting department also would be required.

Companies would need to establish accounting policies, processes and internal controls to begin gathering the required information from a variety of sources. This information would be required both to initially record leases and for ongoing reassessments, as well as for extensive new disclosure requirements.

IT and systems

The revised lessee model would still add significant amounts of assets and liabilities to the balance sheet and require periodic re-assessments. The basic computer programs and spreadsheets many companies use today to help account for leases would most likely no longer be sufficient.

Upon initial application, companies would be required to restate prior comparative reporting periods. In addition, companies may need to keep separate sets of lease data for book and tax purposes.

Planning ahead will allow a company to simultaneously capture numerous sets of information for a single lease and avoid having to recalculate needed amounts later.

Identifying, developing and implementing changes to information technology systems is not an easy exercise, and the amount of time necessary will depend on legacy systems in place.

Companies that are presently designing or upgrading IT financial reporting systems would be well advised to consider the revised lease proposals' future data requirements as part of their current IT development efforts. Timely assessment of the proposals' impact on IT systems could reduce the risk of costly re-work and re-design later. However, companies should be mindful that although IT programs can help accumulate data and perform calculations required by the revised proposals, they are not a magic solution - no program can make the critical estimates or judgements required under the revised proposals.

Tax issues

Despite the simplifications proposed by the Boards, adoption of the revised proposals would still result in additional tax-related considerations. These include initial adjustments to deferred taxes for leases recognised on the balance sheet, tracking of book/tax differences related to amortisation expense, rent deductions and interest deductions. Companies would need to determine necessary changes to tax-related processes and controls for identifying and tracking tax adjustments.

Early planning is the key to successful implementation



What can you do now?

Preparing to adopt a new accounting standard of this magnitude presents a daunting challenge. Although some provisions are still in flux, the basic principles and necessary data for lessees are unlikely to change. 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 companies should begin to consider now:

- ▶ Understand the magnitude of the changes to your company from both a financial statement and a business perspective
- ▶ Establish a project management to plan for adoption of the proposed standard
- ▶ Determine training requirements for individuals responsible for lease accounting and related judgements
- ▶ Determine the population of arrangements that would be in scope
- ▶ Identify lease data to be accumulated based on the requirements of the revised proposals
- ▶ Establish a process for gathering and analysing lease data
- ▶ Consider requirements for maintaining multiple sets of lease data for comparative periods between current lease accounting and the revised proposals, as well as book/tax differences upon adoption
- ▶ Understand IT financial reporting system options – whether current vendors will provide upgrades to existing lease accounting software, or whether new IT systems would be required
- ▶ Continue to monitor the Boards' deliberations

The revised lease proposals have been simplified, but they are not simple. Early planning is the key to successful implementation.

For a more complete technical discussion about the ED and the latest proposed changes, refer to the following publications available through Ernst & Young's webpage www.ey.com/IFRS:

- ▶ *IFRS Developments: Boards to re-expose leases, and propose a new approach for lessors* (July 2011)
- ▶ *Applying IFRS: Lessee model comes together as leases project progresses* (July 2011)
- ▶ *Proposed accounting for leases* (November 2010)
- ▶ *Practical Matters for the C-suite: What do the proposed lease accounting changes mean for you?* (August 2010)
- ▶ *Supplement to IFRS Outlook Issue 79: Proposed accounting changes for leases* (August 2010)

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

Issues and steps	How Ernst & Young may be able to help
Gain a general understanding of the revised proposals	<ul style="list-style-type: none"> ▶ Design and help deliver a training session for company personnel ▶ Share insights of IASB, FASB, SEC views ▶ Provide input into the company's comment letter on the revised ED
Perform a preliminary assessment of the impact of the revised proposals on the company's financial statements	<p>Advise and provide input into:</p> <ul style="list-style-type: none"> ▶ Identifying all arrangements that are in the scope of the revised lease proposals, including contracts that would be considered leases but were previously recognised as service contracts ▶ Gathering necessary lease information to adopt the proposed standard ▶ Summarising lease terms ▶ Developing a process for managing the significant judgements and estimates that would be necessary with respect to estimating lease term and lease payments, including reassessments ▶ Performing a high-level measurement of the right-of-use asset and related liability to make lease payments ▶ Calculating the high-level income statement impact of adopting the proposed standard ▶ Assessing the impact on key financial ratios and performance measures ▶ Identifying shortfalls in available information to adopt the proposed standard
Assess impact of the revised proposals on strategic business decisions	<p>Advise and provide input into:</p> <ul style="list-style-type: none"> ▶ The impact on strategic business decisions and planned transactions (e.g., mergers, acquisitions, and new markets) ▶ The impact on existing loan covenants and borrowing arrangements including the impact to arrangements currently being negotiated ▶ The company's analysis of whether to continue to lease versus buy
Benchmark the company against peers and others in the industry	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching the revised proposals, problems they encountered and solutions developed ▶ Assist in the evaluation of peers, competitors and industry disclosures and expected impact on the financial statements
Assess processes for data collection, internal controls, IT systems	<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 ▶ 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 revised proposals	<ul style="list-style-type: none"> ▶ Advise on analysing tax positions arising from adopting the revised proposals, reducing tax exposure, and determining tax effects of lease modifications
Plan for ultimate adoption of the proposed standard	<ul style="list-style-type: none"> ▶ Advise regarding project maintenance and planning, including timeline, tasks, and resource allocation
Update accounting manuals and accounting policies	<ul style="list-style-type: none"> ▶ Review and provide input into accounting manuals and policies selected by management
Communicate effect of adoption to stakeholders– analysts, regulators, shareholders	<ul style="list-style-type: none"> ▶ Advise on developing a communication plan ▶ Advise on drafting communications

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